

**EXCESSIVE SPECULATION AND COMPLIANCE WITH
THE DODD-FRANK ACT**

HEARING

BEFORE THE

PERMANENT SUBCOMMITTEE ON INVESTIGATIONS
OF THE

COMMITTEE ON
HOMELAND SECURITY AND
GOVERNMENTAL AFFAIRS
UNITED STATES SENATE
ONE HUNDRED TWELFTH CONGRESS

FIRST SESSION

NOVEMBER 3, 2011

Available via the World Wide Web: <http://www.fdsys.gov>

Printed for the use of the
Committee on Homeland Security and Governmental Affairs



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THURSDAY, NOVEMBER 3, 2011

U.S. SENATE,
PERMANENT SUBCOMMITTEE ON INVESTIGATIONS,
OF THE COMMITTEE ON HOMELAND SECURITY AND
GOVERNMENTAL AFFAIRS,
Washington, DC.

The Subcommittee met, pursuant to notice, at 9:07 a.m., in room SD-342, Dirksen Senate Office Building, Hon. Carl Levin, Chairman of the Subcommittee, presiding.

Present: Senators Levin and Coburn.

Staff Present: Elise J. Bean, Staff Director and Chief Counsel; Mary D. Robertson, Chief Clerk; David H. Katz, Counsel; Michael Wolf, Law Clerk; Lauren Roberts, Law Clerk; Christopher Barkley, Staff Director to the Minority; Anthony G. Cotto, Counsel to the Minority; William Wright, Kristin Boutchyard, Brian Murphy, Steven Hutchinson, and William Wright (Senator Brown).

OPENING STATEMENT OF SENATOR LEVIN

Senator LEVIN. Good morning, everybody. Over the past 9 years, this Subcommittee has held a series of hearings on the problem of excessive speculation in the commodity markets. For years now, commodity markets have taken the American people on an expensive and damaging roller coaster ride with rapidly changing prices for crude oil, gasoline, natural gas, heating oil, airline fuel, wheat, copper, and many other commodities. Commodity prices have whipsawed American families, farms, and businesses, run roughshod over supply and demand factors, and made our economic recovery that much harder and more chaotic.

Unstable commodity prices are a key reason why Congress enacted, as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act, new statutory requirements to put a lid on excessive speculation and price manipulation. Congress enacted the new law not only to protect consumers and businesses from unreasonable prices—prices disconnected from the usual supply and demand discipline of the marketplace—but also to protect the commodity markets themselves from losing investor confidence and looking more like a casino or rigged game than a marketplace where supply and demand determine prices.

Commodities markets are not stock markets. Stock markets are intended to attract investors to provide new capital for U.S. businesses to invest and to grow.

(1)

Commodity markets are supposed to serve a different function. Their purpose is not to attract investors, but to enable producers and users of physical commodities to arrive at market-driven prices for those goods and to hedge their price risks over time. Prices are intended to reflect supply and demand for the actual commodities being traded. Speculators, who by definition do not plan to use the commodities that they trade but profit from the changing prices, are needed only insofar as they supply the liquidity needed for producers and users to hedge their risks.

Another big difference between stock and commodity markets involves trading limits. Stock markets do not have them, but U.S. commodity markets have been using trading limits to varying degrees for over 70 years to combat excessive speculation and price manipulation.

Federal law has long authorized the Commodity Futures Trading Commission (CFTC), and U.S. commodity exchanges to impose so-called position limits to prevent individual traders from holding more than a specified number of futures contracts at a specified time, such as during the close of the so-called spot month when a futures contract expires, and buyers and sellers have to settle up financially or through the physical delivery of commodities. Position limits help ensure commodity traders cannot exercise undue market power, such as by cornering the market.

The primary problem afflicting U.S. commodity markets today is an explosion of speculators who, instead of facilitating, have now come to dominate commodity trading, overriding normal supply and demand factors, distorting prices, and increasing price volatility.

That explosion began in large part less than 10 years ago, with the rise of commodity index funds that enable participants to bet on the rise or fall in commodity prices. Commodity index funds are operated by swap dealers that enter into swap contracts with clients seeking to make speculative bets on commodity prices. Those clients typically bet that prices will go up and take the long side of the swap. The swap dealers usually take the short side of the swap and, to offset the financial risk, typically purchase long futures contracts. Within a few years, as the funds grew, commodity index swap dealers became regular purchasers of massive numbers of futures contracts for crude oil, natural gas, wheat, and other commodities. According to CFTC data, as shown in this chart which we are putting up, Chart 1a in our book,¹ commodity index investors and swap dealers have spent about \$300 billion in 2011 alone, mostly on long futures and swap contracts.

Sometimes referred to as "massive passives," commodity index funds have created a massive, ongoing demand for futures contracts unconnected to normal supply and demand for the underlying commodities. Their steady purchases have created an artificial demand for futures contracts. In addition, the more index funds and their swap dealers push to buy long future contracts and outnumber the speculators seeking to buy shorts, the more their buying pressure, by the very nature of supply and demand, will drive up the price of the long contracts. The resulting higher fu-

¹ See Exhibit No. 1a which appears in the Appendix on page 110.

tures prices then translate all too often into higher prices for the underlying commodities, in part because so many of commodity contracts for the underlying commodities use futures prices as the commodity's selling prices. In those cases, higher futures prices translate directly into higher costs for consumers of the commodities. That is why so many American consumers and businesses continue to condemn the speculative money that commodity index funds bring to the commodity markets.

Commodity-related exchange traded products (ETPs), have added further fuel to the speculative fire. Exhibit 6 lists some of the many ETPs which offer securities that track the value of a designated commodity or basket of commodities, but trade like stocks on an exchange.¹ ETPs are marketed to investors looking to make money off commodity price changes without actually buying any futures. The financial firms running the ETPs often support the value of the fund by purchasing commodity futures or using futures to offset risks. The result, as shown in this chart, which is Exhibit 1b,² is that in 2011 alone, these ETPs have poured over \$120 billion of speculative money into U.S. commodity markets.

Now, that is not all. A third wave of commodity speculation has come from the \$11 trillion mutual fund industry which, since 2006, has turned its attention to U.S. commodities in a big way. Hearing Exhibit 7a³ identifies more than 40 commodity-related mutual funds that, by 2011, as shown in this chart, which is Exhibit 1c,⁴ have accumulated assets of over \$50 billion. That chart shows the growth of the mutual fund purchases of these commodity futures. The sales materials from some of those mutual funds, which are included in Exhibit 7b,⁵ show that they are marketing themselves to average investors as commodity funds and delving into every kind of commodity investment out there, from swaps to futures, putting additional speculative pressures on commodity prices.

Now, by law, mutual funds are supposed to derive 90 percent of their income from investments in securities and not more than 10 percent from alternatives like commodities. But the 40 commodity-related mutual funds that we have identified have found ways around that law by, among other steps, setting up offshore shell companies that do nothing but trade commodities.

Those offshore shell companies are typically organized as Cayman Island subsidiaries with no offices or employees of their own and with their commodity portfolios run from the mutual fund's U.S. offices. This blatant end-run around the 90/10 restriction has nevertheless been blessed by the IRS which has issued dozens of private letter rulings, which are listed in Exhibit 7d,⁶ which deem the offshore arrangements to be investments in securities rather than commodities, since the parent mutual funds hold all of the stock in those offshore subsidiaries. The IRS has recently put a moratorium on these private letter rulings while it studies the issues. In addition, the offshore shell corporations are currently exempt from CFTC registration requirements, despite operating as

¹ See Exhibit No. 6 which appears in the Appendix on page 176.

² See Exhibit No. 1b which appears in the Appendix on page 111.

³ See Exhibit No. 7a which appears in the Appendix on page 185.

⁴ See Exhibit No. 1c which appears in the Appendix on page 112.

⁵ See Exhibit No. 7b which appears in the Appendix on page 186.

⁶ See Exhibit No. 7d which appears in the Appendix on page 235.

commodity pools, a situation the CFTC is reviewing as a result of a petition filed by the National Futures Association, as indicated in Exhibit 7c.¹

Now, I am glad the IRS and the CFTC are studying these off-shore arrangements as well as the broader issue of mutual fund investment in commodities. If the mutual fund industry were to step up its commodities investments to even just 10 percent of its overall assets, it would unleash another tidal wave of speculative money into the commodities markets.

There is more. Over the last few years, high-frequency traders have also invaded the commodities markets, seeking to profit from the increasing price volatility. Those high-frequency traders have revved up commodity trading with day-trading strategies that further contribute to constantly changing prices.

Put together the swap dealers, hedge funds, ETPs, mutual funds, and high-frequency traders, and the result is a tsunami of speculative money pouring into commodity markets at unprecedented levels. Today, speculators make up the bulk of the outstanding contracts in most commodity markets, providing typically more than 70 percent of the market. Producers and users of commodities now hold as little as 20 or 30 percent of the outstanding contracts in some markets. So it is no surprise that commodity prices have become increasingly volatile, with exaggerated swings that have little to do with hedging, little to do with supply and demand for the underlying commodities, and everything to do with folks betting and speculating on price changes.

Take the U.S. crude oil market as an example. In 2007, a barrel of crude oil started out the year costing \$50, but by the end of the year had nearly doubled in price. In 2008, oil prices shot up in July to over \$145 per barrel and then, by the end of the year, crashed to \$35 a barrel. In the beginning of 2011, oil prices took off again, climbing to over \$110 per barrel in May. Then they fell to a low of \$77 per barrel in early October, a drop of more than 30 percent in 4 months. Three weeks later, they are back up to \$92 per barrel, a 15-percent increase. This price volatility has taken place at the same time that world inventories were plentiful and basically matched world demand, as shown in this chart prepared for the Subcommittee by the Energy Information Agency, which is Exhibit 1d.² In other words, the price changes in West Texas Intermediate, the benchmark crude oil contract for the United States, cannot be explained simply as a function of supply and demand for oil.

During the same period crude oil prices went haywire, speculators have become the dominant players in the crude oil market. CFTC data indicates that speculators—traders who do not produce oil or use oil in their business—now hold over 80 percent of the outstanding contracts in the oil futures market. While speculation is not necessarily the primary factor setting oil prices, the facts indicate that speculation is a major contributor.

It is not just the numbers telling this story. Major players in the oil industry also point to the role of speculation in crude oil prices. For example, in May 2011, ExxonMobil CEO Rex Tillerson agreed

¹ See Exhibit No. 7c which appears in the Appendix on page 223.

² See Exhibit No. 1d which appears in the Appendix on page 113.

that speculation was contributing to oil prices, estimating that the price of a barrel would be \$60 to \$70, instead of \$110, if governed exclusively by supply and demand.

The same complaint is heard with respect to other commodities. Recently, 450 economists from around the world stated in a joint letter to the G-20 leaders, which we include in the hearing record as Exhibit 9:² “Excessive financial speculation is contributing to increasing volatility and record high food prices exacerbating global hunger and poverty.” And the CEO of Starbucks, Howard Schultz, who tracks coffee prices, had the following to say:

“[W]hy are coffee prices going up? [A]nd in addition to that, why is every commodity price going up at the same time? I think what’s going on is financial engineering; that financial speculators have come into the commodity markets and drove these prices up to historic levels and as a result of that the consumer is suffering.”

Excessive speculation is not new. In fact, much of the law related to commodity markets can be understood as an effort to prevent excessive speculation and market manipulation from distorting prices.

Over the years, one of the most powerful weapons developed to combat the twin threats of excessive speculation and price manipulation has been the imposition of position limits on traders. But over the years, Federal position limits have lost much of their punch due to a growing raft of loopholes, gaps, and exemptions. For example, prior to the Dodd-Frank Act, position limits didn’t apply to some key futures contracts; they often applied only in the spot month instead of other times; and multiple market participants were given exemptions. In addition, until recently, the entire commodity swaps market had no position limits at all.

The combination of increased speculation and weakened position limits has clobbered American consumers and businesses with unpredictable and inflated commodity prices. That is why, when Congress enacted the Dodd-Frank Act last year, Section 737 directed the CFTC to establish position limits on all types of commodity-related instruments, including futures, options, and swaps. The Dodd-Frank Act also directed the CFTC to issue a rule establishing the new position limits by January 2011, one of the earliest implementation dates in the entire law.

The CFTC missed that deadline but 2 weeks ago, after reviewing over 15,000 public comments, at long last issued a final rule. The good news is that the agency complied with the law’s requirements to establish position limits to “diminish, eliminate, or prevent” excessive speculation, and rejected unfounded claims that excessive speculation had to be proven for each commodity before a limit could be established to prevent damage to consumers and the economy. That has never been the law, and it has no basis in the Dodd-Frank Act which is aimed at preventing problems, not waiting for them to occur and cleaning up afterwards.

Also good news is that the CFTC rule applies position limits to 28 key agricultural, metal, and energy commodities; applies those limits to futures, options, and swaps; and covers all types of speculators.

¹ See Exhibit No. 9 which appears in the Appendix on page 244.

The bad news, from my perspective, is that while the limits appear designed to prevent any one trader from amassing a huge position that could lead to price manipulation in a particular month, the limits do not appear to be designed to combat the type of excessive speculation caused by large numbers of speculative investment funds. In addition, exempting multi-commodity index swaps from any position limits, failing to apply effective position limits to commodity index swap dealers, and delaying implementation of the swap position limits for another year are troubling.

Roller coaster commodity prices and the growing flood of speculative dollars continue, while it will be another year before the full range of position limits in the new CFTC rule take effect. In the meantime, we are talking about ongoing gyrations in gasoline prices, heating and electricity costs, and food prices that affect every American family. We are talking about unstable prices for copper, aluminum, and other materials essential to industry. At stake are energy, metal, and food costs key to inflation, business costs, and family budgets nationwide.

Until effective position limits are actually in place, the American economy will remain vulnerable to chaotic price swings that benefit speculators at the expense of American consumers and businesses.

Today's hearing is intended to shine a spotlight on the ongoing role of speculation in U.S. commodity markets and how the new position limits can combat excessive speculation. We will hear today from a panel of experts representing business, consumers, and academia, as well as from CFTC Chairman Gary Gensler.

Now let me invite our Ranking Member, Dr. Coburn, to share his views with us.

OPENING STATEMENT OF SENATOR COBURN

Senator COBURN. Thank you, Mr. Chairman.

I want to thank Senator Levin for holding this hearing today. He has been a leader for years in Congress on efforts to better understand and monitor commodity markets, which should make us more capable of holding market regulators accountable in their efforts to ensure American exchanges remain the most dynamic, transparent, and desirable places to do business.

Commodity markets and pricing have profound effects on the people in my home State of Oklahoma, who are invested in virtually all of the commodities covered by the rules we will discuss today. Whether it is oil, natural gas, wheat, or any of the other 28 commodities, market participants all the way from the producer to the end user will be affected by recent and upcoming regulatory changes.

It is our obligation in Congress to make sure regulators act in the public interest, based on facts and data, rather than reflexively placing restrictions on unpopular market participants. While today's hearing will focus on the concept of "excessive" speculation, it is imperative that we remember one fundamental truth: That futures markets cannot function without speculators who make markets, provide liquidity for hedgers, aid in price discovery, and take risks.

Two weeks ago, the CFTC issued its long-awaited position limits, imposing limits on the number of futures contracts individuals or

institutions can hold. The most recent version of the rule was rushed through the Commission and applied across the board to 28 separate commodities. Much of this seems to have been done in response to intense pressure, and the unfortunate result is likely to be challenged in court.

In addressing commodities, the Dodd-Frank Act said the CFTC “shall by rule, regulation, or order establish limits on the amount of positions, as appropriate.” In at least two Commissioners’ views, those tests have not been met. Yet now every participant in the commodities market must comply with a final rule that is over 300 pages long.

Commissioner Scott O’Malia indicated in his dissenting opinion that the Commission voted “without the benefit of performing an objective factual analysis based on the necessary data to determine whether these particular limits and limit formulas will effectively prevent or deter excessive speculation.” There is no question we want to limit excessive speculation, but it needs to be based on data and facts, not feelings.

Commissioner Jill Sommers also worried that the CFTC “is setting itself up for an enormous failure” by issuing a position limits rule that “ironically, can result in increased costs to consumers.”

Position limits can be a very effective regulatory tool, but must be used in the right way. For example, we have limits on cotton—they are in place—yet the cotton No. 2 futures contract has hit 16 record-setting prices since December 1, 2010. Why is that? Because of crop failures around the rest of the world, and because of a drought in the United States.

Position limits must be set at the proper level for each individual commodity. Unfortunately, the CFTC chose to use the blunt weapon of across-the-board limits for nearly every commodity.

While today’s hearing will be a good opportunity to discuss the effects of that excessive speculation—and in that I agree with my Chairman—we need to be careful not to accuse investors of wrongdoing where none has occurred. Commodity index funds, exchange traded funds, and mutual funds are not diabolical schemes. They are simply financial instruments that some investors use as tools to hedge or gain exposure to commodity markets, thus protecting against inflation and other risks in their portfolios.

Last, I would like to address my strong concerns with the Dodd-Frank Act in general, which itself was rushed through Congress last year. The law that was supposed to help fix our financial system has instead wreaked regulatory havoc, increasing uncertainty and compliance costs, doing nothing to address unemployment, and it did nothing to effect the initiation of the problems that we are presently faced with, basically Fannie Mae and Freddie Mac. The act required over 300 new regulations and studies and has overwhelmed our regulatory agencies while causing widespread confusion in the marketplace.

As we move forward, we in Congress must improve our understanding of the markets being regulated, as well as the internal and external challenges facing our regulators. Continuous oversight and transparency through hearings like this are essential to ensure our regulators do not overreach their mandates and that U.S. markets remain the envy of the world.

One of my greatest concerns is every trader in the world is one click away from trading somewhere else, and there are tremendous markets in this country that are going to be put at risk through this new rule.

The last thing we want to do is suffocate those markets and chase interested participants to other exchanges and trading venues abroad, many of whom would like nothing more than to take away America's business.

Despite my concerns about the Dodd-Frank Act, it must be implemented in a thoughtful, responsible manner by our regulators. I look forward to a healthy discussion during this hearing, Mr. Chairman. I thank our witnesses for attending, and I look forward to hearing your views and recommendations today. Thank you.

Senator LEVIN. Thank you very much, Dr. Coburn.

We are now going to call our first panel of witnesses for this morning's hearing: Paul Cicio is President of the Industrial Energy Consumers of America. Tyson Slocum is Public Citizen's Emergency Program Director. Wallace Turbeville is a Derivatives Specialist with the nonprofit Better Markets, Incorporated.

Now, the Subcommittee invited and we had hoped to have with us Dr. Craig Pirrong, who is professor of finance at the Bauer College of Business at the University of Houston. He was able to make our originally scheduled hearing, but was unable to make this hearing, which we regret that he could not be with us today to give us his views. But what we will do is invite him to provide his views in a written statement.

We do appreciate each of the witnesses who were able to join us this morning. We look forward to your testimony. Pursuant to Rule VI, all witnesses who testify before the Subcommittee are required to be sworn. At this time I would ask our first panel to please stand and raise your right hand. Do you swear that the testimony you will give before this Subcommittee is the truth, the whole truth, and nothing but the truth, so help you, God?

Mr. CICIO. I do.

Mr. SLOCUM. I do.

Mr. TURBEVILLE. I do.

Senator LEVIN. Now, we are going to use the timing system today. About 1 minute before the red light comes on, you will see the lights change from green to yellow, which will give you an opportunity to conclude your remarks. Your written testimony will be printed in the record in its entirety. We would ask that you limit your oral testimony to no more than 7 minutes.

Mr. Cicio, we are going to have you go first, followed by Mr. Slocum, followed by Mr. Turbeville. After we have heard all the testimony, we will then turn to questions.

So, Mr. Cicio, please proceed.

TESTIMONY OF PAUL N. CICIO,¹ PRESIDENT, INDUSTRIAL ENERGY CONSUMERS OF AMERICA

Mr. CICIO. Chairman Levin, Ranking Member Coburn, and Subcommittee Members, thank you for the opportunity to testify before

¹ The prepared statement of Mr. Cicio appears in the Appendix on page 59.

you today. My name is Paul Cicio, and I am the President of the Industrial Energy Consumers of America (IECA).

IECA has been a long-time supporter of setting responsible speculative position limits. Since all of our companies use substantial quantities of natural gas, we will use natural gas illustrations to address the Subcommittee questions.

Speculative trading volumes have been explosive in growth, even though natural gas consumption in the country has only increased moderately. For example, natural gas open interest increased by 590 percent since 1995, even though U.S. consumption has increased only 6.5 percent. Almost all of the open interest is from noncommercial trades.

Large speculative volumes can be a problem because they can move market price and they do increase volatility. Charts 1 and 2 of our written testimony uses CFTC data to show that, in late 2008, four trades controlled about 50 percent of the open interest in natural gas. Eight traders controlled 60 percent of the open interest. That means that only a handful of trading companies can have an incredibly important impact on the price of natural gas.

High volatility will increase the cost of hedging to manufacturers because there is a direct relationship between volatility and, for example, the option price premium. Higher volatility also increases the bid-ask spread in the forward market.

To illustrate the point, using the closing Henry Hub Index price of natural gas, just last Friday, at \$4.04 per million Btu, a call option for 100,000 MM Btus with a 6-month expiration at the money would cost a manufacturer approximately \$36,500. If we increased the implied volatility of only 5 percent, the premium cost goes up 15 percent. If we increased the implied volatility 10 percent, the premium cost rises 31 percent. And if we increase the implied volatility 20 percent, it increases the option premium a whopping 61 percent.

IECA supports the imposition of speculative position limits, but setting the limit at 25 percent of the estimates deliverable supply is too large and will do little to reduce excessive speculation.

Let us put in perspective what setting speculative position limits at 25 percent means by looking again at natural gas. If only 100 traders trade at the spec limit, they would control 25 times the U.S. monthly demand. There are approximately 250 to 350 traders that report to the large trader report at the CFTC from time to time. If only 100 trade, they would control 25 times the entire consumption.

Regarding commodity index funds and ETFs, we believe that passive speculators should be banned from the futures market. At minimum, they should be subjected to individual speculative position limits.

The next best alternative is to set spec position limits on all commodity-related ETFs and index funds. Swap dealers and ETF managers should be subject to speculative position limits except for hedges associated with transactions with producers and consumers of the underlying commodity.

There are several reasons that passive index funds should be banned. First, passive index funds put upward pressure on price. CFTC index investment data for natural gas between December

2007 and September 2011 show that index funds held a long position 86.2 percent of the time and only held short positions 17.4 percent of the time. And index funds continue explosive growth. CFTC data indicates that index open interest contracts increased by 294 percent just since December 2007.

Second, passive index speculators also reduce liquidity by buying and then holding larger and larger quantities of futures contracts. This is inconsistent with the functioning of the futures market that serves consumable commodities that have a prompt month that expires.

And last, they also buy without regard to price, supply, or demand, which, of course, impacts price discovery. Thank you.

Senator LEVIN. Thank you, Mr. Cicio. Mr. Slocum.

TESTIMONY OF TYSON T. SLOCUM,¹ DIRECTOR, ENERGY PROGRAM, PUBLIC CITIZEN

Mr. SLOCUM. Chairman Levin and Ranking Member Coburn, thank you very much for the opportunity to allow me to testify today. I am Tyson Slocum, and I direct Public Citizen's Energy Program. We are one of America's largest consumer advocacy groups, and we are proud to be celebrating our 40th anniversary this year. We work on a range of issues, and I head up our energy work.

I am tasked at Public Citizen with promoting those policies that are going to produce affordable, reliable, and clean energy, and it is clear from my personal work on this issue over a decade that current energy markets are driven not by the supply-demand fundamentals but by speculation.

There has been a lot of great work, Mr. Chairman, by this Committee over the years, as you mentioned in your opening statement, that has helped make that case. But it is not just this Committee, it is not just industrial consumers, and it is not just household consumers, but members of industry as well. You mentioned in your opening statement that the chairman and CEO of ExxonMobil noted the role that speculation plays in the current price of a barrel of oil, and even the investment bank Goldman Sachs earlier this year revealed that they believe the speculation price is around \$27 a barrel for 2011. And Dr. Mark Cooper, a colleague at the Consumer Federation of America, estimated that around \$30-a-barrel-oil of a speculation tax equates to about \$600 in increased gasoline costs for the average family and about \$200 billion across the economy.

So when I am taking a look at these markets, it is clear that around a \$30 speculation tax, which translates to about \$600 costs to the average family over the course of a year is indeed excessive levels of speculation, and it is the duty of Congress and regulators to help protect household consumers and businesses from these excessive costs.

Does the Dodd-Frank Act and the way that it has been implemented by the CFTC effectively address that? And Public Citizen's analysis is that the proposed position limit rulemaking does not go far enough. As my colleague, Mr. Cicio, pointed out, the speculation limit of 25 percent and then 10 percent and then 2.5 percent, de-

¹The prepared statement of Mr. Slocum appears in the Appendix on page 68.

pending on the contracts, allows for too great of holdings. There was some recently leaked data by a U.S. Senator to the media that detailed the positions of individual traders, and this clearly showed that the largest five operators in the WTI market—Goldman Sachs, Vital, Morgan Stanley, Deutsche Bank, and Barclays—had positions that were between 5.3 and 8.7 percent. And that is why Public Citizen believes that speculation limit needs to be more in line with proposed legislation that has sponsorship in both the Senate and the House, S. 1598 and H.R. 3006, that would establish a statutory position limit of 5 percent that would get at the concentrations that the leaked data clearly shows.

It is not just banks that are involved in these markets and making profits. Again, a leaked document that Chevron inadvertently leaked to the public this summer showed that the company earned \$360 million over the first 6 months of this year not from doing what it is supposed to do, which is providing the American public with oil that it works hard and spends a lot of money to get out of the ground in the United States and elsewhere and refine into useful products, but in speculating, that Chevron was speculating far and above their hedging needs and using the commodity markets to make money the same way that investment banks do. And when the *Wall Street Journal* reported this, they noted that Chevron, like other major proprietary traders that also feature control or ownership over energy infrastructure assets, utilized those energy infrastructure assets to have a sneak peek at the market and give them a massive competitive advantage.

Mr. Chairman, like you said, they do not like to gamble. They want to have more certainty, and having a large control over the market in terms of their positions and having access to energy infrastructure assets provides them that advantage. We have seen Goldman Sachs through its control over Kinder Morgan now is going to have control over about 67,000 miles of petroleum product and natural gas pipelines throughout the United States. They have ownership interests now in two refineries in the United States. Morgan Stanley spends hundreds of millions of dollars a year on acquiring control over storage capacity. None of this is adequately regulated, and another issue that Public Citizen promotes is having firm rules limiting the communications between energy infrastructure affiliates and trading affiliates.

In addition, Public Citizen shares the concerns of this Subcommittee and the research that was presented to us in your opening statement that the rise of index funds is highly disruptive, and like my colleague, Mr. Cicio, I believe that index funds do not have a legitimate role in these markets. And I applaud the efforts of the Subcommittee to examine problems of mutual funds getting involved in these markets as well.

Thank you very much for your time, and I look forward to your questions.

Senator LEVIN. Thank you, Mr. Slocum. Mr. Turbeville.

**TESTIMONY OF WALLACE C. TURBEVILLE,¹ DERIVATIVES
SPECIALIST, BETTER MARKETS, INC.**

Mr. TURBEVILLE. Good morning, Chairman Levin and Ranking Member Coburn. Thank you for the opportunity to speak today. My name is Wallace Turbeville, and I am a derivatives specialist at Better Markets, Inc. Better Markets is a nonprofit, nonpartisan organization whose mission is to promote the public interest in the domestic and global capital and commodity markets.

Personally, I have worked in the securities industry for 31 years as a practicing attorney first, as an investment banker at a Wall Street firm, and managing companies as a principal.

In the 10 years since deregulation, commodities markets have changed dramatically, and the public has been plagued by boom-and-bust price cycles. Prior to that time, physical hedgers consistently represented about 70 percent of the futures markets. Now the ratio of participants has reversed. Speculators now account for about 70 percent or more of the open interest in many markets, while physical hedgers have fallen to only about 30 percent. This increased speculation is in large part driven by commodity index funds, which are predominantly sponsored by large dealer banks. These are vehicles reminiscent of residential mortgage structures designed to synthetically convert barrels of oil and bushels of corn into investment asset classes. These changes have profoundly affected prices and price discovery.

Now, the CFTC adopted position limits in response to the congressional mandate to address the issues in energy, agriculture, and metals just recently. This rule establishes some very important principles, but much remains to be done to improve limits on speculators, in particular commodity index traders.

Since 2004, highly structured commodity index investment vehicles have become dominant forces in the futures markets with dramatic impacts in the physical markets as well. Not surprisingly, we are now in a period of boom-and-bust commodity prices as a result. These investments have been marketed to large institutional investors as a new asset class for diversifying investment portfolios, and they have responded quite well for the marketers.

Index investors have injected amounts which have been estimated to be between \$200 and \$300 billion into the market, fundamentally changing the way the futures markets work.

Analysis of commodity speculation is now in the hands of academics, self-interested market participants, and the CFTC. Each seeks the answer to a single question: Are the boom-bust price cycles in basic commodities related to the explosion of speculative and highly structured trading activities? Or is it just merely a coincidence that these happened at the same time?

Now, commodity index investments were created to synthetically mimic ownership of market baskets of physical commodities and are valued using indices. It is kind of an interesting thing. I am not aware that anybody considered the possibility that if you synthetically created a huge ownership interest in barrels of oil and bushels of wheat and corn, whether that synthetic ownership inter-

¹The prepared statement of Mr. Turbeville with attachments appears in the Appendix on page 77.

est in large size would actually affect the market because the market would interpret that as hoarding activity when these vehicles were first created. But the consequences, as it has turned out, are very serious.

Unlike a business with shares that trade, the value of a barrel of oil or bushel of corn derives from its consumption, at which point that value ends. If it can never be consumed, it has no value. However, commodity index funds are, in theory, perpetual. It is a synthetic ownership interest that goes on forever.

To synthesize perpetual ownership and make it look more like a share of stock, the commodity index fund bank sponsors take large futures and physical commodity positions and roll them over continuously in massive amounts at specified times. So everyone in the whole market knows that at specified times during each month this large rollover of futures contracts occurs.

Like the Phoenix, the index hedges, all of them, and repeatedly, are destroyed and re-created with longer maturities at each roll in order to create synthetic perpetual ownership. These repeated events are so important to the market that many trades focus a bulk of their activities on the commodity index rolls.

The concern is that the rolls affect the price curves. Price curves are very important. The price curve is how the market tells the world what prices are likely to be this month and in the month to come. When it slopes upward—that is to say, November prices are higher than October—the futures market is telling producers and consumers that prices are likely to rise. When it is flat or downward sloping, the message is that the prices will be stable or fall. This is tremendously important because businesses organize themselves along these lines.

The shape of the price curve has changed. Historically, it was flat to downward sloping most of the time. Since 2004, it has been upward sloping almost all of the time. The message is that prices are rising, and it is a constant message that is repeated over and over.

Better Markets recently released a study of price curve dynamics in the roll. We isolated the predominant roll periods for each trading month over the last 27 years and compared them to determine whether there was a tendency for prices to rise—sorry, for the price curve to rise at the time of the roll. We found that starting in 2004, when index trading expanded, the correlation between the roll period and its bias was pronounced. In fact, the price bias in the crude oil futures markets was correlated at 99 percent level with the roll. For every other 5-day period in every other month over that 27 years, there was no correlation between upward or downward prices for these periods. So we concluded that the forces which were signaling increased prices were specific to the roll period and were caused by commodity index roll trading.

The market as a whole reacted to the signal, and a price bubble emerged. Eventually, supply-and-demand forces must overcome the trading-driven sentiment, and the bubble bursts.

Thank you for the opportunity to discuss these crucial questions. I am pleased to answer any questions you may have now or in the future.

Senator LEVIN. Thank you very much, Mr. Turbeville, and each one of you. We will try an 8-minute first round. I expect we will have a number of rounds for each panel.

Mr. Cicio, first, tell us again very directly how businesses are harmed when oil futures prices are subject to roller coaster prices like the ones that are pushed up to artificial levels and then plummet down and then climb back up.

Mr. CICIO. The example that we have provided in our testimony is very clear. When there is increased volatility, it increases the cost of hedging. Manufacturers are consumers. They are only going to hedge as much as they are going to consume, or they may hedge less than they will consume. The example that we have provided is an option on natural gas and it illustrates that increased implied volatility has a substantial cost increase on the premium of that option. The 5-percent increase in implied volatility increases the premium cost of that option 15 percent. Fifteen percent all by itself is a large amount for a company to lay out. Anything they lay out above that existing on-the-money option is cash that they have to put up. That is working capital that could be used for other things.

Senator LEVIN. Is that usually passed down to consumers?

Mr. CICIO. Manufacturers compete in a very globally competitive environment. If it is possible for us to pass that through to our customers, we would. But in most cases, costs of this nature cannot be passed through because of global competition.

Senator LEVIN. And the hedging that they want to do is to provide themselves with a stable economic environment so that they can know what the costs of oil or any other commodity is. Is that correct?

Mr. CICIO. Yes, that is correct. Think of it this way: One of the first things we do is buy basic raw materials like natural gas or crude oil that is used to produce our products. The time frame from producing the product to making a widget, a manufactured product, and then getting it out to the customer, is a long time. We price our product out a long time. If we price the product out and in the interim the price of the raw materials continues to escalate, then we have a price with rising costs that reduce our margins.

Senator LEVIN. Now, according to the Consumer Federation of America—and this I will address to you, Mr. Slocum—excessive speculation has added about \$30 per barrel to the cost of crude oil in 2011, and as you pointed out, that added \$600 to the average household expenditure for gasoline in 2011. The total drain on the economy in 2011 from speculation-driven excessive cost is more than \$200 billion, and the report concludes, “Transferring that much purchasing power from consumers on Main Street to speculators on Wall Street puts a severe drag on the economy” and has “already dampened economic growth.”

What do you think of those findings?

Mr. SLOCUM. I agree with it. And like I said, it is also in line with what Goldman Sachs itself said in a research note to its investors. So the estimate provided by Dr. Mark Cooper that you just cited is absolutely in line with what one of the largest speculators in the country, Goldman Sachs, also estimated. And just like Mr. Cicio’s members are hit hard by these increasing prices and the volatility, so are working families across the country. And people

are beginning to understand the role that Wall Street plays in this. We see citizens of all walks of life participating in activities around the country directed at frustrations with Wall Street profits while families are really struggling to make ends meet.

Senator LEVIN. Mr. Turbeville, speculators, according to your testimony, are now overwhelming the commodity markets and dwarfing the participation by commercial hedgers. They now account, I believe your testimony was, for 70 percent or more of the outstanding contracts in many commodity markets while actual hedgers have fallen to only 20 or 30 percent participation, and even lower in some markets.

You have, I think, indicated that this is a historically new shift. Is that correct?

Mr. TURBEVILLE. That is correct.

Senator LEVIN. In other words, a few years ago it was very different, perhaps the opposite, but at least very different from what it is now. Are there any barriers to speculators making up 90 percent of the commodity market, or even 99 percent?

Mr. TURBEVILLE. No. In fact, the new position limit rules go to the percentage of open interest that an individual speculator might have, so that the aggregate amount of speculation in a market, in fact, is not limited. And that is a real concern. It is not just the size of speculation. It is also the structure of speculation and how speculation has created this—has been created in sort of an ecosystem around the big bank traders that are trading these roll period contracts that I described.

So it is both the size, absolute size, and the actual structure of the speculation that is very much a concern.

Senator LEVIN. The most important question is the relationship between the amount of speculation in commodities and the prices of those commodities. We had a chart we put up there which shows that most of the speculative interest is on the long side, but there is obviously a short for every long.¹ But, nonetheless, when the speculative interest is on the long side and is pushing prices upward, sooner or later there may be a short side to make to be on the other side of the deal, but that has an upward price pressure on futures contracts. Like any market, if there is a greater demand for the paper, it is going to push the price of the paper up, if there is a great demand for the long side of that paper.

Now, how does that get translated into the price of the commodity? I think that is what we really need to drive home, that these futures contracts and the demand for futures contracts and the demand for the long side on futures contracts, which will be met by somebody willing to go short, but, nonetheless, as the demand goes up for that long side—or the bet that the price is going to go up—will not just affect the price of the futures contract but that huge demand will be translated somehow into a demand for the underlying commodity.

In my opening statement, I tried to describe how that is done in a very simple way, but could each of you now take a try at that issue. Let us start with you, Mr. Cicio.

¹ See Exhibit 1a which appears in the Appendix on page 110.

Mr. CICIO. One just needs to look at the index fund data that we cited earlier that shows that 86-plus percent of all of the positions are long.

Senator LEVIN. This is for the index fund people.

Mr. CICIO. For the index funds, that is correct.

Senator LEVIN. OK.

Mr. CICIO. And when that happens, there is mounting pressure month after month because they roll their volumes forward. When it comes to speculation and what impact it has on price really depends upon the specific commodity. Like in the case of natural gas today, you saw the numbers. We have a lot more speculators open interest than hedgers and producers. Because there is a lot more of physical natural gas—there is more supply today than there is demand for natural gas—the speculators are having a very difficult time creating that speculation because the physical product is so overwhelming that it is keeping the trading within a narrow range. So in that situation, having tight speculative position limits is not all that important. The reverse is what we are really worried about. If you have a market, a physical market that is basically in supply and demand, or there is more demand than there is supply, is when you need spec limits. That is when it is crucial that those be in place because speculators have a herding effect. They make money on the changes in price. They love speculation. They thrive on it. That is when their profitability increases. And they go to specific commodities when they sense that supply and demand of the physical commodity is in their favor to create speculation. So these things all tie together to impact the price, but it is on a commodity basis.

Senator LEVIN. It depends on the supply-and-demand situation for the underlying physical commodity in your judgment.

Mr. CICIO. Yes, sir.

Senator LEVIN. Mr. Slocum, do you want to try to address my question? How does the speculation get translated into impact on price?

Mr. SLOCUM. I would be happy to. I think what you see—and you kind of alluded to this—is this manufactured demand of these entities buying and selling these contracts and controlling such a big chunk of it, and particularly the disruptive influence that the index funds play, particularly as the contract month comes to expiration, where it is crowding out the folks that are looking to legitimately hedge. And so it is increasing prices for the market as a whole, and a lot of this has to do with the fact that we do not have adequate limits on the size of the positions that the banks can take.

You also see a lot of other effects go on. Markets are based on fundamentals. They are based on opportunities. They are also psychological. Everyone knows that a Goldman Sachs is a major presence and player in the market, so when their analysts produce a report that say oil is going to hit \$90 a barrel or go up to \$100, it has a phenomenon of saying, well, that is where Goldman is headed and that is where we need to head because they are driving the market. And so I think that is an issue that also needs be examined.

Senator LEVIN. OK. Mr. Turbeville.

Mr. TURBEVILLE. When the rollover occurs, you see firms like Goldman Sachs and JPMorgan and all the very sophisticated firms selling the November contract and then buying the December contract at a higher price because they are insensitive to the actual prices they get on the contracts, that all gets passed through to the investors. So they are really doing this rollover on behalf of the investors and passing the prices through.

So what happens is that the message goes through to the market that sophisticated folks believe that prices are on the rise, prices will rise, and it really changes the information that the market has about supply and demand. The assumption is that those sophisticated folks must have some really good supply-and-demand information. That message is very important, and it passes through to prices.

Mechanically, buying the December contract means that for many of the markets the physical delivery of product is indexed usually to the next maturing contract. So if the price curve is sloping upward, upward, upward, and pushed up, up, up, then what gets translated through is next month's future contract is higher; therefore, that gets indexed to the actual delivery contracts for physicals so—

Senator LEVIN. I want to end my questions, but I want you to just drive that point home.

Mr. TURBEVILLE. Yes.

Senator LEVIN. Because this to me is where there is a link, a direct link—

Mr. TURBEVILLE. Absolutely.

Senator LEVIN. A direct link between a futures contract going up in price because of that last month, and that is used by the people who are actually buying and selling the commodity.

Mr. TURBEVILLE. That is right.

Senator LEVIN. So that there is a direct link between the futures contract price going up and the commodity price going up because people buying and selling the actual commodity use that next month's futures price as the basis for their price in the actual commodity purchase and sale. Is that correct?

Mr. TURBEVILLE. That is absolutely the truth. The first thing you would look to, not only is it in the contracts, not only is it in the procedures for Platts and others that create indices like in the oil markets, it actually makes common sense. The first price that you would look to is the price that occurs—that is indicated for the next month. That will tell you whether you should hold onto your commodity or sell it now, which means that the next price is absolutely feeding into by contract, by indices, and by common sense the price for delivery of product in the current month.

Senator LEVIN. Real product.

Mr. TURBEVILLE. Real product.

Senator LEVIN. In the real current time.

Mr. TURBEVILLE. That is right.

Senator LEVIN. Thank you. Dr. Coburn.

Senator COBURN. Let me just follow up on that for a minute. What you are saying is this is divorced from supply and demand, real supply and real demand.

Mr. TURBEVILLE. Actually, what I am saying is that real supply and real demand, there is not a chart that producers and consumers go look up supply and demand, here is the price.

Senator COBURN. No, but take the example—that is not happening on natural gas contracts right now.

Mr. TURBEVILLE. That is correct.

Senator COBURN. And the reason is because there is an absolute excess supply of domestic natural gas in this country. Correct?

Mr. TURBEVILLE. I think there are two reasons. One is that prices are low because of excess supply. The other reason is that natural gas is structure—we have looked at this actually in our research, that natural gas is structurally different from products like oil and wheat. Natural gas comes through pipelines and is largely unstorable, so that the best predictor of price during a delivery month is actually the price in the nearest maturing futures contract, not the next one. And that is how people actually contract for natural gas.

Senator COBURN. Except it is storable because I can show you all the wellheads that are turned off in Oklahoma because there is so much gas and there is no place to put it, so they are leaving it in the ground.

Mr. TURBEVILLE. You are absolutely right. It is relatively less storable—

Senator COBURN. Let me go to each of you. One of our problems is volatility, which the Chairman has talked about, which we are seeing, and the connection of volatility to excess speculation. So would each of you give me what your definition of “excessive speculation” is?

Mr. CICIO. Let me give you a reference point. Prior to 2000, prior to deregulation of this market, producers and consumers of natural gas were about 70 percent of the market, and speculators were 30 percent. And I will tell you, from the energy managers that are a part of our organization, the market worked very well. The prices that we hedged reflected the underlying supply and demand of the market all the time. Now, these same people would say that the underlying price of the commodity does not always do that, and it is because of the influx of a lot of speculators who want to do a deal—but because the producer and the consumer have already taken care of their hedging, speculators will speculate with speculators. They are looking for deals to turn, and, again, the only way the speculators can turn a profit thru relative volatility.

And so when you have large traders like the kind I talked about earlier, five traders or eight traders controlling 60 percent of the natural gas market in 2008, these are companies with large amounts of cash, and they can move markets.

Senator COBURN. All right. But let me go back to my question. What is “excessive speculation”? Because that is our whole problem. And as you answer this, think about this one thing. Can we change the rules here, in our country can we change the rules on our exchanges and solve this problem? Because unless they are doing it in London, unless they are doing it in the rest of the trading centers around the world, my fear is, no matter what we do or how we do it and whether we are right or we are wrong, what we are going to do is the same behavior is going to take place unless

all the exchanges throughout the world—because we will just trade somewhere different. We are just one click away.

So you agree we have to have some speculators in the market to make a market.

Mr. CICIO. Yes, sir, absolutely.

Senator COBURN. So what is your definition of “excessive”?

Mr. CICIO. The only reference point—and this is not a good one. But the only reference point would be the one I mentioned earlier. Prior to deregulation, with 30 percent speculators—

Senator COBURN. So compared to what it was then.

Mr. CICIO. We had deals getting done, producers, consumers, and speculators, and so I would say—this is not an organization statement, but anything more than 30 percent.

Senator COBURN. All right. And I would just say that discounts the change from 2000 to 2011 in terms of the globalization of all this trading, right? I mean, we have a lot of participants in our market that are not Americans.

Mr. CICIO. But, Senator, this market is all about a commodity, a physical commodity, and the players, the number of players and the physical product in this case, natural gas, has hardly changed at all. It has only increased 6.5 percent since 1995, but the volume of trades has increased 600 percent.

Senator COBURN. So it has not had any effect on price.

Mr. CICIO. Today, that is correct because of the oversupply. But just go back a few years ago, and, yes, sir, we did have high volatility and erratic pricing and prices higher than what we should have had.

Senator COBURN. Yes, OK. Mr. Slocum, thank you.

Mr. SLOCUM. Yes, I would like to just build on Mr. Cicio’s comment, but it is clear that the data indicate a rise in the level of speculators, and to specifically answer your question, I think it is when those that do not have physical delivery or production contacts to the underlying commodity have a dominating presence in the market. Those that have delivery commitments or want to hedge—or if they are suppliers and want to hedge their exposure, when they are vastly outnumbered, and particularly with the rise of the index funds, where there is no interest in the physical delivery or supply of the underlying commodity, I think that the markets have become skewed. And transparency and disclosure I think is essential because the more transparent the marketplace is, the better functioning it is going to be for all participants, and we still do not see enough transparency. And I really think we need to see trader-specific-level data, not instantaneous because that would violate some proprietary issues, but for too long the banks have enjoyed their relative obscurity in not being publicly identified.

I remember I was at a hearing at the CFTC, and I was making comments critical of some of the large investment banks for their speculative activities. And there was a gentleman from a hedge fund who sounded a lot like me, and I had to talk to this guy and figure out why a hedge fund guy was sounding a lot like the Energy Program director at Public Citizen. And it was because he was complaining that the banks control the market, that it is too secret. This is a large hedge fund, one of the largest in the country, and he felt that he was at a massive disadvantage to Goldman Sachs.

So imagine if you are one of those smaller independent gas producers in Oklahoma or a manufacturer trying to compete in a global economy. The deck is stacked against them as long as the banks are able to operate in secret and do not have adequate controls over the size of their positions.

Senator COBURN. So it is your assumption that it is all the banks that are creating the excessive speculation?

Mr. SLOCUM. I think the data indicates, and especially the leaked data that finally named some individual names, that the banks clearly are at the top of the list in terms of their positions. But it is also clear that there are major, especially vertically integrated players in the petroleum sector that are also big. Chevron inadvertently disclosed that it—

Senator COBURN. Yes, that is a repeat. Mr. Turbeville.

Mr. TURBEVILLE. I think you start with what excessive speculation is. There is actually some fairly good knowledge on what the required amount of speculation is, and that tends to be somewhere about a third of the whole market. Two-thirds hedging/one-third speculation makes the market work.

Speculation in excess of that really ties into the very purpose of the market, which, interestingly, sort of reflects the language of the Commodities Exchange Act. When they originally talked about back in the old days excessive speculation, they described it as “unwarranted and inappropriate higher prices in volatility.” I think that ties into the purpose of the market. To the extent that speculation is not required but is in excess of what is required, it is excessive, meaning it is bad, if it damages the price discovery function so that suppliers and consumers can know what the forward price is—in other words, it damages the forward price curve that I was talking about before—or it inhibits in anyway hedgers actually hedging their positions in the market—the two real functions of the market, hedging and price discovery, which are related.

So if volatility causes it to be very expensive to hedge, that is a bad thing, and if excessive speculation causes that, it should be ended. If the price discovery function is damaged, meaning I do not know where prices are going because of things that are being done in the speculative market, that is a bad thing.

So speculation is excessive if it damages price discovery or the ability to hedge well.

Senator COBURN. Excessive speculation leads to markedly increased volatility, what you should expect some market force on real supply and demand to have some influence on.

Mr. TURBEVILLE. You would.

Senator COBURN. In up movements you should see exaggerated up movements. In down movements you should see exaggerated down movements. And from the testimony I hear, I am not hearing that there is an excessive down movement. Explain that to me on speculation, when there is a marked excess supply, why we do not see an excessive down movement.

Mr. TURBEVILLE. That is really an interesting point, and it goes to the issue—you would expect to see it. We have all grown up in the Chicago School of Economics that markets work perfectly and are very efficient, which I think sometimes makes it hard for some of the academics to understand what is going on in the commod-

ities markets right now. I am not an academic, so maybe that is easier for me somehow.

Senator COBURN. So maybe you can understand it.

Mr. TURBEVILLE. Exactly. [Laughter.]

I think the reason is the market is actually imperfect. If you have a huge sector of the market that is long only and is insensitive to price and trades on specific days that everybody knows about, what you have is this force, this bias, if you will, towards upward prices. So I think what you see in sort of the boom-bust cycle, what is suggestive, as our research suggested, is that, in fact, what is happening, this constant trading without regard to what the price is, I do not care what price—

Senator COBURN. I know if that is the case, that means the investors in those instruments are price insensitive as well.

Mr. TURBEVILLE. That is correct.

Senator COBURN. And why are they?

Mr. TURBEVILLE. Because they actually are investing to create a portfolio effect in a larger—

Senator COBURN. Then why is not everybody doing that? Why isn't all the money moved there? If it is a sure deal, if it is a sure bet and that price is on the come and it is going to rise, why isn't everybody doing it? You cannot have it both ways.

Mr. TURBEVILLE. Right.

Senator COBURN. If they are price insensitive, if they do not care what the price is because they are sure they are going to make money on the next month as they roll it over, why isn't everybody doing that?

Mr. TURBEVILLE. Well, OK. There are two questions. If you would, indulge me here. The investors are not in it to make money like you would make money on a stock. They are in it because they want to have part of their portfolio that moves just like commodities move.

The other side of the coin, which is a really interesting one, which is our premise is that because of the trading activity, the curve moves up, right? Why don't the arbitrageurs squeeze that out instantaneously? That is a really good question, and efficient markets theorists would say that would happen. Our data suggests that it actually does not happen, so you sort of ask yourself the question why.

I personally believe that the reason why is that the market as a whole—remember, the trading is done by Goldman Sachs and JPMorgan, those folks. As they see those traders pricing those contracts, their interpretation is, well, they must know something that we do not. And it is not random trading activity. But it is not trading activity based on the rationale of profit and loss.

Senator COBURN. Of a transparent market.

Mr. TURBEVILLE. Right. So it confuses the world about what the supply and demand is. I actually think that is what is going on, is that the prices are distorted. So going back to excessive speculation, if the price discovery function is being injured, that is a problem, and I would consider that excessive speculation and speculation that should be corrected.

Senator COBURN. Thank you very much.

Mr. SLOCUM. Dr. Coburn, may I quickly add something?

Senator COBURN. Sure.

Mr. SLOCUM. As part of my written testimony, I took a look at the Goldman Sachs Commodity Index (GSCI), and so your question is, if these index funds are such a good deal, why isn't everyone moving into them? According to SEC filings by GSCI, in January 2009 there were 135 shareholders or entities that were investors in GSCI. Two years later, in January 2011, there were 49,120. Now, they do not provide any explanation of whether or not there was some sort of plausible explanation of this or whether or not Goldman's sales reps are doing a heck of a job selling to institutional investors and high-net-worth individuals. But those numbers are staggering, and it is clear that Goldman is promoting this as an investment vehicle for certain key audiences.

Senator LEVIN. All right. Let us try another round. I want to move to high-frequency trading. Are you aware, each of you, of an increased presence of high-frequency traders in the commodity markets? And if so, are those high-frequency traders exacerbating volatility and price distortion? Let us start with you, Mr. Cicio.

Mr. CICIO. Well, yes, high-frequency trading is putting a lot of pressure on volatility. As stated earlier, traders make their profits on price movements. It does not matter whether it is up or down. And so the high-frequency trades is having a direct impact on moving the market, and that is not good for price discovery when we are looking at a consumer for a price that reflects the supply and demand rather than reflecting high-frequency, computer-driven, technical trading, speculator-driven type of decisionmaking.

Senator LEVIN. Mr. Slocum, do you agree with that?

Mr. SLOCUM. Absolutely. Mr. Chairman, I testified before a panel that the CFTC put together a year or so ago, and after our research at Public Citizen, we deemed that high-frequency traders do not serve a legitimate function in these markets.

With all due respect to the hard-working career staff at the CFTC, which are doing a heck of a lot with relatively little resources—

Senator LEVIN. And they are looking right at you as you testify.

Mr. SLOCUM. Right. They cannot compete with the types of strategies, computers, and resources. It is overwhelming for enforcement staff to keep up with the activities and the volume and the constantly evolving strategies of these high-frequency traders. And as long as our hard-working regulators are unable to get a handle on how these high-frequency traders are operating, it is clear that they are not serving a legitimate market function. It is clearly disadvantaging those that are seeking to enter the market for legitimate hedging purposes.

Senator LEVIN. OK. Mr. Turbeville.

Mr. TURBEVILLE. I agree with the other panelists in what they have said. The high-frequency trading is to gain advantage based on a different level of knowledge that others in the market have. That is the whole point of it. And in the commodities markets, that is a very dangerous thing. It is different from the stock markets and bond markets which are really—there is no such thing, for instance, as excessive speculation in the stock market. So that kind of activity in the commodities market can be more damaging to the

market itself because of the functions that we described, hedging and price discovery being the main ones.

I am also concerned about this: I am concerned that as the markets evolve into markets with swap execution facilities so that everything is electronic but that there are multiple venues in which transactions can be matched, that the ability of high-frequency trading to actually move around from venue to venue to venue to take advantage of things like payment for volume—in other words, a swap execution facility could well pay for volume because they get value from the other side of the trade—that you might see the kind of activity from high-frequency traders that is actually gaming the system that is actually created to maximize full disclosure of what is going on. So the full disclosure is really good, but without some kind of a control to make sure that HFT types do not move transactions around, that could actually allow those folks to game the system to the detriment of others and make it an unfair system.

Senator LEVIN. Let me ask you about Exhibit 1b,¹ which is a chart which shows total assets invested in commodity-related exchange traded products. These totaled over \$100 billion last year, these commodity-related ETPs, as they are called. And we have listed a lot of those in Exhibit 6² in our book. ETPs offer securities now that track the value of a commodity—or a basket of commodities, but they trade like stocks on an exchange.

Are ETPs adding to speculative pressures on the commodity markets? Let us start with you, Mr. Turbeville.

Mr. TURBEVILLE. There is no question. If you look at it from a more cosmic level, the 30,000-foot level, one of the things happening is you are creating a huge amount of synthetic ownership of commodities as if they were hoarded, and the market is actually interpreting that at some level the commodities are being hoarded, therefore, the prices move up until something happens and the bubble bursts and everybody say, oh, yes, I remember now, those were just synthetically hoarded. So it is absolutely a similar kind of thing.

To be honest with you, there is one question that the world should ask itself. This desire to own commodities, if you own a basket of commodities for 125 years, should we all live that long? You will have made something like the inflation rate on that market basket. That is all.

The world should ask itself: Why is this such a popular thing to do? Is it because it is a good thing to sell by the sales folks? Or are people actually making sensible investment decisions by actually putting their money into commodities if, in fact, what I said is true, is after 100 years you have just got inflation after all?

Senator LEVIN. Just very quickly, because I have some other questions, Mr. Slocum, would you agree with that, that ETPs are adding to speculative pressures on the commodity market?

Mr. SLOCUM. I would, absolutely, and I really applaud the efforts of this Subcommittee to address some of the issues of this, particularly what you outlined in your opening statement about mutual

¹ See Exhibit No. 1b which appears in the Appendix on page 111.

² See Exhibit No. 6 which appears in the Appendix on page 176.

funds using their investments in this to kind of get around some existing regulations. That is clearly problematic.

Senator LEVIN. OK. Mr. Cicio.

Mr. CICIO. Most certainly.

Senator LEVIN. And now let us go to the mutual funds question. As I mentioned, we have an exhibit, Exhibit 7a,¹ that identifies 40 mutual funds that primarily trade in commodities. The commodity-related mutual funds over the last several years have gotten into the game big time. We have come across one mutual fund that has over \$25 billion in assets with one of its primary purposes to trade in commodities.

Are mutual funds that trade in commodities also contributing to commodity price speculation? And do you believe that we ought to keep the 90-percent rule that investment revenues accrued by mutual funds must be realized from investments in securities and no more than 10 percent should be realizable from alternative investments, including commodities? Can you give me a yes, no, or maybe? Mr. Cicio.

Mr. CICIO. We think that mutual funds should not be participating in commodities period because, again, it has nothing to do with supply and demand and price discovery.

Senator LEVIN. We currently have a 10-percent rule, so you at least would want us to hold to that.

Mr. CICIO. Yes, sir.

Senator LEVIN. Mr. Slocum.

Mr. SLOCUM. I agree, absolutely, yes.

Senator LEVIN. OK. Mr. Turbeville.

Mr. TURBEVILLE. The numbers are just staggering. Any percentage of mutual funds added compared to an open interest in commodities, in physical commodities of around \$900 billion would just swamp it, yes.

Senator LEVIN. And there is no stopping it now if they are allowed to continue to have these offshore deals that they wholly own and if they are allowed to in other ways circumvent the 10-percent rule?

Mr. TURBEVILLE. There is no stopping it, and the sales forces must be very effective, as I pointed out before.

Senator LEVIN. By the way, we did actually stop it in the Senate. We had a House bill which would have eliminated that limit of 90 percent and said you can have as many speculative investments as you want in commodities. It came over from the House with the abolition of the 10 percent. We were able to strike it here. And the Senate sent it back to the House without that. There were some other things, mutual funds requested, but it did not get that one. And I think there has been very little attention paid to this issue, and I would hope that one of the things this hearing will do is to focus on this question really for the first time as to whether we ought to have this circumvention, through the offshore—these corporations which are shell corporations, and who is going to regulate them, and that is a big issue which we will also get into with Mr. Gensler.

I think I am over my time on the second round. Dr. Coburn.

¹ See Exhibit No. 7a which appears in the Appendix on page 185.

Senator COBURN. Thank you. Let us go back to what we have kind of created. It is very interesting. I am trying to get a balance on where this bubble, if we do not do something about what is going on, is going to end, because it is not going to go up forever. In other words, there is going to be a point in time where somebody says, well, these guys are trading this next month. They are saying, "How do I make money off that?" And then there is going to be the opposite of that.

So, we are always going to have to have speculators to make a market. We really cannot make a market without some speculation in it. If we could, we would not be where we are today. If we go too far or if we do not go far enough, we are going to have price exaggerations, either below or above, and I think everybody would agree with that. And we are always going to have some price exaggeration based on world events, whether it be Libya causing oil to cost \$15 to \$17—maybe that was exaggerated based on what we are seeing today, but the fact is there was a world event that put world oil supplies at risk and that should have some effect on commodity prices. The same thing on cotton, as I mentioned before. You had crop failures. You had \$4 cotton in this country, which nobody had ever seen.

Was that an exaggeration because of this? Was it made worse? So I would like your comment on how you tie in true supply-demand effects and what we are seeing. How are those true supply-demand effects that enter the market, that are fundamental differences in available supply or excess supply or marked increase in demand for some reason or another, how do those interact with what we are seeing going on in the market?

Mr. SLOCUM. I think that there is no question that the supply-demand fundamentals play a role in these markets. It is why you have seen this big disconnect with natural gas and crude oil. It is because natural gas is not globally priced, and we do have enormous supply. That will definitely change if we start switching more and more of our coal plants to gas or if T. Boone gets his way and we have got more trucks on the road using natural gas. And as Mr. Cicio noted, it was in the very recent past that we saw significant price increases and volatility. Natural gas has a long history of that kind of volatility.

But it shows that with massive amounts of supply-demand evidence that is dominating the market, supply-demand can play a role, but in a globally priced commodity like crude oil, where you have speculators playing a significant role, I think that what we see is the volume being driven by these speculators and by the index.

Senator COBURN. With the marked excess in supply of natural gas, why isn't it significantly lower than it is today if these guys are playing? Why isn't it \$2 instead of \$3.60 or \$3.90?

Mr. SLOCUM. Right.

Senator COBURN. Why isn't it \$2?

Mr. CICIO. That is what manufacturers are asking.

Senator COBURN. But I am asking it on the basis if we have excess speculation based on market forces or intended market forces, why aren't we seeing an exaggeration on decreased price? That is my whole problem with what we are being presented with here

today. Everything seems to be rigged for an upward bias, but when there is fundamental market indices that say there is absolute two to three times as much natural gas as this country can consume available right now, why aren't you seeing the other side of this? Where is the market failure in that?

Mr. CICIO. Well, actually, Senator, as consumers, given the increased supply of physical natural gas, we think that prices probably should be lower than they are. But because of the ETFs and the ongoing long positions that I talked about, remember, 86 percent of all of the index positions historically have been long. There is this growing amount in volume of long positions that keeps encouraging the upward pricing pressures versus a reflection of the oversupply of the marketplace.

But interesting about natural gas is that if you look at the Chicago Mercantile Exchange, which I did last week, and look out 5 years to see what the price of natural gas is, given our vast supply of natural gas, one would think that there would be a downward price curve, much like what was talked about earlier, which is historically what commodities had. They had a downward pricing curve. Natural gas prices 5 years out show a 52-percent increase.

Senator COBURN. Yes, but that is readily explainable. We are building LNG terminals. We are going to ship it to the Chinese and Europe. The other factor is we are going to see massive inflation in this country in 2 or 3 years, and people are anticipating that. So maybe that is the reason that there is not the downward side to it. But I still have problems. Mr. Turbeville.

Mr. TURBEVILLE. One of the things that occurs to me about natural gas is something you mentioned, which is that natural gas gets stored in the ground as opposed to next to its use. So there is a limit on how low natural gas can go because no matter how much the supply is, the constraint is actually the transmission associated with it. But the fact is that one way to approach all of this is to try to decide how much—or what really is the effect of trading as opposed to supply and demand, is to look at elements that are unrelated to supply and demand—I am sort of promoting what we did, but that is specifically why we did it.

We looked at the 5-day roll periods—over 27 years, which has nothing to do with supply and demand, and looked at the bias associated with that. The law of supply and demand has not been repealed. Nobody should think that is true. However, it is fairly certain that this inefficiency does occur on the margin, and how much is it? It is hard to say. The St. Louis Fed has said it is something like 17 percent of the price. It probably changes over time. But it also is biased towards upward levels, and it is because of this huge price-insensitive long that is in the market. I believe that is true, too.

Senator COBURN. All right. Thank you.

Senator LEVIN. The rule that came from the CFTC makes a distinction between commodity swaps that reference a single commodity, like oil, and those that reference a basket of different kinds of commodities, like oil, gold, and wheat. The rule applies position limits to single commodity swaps but no limits at all to multiple commodity swaps.

Can you give us your opinion as to the basis for that distinction? And how does it affect the effort to combat excessive speculation? Let us start with you, Mr. Slocum.

Mr. SLOCUM. Well, in terms of why the CFTC has taken this approach, I think Mr. Gensler is following us, and I think he is a lot more qualified to—

Senator LEVIN. We will ask him, too, but do you—

Mr. SLOCUM. Yes, I do not know why they have done that. I am concerned that differing treatment is problematic and will encourage levels of speculation because of that loophole that are going to be problematic for consumers.

Senator LEVIN. OK. Mr. Turbeville.

Mr. TURBEVILLE. I guess we are mostly interested in the result, right? Do commodity index funds get effectively regulated and limited? They have taken this approach of saying a multiple index swap is not disaggregated into its component parts. It is just a swap that exists out there and is not subject to—

Senator LEVIN. Does that trouble you? Are you OK with it?

Mr. TURBEVILLE. I am OK with it as long as the actual limits themselves—because what happens is, of course, the bankers then have to go do swaps and futures on the other side of that. If those swaps and futures really got effectively regulated, it would not be a problem. My concern is that there are too many ways to use the single entity limits in such a way and to manipulate them so that the bankers never will get regulated. So the better result would have been to say a multiple swap is regulated and limited.

Senator LEVIN. What happens if a basket is 99 percent oil and 1 percent something else? Doesn't that kind of make the position limits ineffective?

Mr. TURBEVILLE. Yes.

Senator LEVIN. I know you are worried about that. We are just warming up for Mr. Gensler. [Laughter.]

Mr. TURBEVILLE. I understand. Yes, I would have been personally, and as an organization, more comfortable to go ahead and address the issue straight on and say let us talk about the swaps themselves rather than indirectly trying to get—you are right. What happens is it becomes a metaphysical concept.

There is by analogy in other rules, agricultural rules, that more than 50 percent will constitute that swap, an oil swap, but it does not actually apply to oil.

Senator LEVIN. OK. Mr. Cicio, do you have a thought on that?

Mr. CICIO. Well, just briefly. We were troubled by the differing treatment as well, and we would rather have the spec position limits apply to all, so undifferentiated.

Senator LEVIN. OK. Just one last question about a netting rule in the final rule of the CFTC which allows a swap dealer who sponsors a single commodity index fund to net any short position created by the sale of a commodity swap to a client with a long future involving the same type of commodity. So the netting rule means that to the extent the swap dealer is hedging its financial risk by buying long futures to offset its client's speculative bet, the swap dealer can claim his position is flat and not subject to any position limits.

So the swap dealer then could sell \$1 billion in swaps to a lot of clients and then offset that risk by buying \$1 billion in futures, affect the price of those futures it is buying, but still not be subject to any position limit. Does that netting rule open up a loophole for swap dealers who will be able to sell and offset as many single commodity swaps as they want even if that activity floods the commodity markets with speculative money? Is there a loophole created by that rule, Mr. Turbeville?

Mr. TURBEVILLE. That was a change to the proposed rule that was in the final rule. The concern there is that what the rule suggests is that the swaps market and the futures markets are all one market and should be viewed as such. We think that is not appropriate. We think that the futures market is a very specific market that creates a very important—it has a very important role in price formation and price discovery. And so the netting across those two clearly should not be allowed, although it is.

Senator LEVIN. OK. Mr. Slocum, do you want to comment on that?

Mr. SLOCUM. I definitely share your concern. I think you articulated a potential abuse, and I think it underlies the fallacy of creating this potential for loopholes.

Senator LEVIN. OK. Mr. Cicio.

Mr. CICIO. And we agree with you, sir.

Senator LEVIN. I said that was my last question, but I do have one other comment I want to make, and that has to do with a comment of the CEO of the Intercontinental Exchange (ICE). It is headquartered in Atlanta, and Jeffrey Sprecher was quoted in a September investment bank research report as saying that the energy markets may work better with position limits in place. It is a very important comment because it is coming from the CEO of ICE, but it has not been, I think, widely quoted yet, and I hope this may help a little bit if I quote it:

“It is not necessarily a bad thing for exchanges to prevent one large player from having concentration. ICE imposed its own version of position limits in its markets. The volume had actually increased. There was a healthier market with more and smaller players as a result.”

And here is what he then said: “A lot of people do not like the thought of being limited in any way, but the reality is, and the evidence so far at ICE is, that we have grown very well during a position limit regime.”

I am just wondering whether each of you would welcome that kind of a comment from a person in that position. Mr. Cicio.

Mr. CICIO. Clearly, yes, sir.

Senator LEVIN. OK. Mr. Slocum.

Mr. SLOCUM. Yes, I think it underlies how much of the debate on this issue, and sometimes others, where you have some powerful interests where their status quo is threatened and they will claim that the sky is falling is very basic regulatory oversight is applied to their sprawling complex operations. And every once in a while you get a moment of truth in that, like apparently the CEO of ICE. So I am glad that you are quoting him on that.

Senator LEVIN. Mr. Turbeville.

Mr. TURBEVILLE. I not only welcome it, I agree with everything he said.

Senator LEVIN. Thank you all. We are going to make all the statements part of the record, and there is an additional request for a statement to be made part of the record by the Petroleum Marketers Association of America and the New England Fuel Institute, and we will make that testimony part of the record. We will leave the record open for other organizations that might wish to file statements.¹

We will thank this panel. It has been very useful and helpful testimony. Thank you all.

[Pause.]

Mr. Gensler, we welcome you. We appreciate your not just coming here to testify but taking some extra time to listen to our other witnesses. We very much appreciate that. We look forward to your testimony.

I think as you know, all the witnesses who testify before our Subcommittee are required by our rules to be sworn, so I would ask you to please stand and raise your right hand. Do you swear that the testimony you are about to give will be the truth, the whole truth, and nothing but the truth, so help you, God?

Mr. GENSLER. I do.

Senator LEVIN. The light will go on from green to yellow about a minute before the 10-minute period is up, so we would ask you to try to limit your oral testimony to no more than 10 minutes. There will be whatever time we need, obviously, to get your entire testimony in one way or another. So we again thank you for being here and please proceed.

TESTIMONY OF THE HON. GARY GENSLER,² CHAIRMAN, COMMODITY FUTURES TRADING COMMISSION

Mr. GENSLER. Good morning, Chairman Levin and Ranking Member Coburn.

Senator LEVIN. We expect he will be able to return. He had another important mission here this morning.

Mr. GENSLER. Well, if Ranking Member Coburn is listening somewhere, I thank him as well.

I thank you for inviting me here today to talk about the changing nature of the derivatives markets and on position limit rules.

The derivatives markets have changed significantly since the CFTC opened its doors back in 1975, and you have noted in some of your excellent charts these changes. But, first, there is the swaps market as well. This emerged in the 1980s, and it is now seven times the size of the futures market.

Second, instead of being traded just in the trading pits in Chicago and New York and elsewhere around the globe, much of the market, over 80 percent, is traded electronically, a click of a button.

Third, while the futures market has always been where hedgers and speculators meet in a marketplace, a significant majority of the market is made up of now swap dealers, hedge funds, and other financial traders.

¹The prepared statement of Mr. Ramm, Petroleum Marketers Association of America and the New England Fuel Institute which appears in the Appendix as Exhibit No. 10 on page 266.

²The prepared statement of Mr. Gensler appears in the Appendix on page 98.

Fourth, the vast majority of trading is now day trading or trading in what is called calendar spreads, between 1 month and a later month, but not necessarily to go outright long or outright short. And I would add, as your charts suggest also, a fifth point is that a significant portion of the market is now in these index investments, more on the long side than on the short side.

Now, the CFTC is focused on ensuring our regulations are responsive to today's markets. We are an agency that is not set up to be a price-setting agency, but it is an agency to promote transparency in markets, to police against fraud, manipulation, and other abuses, and to ensure that there is integrity in markets and the price discovery in the market has integrity for all the hedgers in this market.

This summer, of course, with the Dodd-Frank Act's passage, we turned a corner and began finalizing many rules with regard to the swaps market but also updating some of the market rules on the futures market, and to date, we have completed 18 final rules and have a busy schedule throughout the rest of the year and into next year.

We have completed rules giving the CFTC enhanced anti-manipulation and anti-fraud authority, and it extended the Commission's reach to include reckless use of fraud-based manipulative schemes. And I know we have chatted about this in the past as a very important extension of our authority to fill a gap in our enforcement tools.

The CFTC also approved a final rule on large trader reporting for physical commodity swaps. For the first time, the clearinghouses and the dealers, the swap dealers themselves, must report to the Commission information about swaps activity on the large trades, and that rule actually went effective last month—well, now 2 months ago, September.

The CFTC also completed the rules that are the center of this hearing, the aggregate position limits rules for physical commodities. A position limit regime is a critical component of comprehensive regulatory reform of the derivatives markets. Position limits have served since the Commodities Exchange Act passed in 1936 as a tool to curb or prevent excessive speculation that may burden interstate commerce, and the emphasis might be on prevent, as the Chairman mentioned earlier, and it has been used since, I think, we first put in place our predecessor's position limits in 1938 using that initial authority. I think it was then in bushels. It might have been 2 million bushels of a certain grain.

And though, as I mentioned, the CFTC is not a price-setting agency, at the core of our obligations is to promote market integrity, which the agency has historically interpreted to include ensuring markets do not become too concentrated. You mentioned that quote of an exchange leader—but I think that was really at the core of what Mr. Sprecher's quote was—about concentration of markets and making sure that there is no one who has an outsize position.

In the Dodd-Frank Act, Congress mandated the CFTC to set aggregate positions for physical commodity derivatives, and this would include for the first time and historically position limits on swaps as well as futures, which I mentioned are seven times the

size of the market, and even certain linked contracts on foreign boards of trade that might be trading overseas but linked to these contracts. And the final rule achieved that.

The Dodd-Frank Act also tightened the definition of bona fide hedging. Since the 1930s, the concept was this was a limit on speculators not hedgers, but over time there had been some creeping and widening of that by the CFTC, various rules and interpretations and sometimes no-action letters. Congress addressed that and said it should be narrowed such that the exemption only be for transactions and positions that served to mitigate risk in the cash market for a physical commodity, and I believe the final rule achieved that as well.

The Dodd-Frank Act also mandated that we set position limits for energy, metals, and agriculture for the spot month and something called individual month and all months combined, and I believe the final rule achieved this on the 28 physical commodities. I would mention that the rule re-establishes position limits for all months combined and individual months for energy and metals, which had existed actually, but had been taken off in 2001 in energy and in the late 1990s in the metals markets.

Before I close, I would like to briefly mention the events this week of MF Global, if I might. Earlier this week the CFTC and SEC determined that the Securities Investor Protection Corporation-led bankruptcy proceeding would be the safest and most prudent course of action to protect customers of this failing financial institution. The most troubling aspect about MF Global's situation is the shortfall of customer money in the firm. Segregation of customer funds is at the core, and it is really a foundation of customer protection in the commodity futures and swaps markets. Segregation must be maintained at all times. Simply put, that is at every moment of every day down to the nanosecond.

The Commission intends to take all appropriate action within the purview of the Commodities Exchange Act and the Bankruptcy Code to ensure that customers maximize the recovery of funds and, I say, to discover the reason for the shortfall in the segregated customer money. The CFTC and SEC and other regulators will continue to closely coordinate actions, and I thank you. I would be happy to take any questions.

Senator LEVIN. Well, thank you very much, Mr. Gensler. Since you made reference to the MF Global, let me just start with that. Is there any risk of a taxpayer bailout in this case?

Mr. GENSLER. No, I think this was an example, actually, of a financial institution having the freedom to fail.

Senator LEVIN. So there is no risk of a taxpayer bailout.

Mr. GENSLER. I think that is right. I think when the Chairman of the SEC and I were on these middle-of-the-night conference calls from 2:30 a.m. to about 7 a.m. on Monday and we not only informed that there was not somebody to take the customer positions over but that there was the shortfall in the customer accounts, we really saw no alternative but to protect the customers, put it into bankruptcy, and it is in liquidation. But, Chairman, I do not think that there is any taxpayer money behind this.

Senator LEVIN. Or at risk.

Mr. GENSLER. Or at risk.

Senator LEVIN. Now, you made reference to what the CFTC is going to do or continue to do, I think was your word. Can you tell us just briefly what you have done and what actions you can take or will take to protect their clients?

Mr. GENSLER. Well, throughout this week we have worked very closely with the court-appointed trustee who is now in place over this company, and we have worked very closely with the various clearing organizations and other clearing firms to try to move the positions. We were successful yesterday that the bankruptcy court did an order to allow customer positions to move. But the monies themselves may have to wait a bit because the trustee and the bankruptcy court have to really do a full accounting. We are in there as well. We have had people at MF Global since last Thursday really trying to assess this, but, of course, events changed dramatically on Monday with the shortfall.

Senator LEVIN. OK. Now, getting back to the subject of the hearing today, let me start by asking you about the Dodd-Frank Act requirement that you have attempted to implement in your rule and trying to curb excessive speculation and manipulation in the commodity markets by imposing position limits on commodity traders. I am just wondering whether you feel, as the Dodd-Frank Act believes and reflects, that it is critical to put this rule in place for jobs, for economic recovery, to help ensure that prices for vital commodities like crude oil will reflect supply and demand rather than speculative pressures.

Mr. GENSLER. I do think it was critical to put this in place and to fully implement it. I think it is critical that these markets have only—that they not have outsize concentration by one party or another, and particularly as Congress intended for us to do to place these limits on speculators. I think that markets work best when they have a diversity of points of view and a diversity of speculative interest. They are really primarily, as I think you and others have said, for hedgers to hedge. It was originally somebody growing corn or wheat to lock in the price at harvest time, and then, yes, there was a speculator on the other side who locked in that price and in a sense was taking a bet on where corn or wheat would trade.

Senator LEVIN. But the speculation has now gone way beyond providing the needed liquidity for that kind of hedging, so now speculation is a greater part of the market than the actual trading that is needed if you are going to hedge. Would you agree with that?

Mr. GENSLER. Yes. I remember discussing this with you about 3 years ago when we were in your office, when I was just a nominee for this job. But I think I share that view.

Senator LEVIN. And do you believe that the price swings in oil futures in 2008 and 2001 were caused in part by speculation and that became disconnected to the fundamentals of supply and demand, that these broad price swings in oil obviously have an actual market connection to the real fundamentals of supply and demand, but that there is a significant part of these price swings in oil futures that are the result of speculation.

Mr. GENSLER. We are not a price-setting agency, but when the markets are made up of—I will use oil—approximately 12 or 13

percent of the long positions of producers and merchants, and if I recall, maybe 18 percent of the shorts. And we publish these figures every Friday. They are public. So that means 80 to 87 percent of the market are financial participants, swap dealers, hedge funds, and other financials.

Senator LEVIN. Those are the speculators we are talking about.

Mr. GENSLER. People generally use that word.

Senator LEVIN. Right.

Mr. GENSLER. But I think it is both hedgers and speculators, and financials have an influence on price, so on any given day it is hard to determine whether it is up or down, but I think it is uncontroversial that speculators, when they are 80-plus percent of the oil market, and some of the agricultural markets at 60 percent, have a role to play, as has been known since the 1930s, and then we police for fraud and manipulation. We promote transparency, and then we use position limit regimes to ensure against any concentrated position and also to police against manipulation.

Senator LEVIN. So there is a legitimate role that is played by people who obviously have to fund people who want to hedge. That is a legitimate role.

Mr. GENSLER. That is correct.

Senator LEVIN. In terms of the excessive amount of speculation, you do not consider that to be legitimate? If it is excessive, it is not legitimate.

Do you agree that excessive speculation, however it is defined, is not legitimate? By definition do you agree?

Mr. GENSLER. Well, I think Congress made a finding, and what we were asked to do is then to set position limits, which we have done not only just 2 weeks ago but since the 1930s, to ensure against the burdens that may come. The burdens can be just that a large position wants to sell at an inappropriate time for everybody else. It is their right to sell, but it could distort prices in the midst of a crisis or even in clear times. Or the burden could come from either direction because it is an outsize position that pushes the price down or up. So we have used it to sort of ensure against the concentration of positions in the marketplace.

Senator LEVIN. And are price distortions and large price swings a problem?

Mr. GENSLER. Well, these markets—and again, we are not a pricing agency—will have volatility, just like securities markets will have volatility. But what producers and merchants want to do is lock in a price so that they can do what they are really good at. What they are really good at is either tilling the field or merchandising product to consumers. And so it is important that they have confidence in the markets and can ensure that the markets have supply and demand at their core of the price discovery.

Senator LEVIN. And is it important that supply and demand be at the core of price discovery?

Mr. GENSLER. Yes.

Senator LEVIN. And is that frustrated when there is a large amount of speculators, as we have defined it here, in the market where that dominates?

Mr. GENSLER. It is an excellent question, is there, in essence, a percent, as was asked earlier.

Senator LEVIN. I am not asking you what the percent is. Is that legitimate function for hedging frustrated when there are large amounts of speculation as we have defined it?

Mr. GENSLER. I think at our core is to ensure that the markets are free of manipulation and fraud—I am thankful that you and others helped us get better manipulation authority—and then to use these position limits to ensure that no one is greater than a certain percent. For instance, at the core of our rule is that no one is greater than approximately 2.5 percent of these markets for the all-months combined. I mean, if they are a smaller market, there is another percent. And so that means there in essence would have to be a diverse number of speculators, not one that necessarily has an outsize position.

Senator LEVIN. Do you believe that the purpose of our congressional enactment is to prevent excessive speculation? The word “prevent,” which is in the law, do you believe that is the congressional intent?

Mr. GENSLER. I am well advised by counsel that once worked with you who tells me it is to prevent the burdens that may come from excessive speculation. So it is preventative and forward-looking, and that is how we have used it in the past, and I think Congress understood that, and it is the clear intent of the statute, Dodd-Frank Act, that we set these aggregate positions.

Senator LEVIN. Let me read Section 737 of the Dodd-Frank Act to you: The CFTC “shall set limits . . . to the maximum extent practicable . . . to diminish, eliminate, or prevent excessive speculation . . .” So is that one of the purposes of the Dodd-Frank Act, to prevent excessive speculation?

Mr. GENSLER. I do not have the actual words. I always thought it was “the burdens that come from,” but I trust—

Senator LEVIN. Is the word “burdens” in there?

Mr. GENSLER. I thought, but if not—but I trust whatever the Chairman’s reading.

Oh, I see. I am thinking of 4(a)(1), and there is—

Senator LEVIN. I am reading Section 737. In that section, would you agree I read it correctly?

Mr. GENSLER. Yes.

Senator LEVIN. That is good. Did you hear me when I quoted the head of ICE, Mr. Sprecher?

Mr. GENSLER. Yes.

Senator LEVIN. Were you familiar with that comment before that?

Mr. GENSLER. I was familiar with his thinking, though maybe not the exact quote, but he had shared that thinking with us, yes.

Senator LEVIN. And do you agree with him about the potential benefits of position limits creating healthier commodity markets?

Mr. GENSLER. I do. I voted for the rule. I did because I think Congress mandated that we do it, but I also believe that it helps promote the integrity of markets.

Senator LEVIN. Much of the new speculation comes from the commodity index fund investors and swap dealers who sponsor those funds, hedge their risk on their client’s speculative bets by purchasing long futures contracts. Do you know approximately what percentage of the demand for long futures contracts across the

futures markets is attributable to commodity index funds, approximately?

Mr. GENSLER. The figures that we put out monthly show—and I think they were summarized in the charts—approximately this \$250 or \$260 billion equivalent in futures because some of that is swaps investment. The marketplace in the commodities, the most recent figures, is about \$1 trillion in notional amount of futures. So it is a little bit of apples-to-oranges, but you can think of it roughly as about 25 percent of the longs and, because the shorts are about \$70 billion, about 7 or 8 percent of the shorts, though I would note there is a little apples and oranges there.

Senator LEVIN. OK. When you testified before the Subcommittee before regarding excessive speculation in the wheat market in 2009, I asked if the CFTC as part of its work would look at the question of whether or not commodity index trading constitutes excessive speculation in the wheat market, and you told us that the CFTC would be looking at it not only for index investors but also for the broader class of speculators in financial markets. I am wondering if you have conducted that review.

Mr. GENSLER. Well, I think since then—and I apologize, I do not remember the exact date of that hearing—we had three public hearings in the oil markets and one in the metals markets, and then we have had two public meetings on this rule itself and conducted a great deal of inquiry, including 8,000 comments on the initial rule and 15,000 on the latter and hundreds of meetings. So collectively, yes, we have also looked at over 50 studies that were referenced in the comment file on position limits and reviews those and had our Office of the Chief Economist review those studies.

Senator LEVIN. We have talked this morning about the commodity-related exchange rate traded products (ETPs), which are set up as securities but are designed to enable speculators to bet on changes in commodity prices without buying the underlying commodities. These are hybrids that combined securities and commodities. They can directly affect commodities futures prices. They are currently responsible for about \$120 billion in commodity investments. Do you believe that exchange traded products that offer investors the chance to invest in baskets of commodities have added to the speculative money in the commodity markets and that they have contributed to speculative pressures on commodity prices?

Mr. GENSLER. Well, they are a group of financial investors that are speculating. Again, as hedgers and speculators meet in markets, this is a new vehicle for the retail public for the person to invest rather than maybe buying a bar of gold or—when I was growing up, my dad used to have a couple of gold coins, I remember he would show them to me every once in a while. He thought it was good always to have a little gold. This is a new vehicle to have that.

Senator LEVIN. My dentist, by the way, is telling me the same thing. It is good to have a little gold.

Mr. GENSLER. I see.

Senator LEVIN. Anyway, I interrupted you.

Mr. GENSLER. No.

Senator LEVIN. The Dodd-Frank Act acknowledged the existence of these mixed swaps as hybrid instruments that warrant oversight

from the SEC and the CFTC, and I am wondering if ETPs are not the same, essentially, set up as securities but intended to function as commodity investments. Would you agree?

Mr. GENSLER. Yes. One of our staff calls it a "securitized warehouse receipt." In a warehouse somewhere there is gold or silver, but it is traded in the securities market. Not all of these are that, but the majority of them are.

Senator LEVIN. And, therefore, does it require oversight from either or both the SEC and the CFTC?

Mr. GENSLER. Well, the SEC does have oversight. We have coordinated with them for the last 6 or 7 years when this market started on that. But most directly it is the SEC's oversight, though they have done it in a cooperative way with us.

Senator LEVIN. Are the commodity-related issues looked at by the SEC? Their function is not to look at the issues involved in commodities trades, so I want to know who is looking at the commodity-related issues in these instruments.

Mr. GENSLER. On these instruments, if they were used with regard to a manipulative scheme in the commodity futures markets or shortly in the commodity swaps markets, we would. But if it were just the trading of these and they did not come into a manipulative scheme, then it would be separate. But it would also, if I might say, be somewhat like if somebody was just trading gold but it was not part of a manipulative scheme, we would not necessarily be looking at that either.

Senator LEVIN. And are you taking steps to prevent them from being used as manipulative schemes, or are you waiting for something to happen? In other words, are you doing the oversight of these securities and the way they are used as commodity trades? Is that something you are trying to prevent manipulative schemes from being used, or you are just saying, well, the SEC is looking at the trades and we are going to wait until there is some evidence that accumulates somewhere?

Mr. GENSLER. I think, frankly, this would have to be a little bit more evidence-based, if we saw something in our futures markets we oversee or a whistleblower or somebody comes to us. Frankly, with the 700 people that we have, the resources are not such—nor do we necessarily just go to see if somebody is doing something with gold. But if it comes into our markets, comes into the futures markets that we oversee or shortly the swaps market and becomes part of a manipulative scheme or device, we have in the past and will in the future do so.

Senator LEVIN. So the oversight of these particular types of products is different from the futures.

Mr. GENSLER. That is correct, sir.

Senator LEVIN. And isn't that a problem?

Mr. GENSLER. It may be. I do believe that if it came to our attention it was being used as part of a manipulative scheme, we would certainly use everything that we have in our resources, but I think you have the accurate picture.

Senator LEVIN. Thank you. Senator Coburn.

Senator COBURN. Welcome. Sorry I was not here to hear your oral testimony.

How does the CFTC define "excessive speculation"?

Mr. GENSLER. Congress actually had a finding in the 1930s, and we first put position limits in in 1938 based on that finding. And though some of the language has changed over the years, it is really that we were to use position limits to help curb or prevent some of the burdens that may come from excessive speculation. And so what we did then and have over the decades is really looked to ensure two things: In the spot month, when somebody is actually delivering the natural gas down in a certain spot in Louisiana or delivering the oil in Cushing, Michigan, which you know well, that there is not a corner or a squeeze or a manipulation in that delivery period; and then, second, that over all of the contracts, which we call all-months combined, that there is not a concentration or an outsize position. It used to be labeled in numbers of bushels of grain, the first position limits were that way, and then subsequently, by the 1970s and 1980s, we turned to a percentage of the market. This most recent rule really used a formula that we put in place through notice and public hearings in the late 1980s and early 1990s, so it is about 20 years ago, and it is roughly 2.5 percent of the speculators. The speculators could not each have more than 2.5 percent.

Senator COBURN. So is excessive speculation happening now? We did not really get to a definition. So whatever it is, is it happening now?

Mr. GENSLER. The markets are made up of hedgers and speculators coming together, and one of the increasing features of the market is more and more financial parties. In the oil or natural gas markets, about 13 to 18 percent of the market are producers and merchants, and the other 80-plus percent are hedge funds and swap dealers and other financial actors. What we do is we use our authorities to police against fraud and manipulation and ensure transparency, that people see that price function, and then also to have positions to help prevent against manipulation, corners and squeezes, as I mentioned, help ensure the integrity of the market with regard to the all-months combined, that no one speculator has an outsize position.

Senator COBURN. So I will go back to my question. Is excessive speculation happening now?

Mr. GENSLER. Well, we know that the speculative group in the market can be anywhere from 50 or 60 percent in the grain markets to 80 to 88 percent or so in the energy market. Congress made the finding not only in the 1930s but also in the Dodd-Frank Act, once again came back to it, added more words that the Chairman and I just were—he was good enough to remind me of the additional words—and asked us, really mandated for us to put in place these regimes to help as a preventative matter moving forward.

Senator COBURN. So you do not know whether excessive speculation is happening now? Or you do know and do not want to define it? Or you are just responding to Congress and the assumption that there is?

Mr. GENSLER. Well, I think that we have been responding to Congress for 70-plus years on this, and it has been reaffirmed by Congress just last year that to ensure for the integrity of markets that we have a per se limit, that it is a specific limit that we set

in place. So we use these well-worn formulas that have worked. We had limits in the energy and metals markets before.

Senator COBURN. I am not debating that. Is the assumption by the CFTC there is excess speculation now so, therefore, you wrote new position limits?

Mr. GENSLER. No, I think that what we took was Congress' clear mandate to do this, and with the regime that we have used in the past—

Senator COBURN. The language says "as necessary," so how do you decide whether it is necessary unless you assume there is excess speculation?

Mr. GENSLER. Well, we took this up and had many comments, some on both sides of this very issue that you just raised, Senator. It is the Commission's belief in finalizing this rule that Congress mandated that we move forward and that it is not necessary to find that there had been a burden, that these are also preventative, these are forward-looking, so ensure that there is not manipulative schemes, corners, and squeezes.

Senator COBURN. So the new regulation is not based on the fact that there is an assumption that there was excessive speculation. It is to prevent any future excessive speculation. Is that what you are telling me?

Mr. GENSLER. That is what the statute actually says, and the Commission's finding on this is that. But in addition, we had over 50 studies referenced in the file, and about half of them are on one side and about half of them are on the other. I do not want to say a percentage, but they are mixed, the economic studies.

Senator COBURN. So for clarity for the American people, either there is or there is not excessive speculation, and we have put forward regulations to prevent the potential for that in the future.

Mr. GENSLER. To prevent the burdens that may come from excessive speculation.

Senator COBURN. Well, position limits are designed to stop excessive speculation, correct?

Mr. GENSLER. I believe that the statute has in 4(a)(1) the words to curb or prevent the burdens that may come to interstate commerce from excessive speculation, and then in 4(a)(2), as the Chairman pointed out, there were added four factors, and so it was also about manipulation, it was about promoting liquidity in the markets, and promoting the price discovery—

Senator COBURN. So you could have written a rule that would have allowed for excessive speculation but would not have had a burden.

Mr. GENSLER. I am not sure I am following that.

Senator COBURN. Well, you just said the statute is to prevent the burden in terms of the price to the markets and to the country. So you could have had a rule that allowed for excessive speculation as long as the excessive speculation did not affect the price.

I will not go any further on it. The point is the factual basis of determining excessive speculation needs to be based on something that is concrete, not an aftereffect but something that is concrete. And my worry is you are going to get tied up in a lawsuit that is going to—the well-intentioned thought of eliminating excessive speculation and decreasing volatility so that people are not paying

too high of a price for something that the market truly is not saying—that speculation caused it to be higher, more speculation than necessary to then create the market. What my worry is is two things: One is that you are going to get tied up and spend a lot of your budget defending it; and two is what we have written here is a click away from not having any effect at all because they are going to go to some other market.

What do you think will happen in the rest of the commodity exchanges around the world on the basis of the new rule that you all have put out?

Mr. GENSLER. I think we have made very good progress. In September, working along with international regulators in something called—I do not know that you are familiar with it, but it is the International Organization of Securities (IOSCO) regulators—put forward a joint report, and then that was moved up actually to the G-20, the 20 countries that form the Financial Stability Board, to put in place regimes that have anti-manipulation rules similar to what we have that could go after attempted manipulation, have more transparency. We actually have some of the best transparency here. And, also, it included—they called it “position management regimes,” a little bit different word. We would be glad to brief your staff on that.

So I think we have made good progress, but you are absolutely right, capital and risk knows no geographic boundary. So Congress also included that if there was a foreign exchange that linked their contract to contracts here, for instance, if somebody in London linked the contract to something in your State, Oklahoma—it is called West Texas, the WTI contract. If it were linked, that has to come under the position limits, and we finalized a rule that said if anywhere around the globe a foreign board of trade links it to one of the contracts here, then it has to be in that same regime.

Senator COBURN. Yes, but none of that is implemented anywhere yet, correct? Those are proposals to be implemented.

Mr. GENSLER. That is right.

Senator COBURN. We have a rule that is going to be in effect, questions about it, lots of learning curve on it. What is going to happen in the meantime? Let me just assume for a minute, since Europe is functioning so well—they are functioning just about as poorly as we are as a legislative body. What happens if those do not get put in effect given ours goes into effect? What do you foresee—what is the downside for American jobs, American price discovery, American valuation for products and commodities that are made here, what is the downside for our country if that does not happen in the rest of the trading centers around the world? What is the downside?

Mr. GENSLER. I think we saw some of the downside of weak regulation in 2008. I think our financial system failed in part because our regulatory system failed in 2008, and 8 million Americans are out of work today because of that, not because of position limits but because of our weak regulatory system.

Senator COBURN. Well, let us talk about what I asked you. What is the downside if they do not do it and we have?

Mr. GENSLER. But I think that Congress mandated us to do this and a lot of other pieces of—

Senator COBURN. I understand. What is the downside?

Mr. GENSLER. I think the downside is if we do not protect our markets, the price discovery and the integrity of these markets are weakened. So I think what Congress recognized and what the Commission recognized is that we have to promote the integrity of the markets and the price discovery function here. Congress also did ask—and we will do this—1 year after these rules go into effect, we have to report back to Congress, and one of the specific things Congress asked us to report on is exactly that which you raise, about the overseas effect, where are we at that point in time and report back, whether it is—I do not remember the exact words, but any effects of where we are overseas versus here. And I think that was very appropriate.

Senator COBURN. So I take it from your answer you are not extremely concerned that disconnecting from WTI, disconnecting from the Chicago Board, disconnecting from all these others, that people decide that they will speculate somewhere else, and given that we are in a global economy, we cannot regulate the global economy by only regulating us, and the very things that we are trying to limit, excessive speculation, whatever that is—since nobody will define that for me except Mr. Turbeville—excessive speculation is going to occur somewhere else outside, and we are still going to have the same price swings in our market. Is that not the downside?

Mr. GENSLER. I think that we are working very closely with international regulators, and I share your view that we should harmonize as much as we can. But we do have, as you mentioned, different political systems, different cultures, and it is possible, it is even likely that we will end up with some differences in not only position limits but anti-manipulation, the oversight of swap dealers, and the like.

Senator COBURN. How many people are employed in commodity trading in this country?

Mr. GENSLER. I know the figures for the whole financial industry is into the hundreds of thousands. I do not know the specific number to your question, but we could try to get back to you on that.

Senator COBURN. Well, we have got it. The point I am saying is we have a problem, the Chairman has identified a problem. We know we want real price discovery. We know we want real transparency in our markets. We know we have to have speculators to create a market. We know we do not want excessive speculation. We know we want the CFTC when they are cornering markets or abnormal. Is the regulatory framework that you put up, without that being put up around the rest of the world, going to be effective in accomplishing what—even if Congress told you to do it or whether it was apparent as necessary you should do it, is it going to accomplish its goal?

Mr. GENSLER. I think that it is important that we promote the price discovery and the integrity of the markets that we can oversee here. You are absolutely right. We do not oversee all the markets around the globe. If it is linked back to these markets, we do. We have that hook. But you are right—

Senator COBURN. Yes, but all they will do is delink it. I mean, think oil. Where is the vast majority of the oil produced? Not here. So if, in fact, we have trading limits here and the rest of the world

does not put them in, the oil is not going to be traded here. It is going to be traded in London, or it is going to be traded in Singapore. It is going to be traded somewhere else besides here, and we will not have accomplished the purpose. And what needs to happen is the effective implementation of transparency and price stability in all the markets, not here. Because what my worry is is we are one click away—my computer, one additional click, I can go to London and trade.

Mr. GENSLER. No, that is my worry about the European crisis right now. We are one click away the other direction. So we are working pretty hard to finish our rules to make sure our financial institutions are less at risk, less interconnected through the swaps market, and that the more transparency in the markets that we can oversee actually have greater transparency and greater integrity.

Senator COBURN. Let me go to one other area if I might for a moment.

Senator LEVIN. Sure.

Senator COBURN. Have you all created a true definition of what a swap is?

Mr. GENSLER. I think that Congress had a very good definition. We were asked by Congress to further define the word “swap,” working along with the Securities and Exchange Commission. We had a lot of public input through what is called an Advanced Notice of Proposal, and we are working to finalize that in the next several months.

Senator COBURN. So you cannot regulate it until we define it, correct? You are going to have trouble applying a position limit on a swap until you have a definition of what a swap is.

Mr. GENSLER. We have actually envisioned exactly that these rules go into effect for certain futures products in the spot month, but to the extent that they relate to swaps, because Congress asked us to “further define” it with the SEC, we need to finalize that role. As I say, we are envisioning—

Senator COBURN. When does that have to be done by?

Mr. GENSLER. Well, Congress asked us to finish it by this past July, but we are not working against a clock. We are working to get this in a balanced way.

Senator COBURN. And when do the regulations on swap position limits take effect?

Mr. GENSLER. The spot month limits that are on certain futures will take effect, but the ones that relate to swaps we need to finalize that further definition, as the Senator says, and that is probably several months away.

Senator COBURN. Yes, it is not going to take effect—there are no limits on a swap until you have defined a “swap.” Is that what you are telling me?

Mr. GENSLER. That is generally correct. There are some exceptions because in a law passed in 2008 around significant price discovery contracts, there are some in natural gas, but—we do have some.

Senator COBURN. So there is not going to be any position limits enforced by the CFTC until the definition of what a swap is is out, with the exception of what you described in—

Mr. GENSLER. That is generally correct.

Senator COBURN. All right. You already have position limits for legacy contracts, correct?

Mr. GENSLER. That is correct.

Senator COBURN. And is cotton No. 2 one of those?

Mr. GENSLER. Yes, sir.

Senator COBURN. And yet cotton hit 16 record-setting prices in the last 12 months, did it not?

Mr. GENSLER. If that is the number you have, sir, I trust the number.

Senator COBURN. Did the position limits in place prevent wheat, corn, and soybean volatility in 2007 and 2008?

Mr. GENSLER. We are not a price-setting agency. I think that position limits are to help ensure the integrity of markets, that no one party has an outsized or concentrated position in the markets.

Senator COBURN. I know, but the reason I ask the question is the panel before you, based on these new methods of trading, outside of true commodity users and people who are hedging, the implication was that the price is on the way up regardless of supply-demand, essentially, unless extreme supply-demand differences. And yet in wheat, corn, and soybeans, from 2007 to 2008, we saw tremendous price increases, yet we had position limits on them. We saw a tremendous increase in volatility. And I agree with you, you are not in the position to control price. You are in the position to create transparent and stable markets.

Mr. GENSLER. We agree on that.

Senator COBURN. So the point I am making is we had position limits on those commodities, yet we saw tremendous swings, tremendous increased speculation, and tremendous increased volatility. So my point is we are not necessarily going to change pricing, which was our testimony of the first panel, that the bias is for an increased price, that there are no real market forces in the long term to drive price the other way on the other side of the trading with position limits. The whole goal for position limits is to make sure not anybody is manipulating the market, correct?

Mr. GENSLER. I think that it is—in my own words, we are not a price-setting agency. It is to ensure that the price discovery function has integrity, and that is integrity against manipulation, but also, as the agency has for decades, that there is not concentrated parties that can distort on the way down or distort on the way up, just that there is a diversity of actors. There are more actors on a stage, there is more competition in the market, less likely that one party distorts the market.

Senator COBURN. But you would agree that the prices on corn, soybeans, and wheat had good price integrity during this period of increased volatility, increased speculation? I mean, corn is still at \$6.40 a bushel. Three years ago it was at \$3. There is nothing wrong with that pricing mechanism, is there? It worked.

Mr. GENSLER. Well, in some of these there are issues about the pricing mechanism with regard to convergence, which was an earlier hearing, in the wheat markets.

Senator COBURN. Right.

Mr. GENSLER. And there is still very much focus—

Senator COBURN. You mean in terms of the close-out month.

Mr. GENSLER. The close-out month, and there are very serious issues still in a couple of contracts that we watch on a very regular basis. We also look in closed-door sessions at surveillance and look at issues of enforcement matters. I do not want to ever say that there are not things that we look at on a very regular, intensive way.

Senator COBURN. I appreciate that.

Mr. GENSLER. But I think I share your view that position limits are about—I believe our whole regime, position limits, anti-manipulation, transparency, and the other rules we have, is to ensure for the integrity of markets and the price discovery. It is not about whether prices should be higher or lower.

Senator COBURN. Right.

Mr. GENSLER. It is to allow the markets to come together and these hedgers and speculators to meet in this market.

Senator COBURN. Yes. I want to thank you for your testimony, also for your service. I will have some additional questions for the record, if you would not mind responding to those.

Mr. GENSLER. I would look forward to it and meeting with you at any time.

Senator COBURN. And I would just re-emphasize my worry, Mr. Chairman. If this is not a global regulatory scheme on commodity pricing, what you have done will have no significant effect. This is a global market. We live in a global world in terms of commerce, and what we will do in our attempt to do something good, we will actually hurt our country, hurt a lot of jobs that are employed in the commodities exchanges and trading in this country, and what we are going to do is shift it, like we have the medical device industry, to Europe or to Singapore.

Senator LEVIN. Would you agree, Mr. Gensler, that the goal of making our markets more transparent and greater integrity is an attraction to investors?

Mr. GENSLER. I do.

Senator LEVIN. And so even if other markets do not have integrity that we do, do not have transparency that we do, do not follow rules that help a market have integrity, that those markets are not necessarily going to be attracting investors; they may be, as a matter of fact, putting investors off that want markets that have integrity. Would you agree with that?

Mr. GENSLER. I do. Market participants want to come to deep pools of liquidity where a lot of other actors are, where no one party can control the market—and in that regard I think position limits help—and where there is market integrity and when there is a cop on the beat.

Senator LEVIN. And removing a cop on the beat is what we tried before, and we saw the result of it with the 2008 problem that we had. Would you agree with that?

Mr. GENSLER. I think that was certainly part of it. There are a lot of other reasons as well, of course.

Senator LEVIN. There are good reasons to have a global regime. I happen to agree with that. But we want to have markets that have integrity, investor confidence, even if markets in other places do not, and rather than money flowing out, we are going to have money flowing into a market that has integrity if it is competing

with markets that do not have integrity, do not have the kind of transparency, do not have the kind of anti-manipulation regulators in place.

Mr. GENSLER. I agree with that, but if I might add, I also think that market integrity helps protect the taxpayers against some of the bailouts that so unfortunately our public had to face in 2008 and unfortunately then Europe is struggling with now.

Senator LEVIN. I think we all would agree with that. There are a lot of reasons for assuring market integrity.

Would you agree with me, without having to go back and read the Dodd-Frank Act, that the CFTC is allowed to prohibit foreign countries from installing trading terminals here in the United States unless they have similar position limits?

Mr. GENSLER. Yes.

Senator LEVIN. So you can use that authority to level the playing field. Is that correct?

Mr. GENSLER. Yes.

Senator LEVIN. On the question of mutual funds, we have an existing law which says that for certain tax benefits, mutual funds can invest no more than 10 percent in alternative investments, including in commodities. Alternative investments meaning alternatives to investments in securities. Mutual funds are getting around this 10-percent limit in one of two ways, both of which have been so far approved by the IRS but which the IRS is now reviewing. One, they are investing in commodity-related ETPs which qualify as securities; and, two, some mutual funds have established offshore entities that they use to invest in commodities, doing indirectly what they cannot do directly by creating shell corporations offshore which they control.

Now, we have identified in Exhibit 7,¹ 40 mutual funds whose primary focus is to invest in commodities, adding tens of billions of dollars of additional speculative pressures on commodity prices. What is your understanding of the extent to which mutual funds are active in commodity markets now, either directly through ETPs or indirectly through offshore shell entities?

Mr. GENSLER. Well, I think this is an excellent exhibit for the public and for us as well. But this is part of that other number, the \$250 billion or so that is in our monthly reports on commodity index investment. So this is a piece of that larger pie.

Senator LEVIN. My staff is saying that they are not a subset; they are an overlap here.

Mr. GENSLER. It is not a perfect subset; that is correct. There is some overlap because the way that we collect that data is not this entire universe. We collect that data through swap dealers and some large index investors. So there is an overlap, which I think it would take a bit of research to see what the extent of the overlap is. When I meant "part of this," it might make it 280 or 290, but it is part of the same overall investment piece.

We did propose something earlier this year—it could have been late in December of last year—which we have yet to finalize, which is with regard to certain exemptions that were granted, I think in 2003, for commodity pool operators and whether they file with us

¹ See Exhibit No. 7 which appears in the Appendix on page 185.

as a commodity pool operator that also relates to some of these exemptions that you are referring to in the mutual fund area. And we actually proposed revising and in some cases repealing them—this is Section 4.5—that would, if we were to finalize it, I think give us greater transparency as an agency. It just means they are filing their financials. But it still is a helpful piece to have them file as a commodity pool operator, some that had been getting exemptions for their offshore pieces.

Senator LEVIN. All right. So you are looking at eliminating that exemption.

Mr. GENSLER. We have actually proposed that exemption from 2003 with regard to certain Section 4.5, so to speak, entities.

Senator LEVIN. All right. So as I understand it, these offshore affiliates of mutual funds that do not now have to register as commodity pool operators with you, even if they market themselves to investors as commodity funds and actually operate a commodity pool. This is allowed because of Rule 4.5, which is a regulation exempting them from the registration requirement on the ground that they are subsidiaries of mutual funds which are regulated by the SEC. And so the question that you are addressing, as I understand your testimony, is given their exclusive or primary activity in the commodity markets, they are going to have to register? Is that correct?

Mr. GENSLER. Well, we have not yet finalized the rule, and we have a lot of comments. We have had mutual funds come in and remind us, “Well, we do not have to file right now.” I would say they did not remind me. I did not quite know that we had somehow missed this in 2003. But they were exempted in 2003. We proposed revising and repealing in certain parts that, and we are looking at how to finalize it. The mutual fund companies have a point of view, and they have expressed it in their comment letters.

Senator LEVIN. Is there a proposed rule change then that you have published?

Mr. GENSLER. Yes. I am sorry, in the *Federal Register*, I think, last December or January.

Senator LEVIN. So when is that due to be finalized?

Mr. GENSLER. I would think in the first quarter.

Senator LEVIN. All right. Getting back to Dr. Coburn’s important question about a definition of “swap,” his point is you are going to have to define “swap” before the new rule affecting swaps comes into place. And I could not agree with him more.

My understanding is that your definition is due to be published fairly soon. Is that not true?

Mr. GENSLER. That is true. It is a joint rule with the SEC, and we are sorting through a lot of things. We also had the events of MF Global this week, as the news reports, that we were doing some other things, Chairman Mary Schapiro and I.

Senator LEVIN. But is it fair to say that we could expect that definition this month or no later than the end of this year? Is that fair?

Mr. GENSLER. It would be every bit my hope, but I would say this to be transparent: The next joint rule with the SEC that is in our docket is the joint swap dealer definition, and these are the two definitional things. So we are looking at trying to finalize the

“swap dealer” definition first, and we are very close on that, and then the “swap” and “security-based swap” thereafter. So I would say in the next several months, but I would not say in the next month.

Senator LEVIN. But it is clear that it has to be defined before the rule takes effect using the word which needs to be defined.

Mr. GENSLER. Yes, though it was——

Senator LEVIN. I think that is what Dr. Coburn——

Mr. GENSLER. No, I am agreeing with both of you.

Senator LEVIN. I think that is what his point was. It is obvious, isn't it?

Mr. GENSLER. It is interesting. Congress actually defined the word “swap” and then said we were supposed to “further define” it. So it is all in this, what does it mean, “further define.”

Senator LEVIN. Well, that is what regulators do. We adopt laws and you guys implement it, and in your discretion you further define things. Isn't that your function to do that? We have a law, in the Dodd-Frank Act, which says you are supposed to “set limits to the maximum extent practicable” in your discretion—the limits would be in your discretion—to “prevent excessive speculation.” That is what we say, “prevent excessive speculation.” But what is the maximum extent practicable? You have got discretion to determine that; isn't that just your ordinary function?

Mr. GENSLER. Right. So we will finalize—one of the reasons I say that, I think most people know what 2-year interest rate swap is.

Senator LEVIN. All right. My time is up. Dr. Coburn.

Senator COBURN. I am going to send you some questions on MF Global just simply because here we now have a regulatory scheme. If, in fact, it is true investor money was used inappropriately, that is a regulatory concern for me. I am very interested in how in the world did that get past you all, how it got past the SEC. Here we now have a new regulatory scheme. We have done a lot of changing since what happened in 2007 and 2008, and it is concerning that we have another company that has just potentially blatantly violated the rules. So I will send you some letters on that.¹

Again, I thank you for your service. You do not have an easy job. You have a tough budget. I understand that. It is not going to get any better, the budget. The job is probably not going to get any better either, but I appreciate the work of you and your staff, and I am concerned about the challenge to this rule. I hope you do not end up spending a lot of time in court defending it because of some of the lack of definition.

Mr. GENSLER. I appreciate your advice, your questions, and it is an honor to be in this job. It truly is. And I think it is about protecting the taxpayers and promoting these markets, and as relates to MF Global, and all companies, protecting customers. I said—and I will repeat it because you were not in the room at the time—that I think at the core of our regime is customer money, the sanctity of it. It is supposed to be segregated. It is sort of like you do not put your hand in the cash register. You just do not. It is the customer's money, and it is supposed to be there every nanosecond of the day, segregated.

¹ See Exhibit No. 13 which appears in the Appendix on page 309.

Senator COBURN. Thank you. Thank you, Mr. Chairman.

Senator LEVIN. I think we all agree on that, by the way. Thank you, Dr. Coburn. There may be some disagreements on some subjects, but when it comes to protecting the taxpayer, we are going to take steps to do that, and that is going to require regulators being put back on the beat. We are going to protect the taxpayers from companies that are too big to fail. We are going to try to make sure we take steps that we do not see the taxpayers bailing out companies again. The issue, as I understand it, with the fund that went bankrupt is that the customers may have gotten injured by improper activity, or they may have gotten injured by taking risks. But to me, it is your function to help protect customers of that hedge fund, but it is doubly important that we understand that there is no taxpayer liability here that you know of.

Mr. GENSLER. This is an example of freedom to fail, and I was part of that decision set of putting it into bankruptcy, and no taxpayer money is behind this at all.

Senator LEVIN. If there was improper activity here that impacted their customers and their clients, that needs to be taken up as well.

Mr. GENSLER. We are going to fully pursue this.

Senator LEVIN. We are, but it is a very different issue from the battles which we have been waging here to try to protect taxpayers and the Treasury from companies that are too big to fail, either getting bailed out or going under and there being some kind of a governmental obligation. That is not the case here, thank God, but what may be the case here is something which should not be allowed to happen either because we do not want customers to be either defrauded or to be improperly dealt with. We do not know that is the case here, but we have cops on the beat to help prevent that as well, and you folks are into it.

On the high-frequency trader, we have CFTC data showing that up to 80 percent of trading in key futures markets is day trades or trading around the expiration of contracts. The day trading is conducted in part by high-frequency traders that use computers to engage in rapid-fire trades, usually profiting from slight price increases over a brief period of time. Do you believe that this day-trading activity is adding to the volatility in the commodity markets?

Mr. GENSLER. I think that there are a number of things that have changed in our marketplace, and you have addressed one important one. What was once day trading in a sense on the floor of the futures market or even the floor of the securities markets is now in a computer group, and it is called high-frequency trading. I think that while in calm markets they can—and there are studies that have shown they can—even narrow the difference between the bids and the offers and, so to speak—narrow the big-offer spread, that in times that are not so calm, like a year and a half ago on May 6, 2010, they can sometimes step away from a marketplace, and the liquidity—sometimes people confuse volume in a market for liquidity. And they have added greatly to the volume in the market. It is not clear that at all times they are adding to liquidity in the market.

So we have come forward with proposals. These are not final rules, but we have proposed that exchanges and clearinghouses have to have new pre-trade risk filters and pre-trade risk controls with regard to protecting the markets and the integrity of the markets better in these circumstances.

Senator LEVIN. There has been some discussion here this morning about position limits not applying to the multicommodity swaps. You have made that distinction. These are extremely common in the commodities markets. Some of our earlier witnesses did not know why you made that distinction. Why did you?

Mr. GENSLER. I would say a number of reasons. One, if I might say because you mentioned it, the Goldman Sachs Commodity Index, there is actually a futures commodity, that index, on CME, and they do have a position limit, a hard 10,000-contract limit. So we addressed ourselves to that is not the only reason, but that is one reason. But what we addressed ourselves to is these 28 individual commodities and trying to reimpose or bring back in the energy and metals markets where there had not been for all months combined, and trying to sort through a really significant docket with regard to what Congress mandated to do.

The commodity index is not really about the corner and squeeze issue in the same way because it is an index across many products and you cannot deliver oil or wheat or corn into the commodity index. It is an index. It is not—has the same delivery function. So I think given the full docket of trying to take on the 28, given that the exchange actually right now does have this limit on this one contract, and that it is less about the spot month and the delivery period, these are some of the factors that influenced us. It is also something we can still take up. I mean, it is not that we cannot take it up.

Senator LEVIN. Do you expect you will take that up?

Mr. GENSLER. I do not know, sir, just given the full docket of what we are doing, and also we are supposed to report back to Congress in a year as to how the current regime is working.

Senator LEVIN. Would it be useful for you to take that up?

Mr. GENSLER. Well, I think there are a number of questions, that plus there are these questions that were raised on the earlier panel and that you have raised about limits across a certain sector and so forth that I think are additional issues that—whether it be in the study that we report back to Congress or otherwise, are things that many people will continue to review.

Senator LEVIN. You made reference to the mutual fund industry's effort to eliminate the 10-percent restriction on alternative investments, in particular because they want to increase the percentage of their portfolio investments in commodities. They did not succeed in that bill. I am glad for that and had something to do with that, but in any event, they are trying to apparently continue their efforts to remove that restriction.

What would be the impact in your estimation as to the amount of speculation in commodity markets if that 10-percent restriction on mutual funds' alternative investments was removed?

Mr. GENSLER. I do not have a developed view.

Senator LEVIN. Do you have a hunch as to whether it would increase speculation?

Mr. GENSLER. I frankly——

Senator LEVIN. That is why they want to get it removed, so would you think that if that is their motive in getting it removed that it would have the effect they seek, which is that they would be able to speculate more than 10 percent of their funds in the commodities markets?

Mr. GENSLER. Well, it would open up a broader class of investors in the marketplace or broader class of speculators, but I just will pause there and say I am just not familiar enough with the provision that they were seeking to pull——

Senator LEVIN. Are you familiar with the 10-percent limit on alternative investments that mutual funds have?

Mr. GENSLER. I mean, just generally, but I am not familiar with what they are trying to change.

Senator LEVIN. They are trying to get rid of it.

Mr. GENSLER. They are trying to get rid of it, so it would broaden the class of potential speculators.

Senator LEVIN. A hundred percent of \$11 trillion could go into speculation in commodities if they so chose.

Mr. GENSLER. So some of these ratios that we had earlier could go up. There would be more financial actors.

Senator LEVIN. Do you have an opinion as to whether or not if they got rid of that limit and there is now a possibility of \$11 trillion getting into speculation in commodities, whether or not, in fact, there would be a significant increase in mutual funds' purchase of those investments or betting on commodities? Do you think there would be an increase? You do not have an opinion on it?

Mr. GENSLER. I just have not developed a view. I mean, this is the first discussion I have had on it. I am glad to look at it and come back and meet with you or at the least——

Senator LEVIN. No, you do not have to do that. I would just ask you that question for the record so you can discuss that with your staff as to whether the elimination of that 10-percent limit on mutual fund purchases and investments so that they could invest more than 10 percent of their funds in commodity speculation, whether or not that would have an increase—whether there would be an increase in speculation in commodities. That is my question. You can take that for the record.¹

Mr. GENSLER. It certainly would expand the pool of parties that could invest.

Senator LEVIN. How about the amount of money that would be or could be invested?

Mr. GENSLER. It would expand the pool of money.

Senator LEVIN. But you do not have an opinion as to whether it would lead to that?

Mr. GENSLER. I have not talked to any mutual funds. I am not familiar with the——

Senator LEVIN. Could you get yourself familiar with us and let us know?

Mr. GENSLER. Sure. I will try my best.

¹ See Exhibit No. 12 which appears in the Appendix on page 308.

Senator LEVIN. For the record—I assume if you try your best that we can count on you to give us an answer for the record to that question.¹

Mr. GENSLER. Yes, of course.

Senator LEVIN. Well, we thank you. It has been a long morning. You have a huge amount on your plate, and you are doing the very best that you can to follow the congressional wishes and intent, which are the wishes of our people, to get a cop back on the beat, and Wall Street needs it big time. And you are one of the folks that can bring it back. We hope you do it with gusto, and we will stand adjourned.

Mr. GENSLER. Thank you.

[Whereupon, at 12:08 p.m., the Subcommittee was adjourned.]

A P P E N D I X

**Opening Statement of Senator Carl Levin
Before
U.S. Senate Permanent Subcommittee on Investigations
Hearing On
Excessive Speculation and Compliance with the Dodd-Frank Act**

November 3, 2011

Over the past 9 years, this Subcommittee has held a series of hearings on the problem of excessive speculation in the commodity markets. For years now, commodity markets have taken the American people on an expensive and damaging roller coaster ride with rapidly changing prices for crude oil, gasoline, natural gas, heating oil, airline fuel, wheat, copper, and many other commodities. Commodity prices have whipsawed American families, farms, and businesses, run roughshod over supply and demand factors, and made our economic recovery that much harder and more chaotic.

Unstable commodity prices are a key reason why Congress enacted, as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act, new statutory requirements to put a lid on excessive speculation and price manipulation. Congress enacted the new law, not only to protect consumers and businesses from unreasonable prices – prices disconnected from the usual supply and demand discipline of the marketplace – but also to protect the commodity markets themselves from losing investor confidence and looking more like a casino or rigged game than a marketplace where supply and demand determine prices.

Purpose of Commodities Markets. Commodities markets are not stock markets. Stock markets are intended to attract investors to provide new capital for U.S. businesses to invest and grow.

Commodity markets serve a different function. Their purpose is not to attract investors, but to enable producers and users of physical commodities to arrive at market-driven prices for those goods and hedge their price risks over time. Prices are intended to reflect supply and demand for the actual commodities being traded. Speculators, who by definition don't plan to use the commodities they trade, but profit from the changing prices, are needed only insofar as they supply the liquidity needed for producers and users to hedge their risks.

Another big difference between stock and commodity markets involves trading limits. Stock markets don't have them, but U.S. commodity markets have been using trading limits to varying degrees for over 70 years to combat excessive speculation and price manipulation.

Federal law has long authorized the Commodity Futures Trading Commission (CFTC) and U.S. commodity exchanges to impose so-called "position limits" to prevent individual traders from holding more than a specified number of futures contracts at a specified time, such as during the close of the so-called "spot month" when a futures contract expires, and buyers and sellers have to settle up financially or through the physical delivery of commodities. Position limits help ensure commodity traders cannot exercise undue market power, such as by cornering the market.

Speculation Explosion. The primary problem afflicting U.S. commodity markets today is an explosion of speculators who, instead of facilitating, have now come to dominate commodity trading, overriding normal supply and demand factors, distorting prices, and increasing price volatility.

That explosion began in large part less than ten years ago, with the rise of commodity index funds that enable participants to bet on the rise or fall in commodity prices. Commodity index funds are operated by swap dealers that enter into swap contracts with clients seeking to make speculative bets on commodity prices. Those clients typically bet that prices will go up and take the long side of the swap. The swap dealers take the short side of the swap and, to offset the financial risk, typically purchase long futures contracts. As the funds grew, commodity index swap dealers became regular purchasers of massive numbers of futures contracts for crude oil, natural gas, wheat, and other commodities. According to CFTC data, as shown in this chart, Exhibit 1a, commodity index investors and swap dealers have spent about \$300 billion in 2011 alone, mostly on long futures and swap contracts.

Because of the key role they play in commodity speculation, we should take a moment to explain how commodity index trading works. Commodity indexes are mathematical constructs whose value is calculated according to the value assigned to a specified basket of futures contracts, which can include agricultural, energy, and metal commodities. When the selected futures prices go up, the value of the index goes up. When the futures prices go down, the index value goes down. Speculators don't invest directly in the index, since it is nothing more than a number. Instead, they buy financial instruments -- typically swaps -- whose value is linked to the index. In essence, by buying these financial instruments, speculators place bets on whether the index value will go up or down.

Speculators often place those bets with a swap dealer, usually by entering into a swap contract whose value is linked to a specified commodity index. The swap dealer charges a fee for entering into the swap, and then effectively holds the other side of the bet from the client placing the speculative bet. When the index value goes up, the client makes money from the swap. When the index value goes down, the swap dealer makes money.

Most swap dealers, however, don't like to gamble and instead typically hedge their bets by buying the futures contracts on which the relevant index is based. Then if their side of the swap bet loses value, they offset the loss with the increased value of the futures they've purchased. By holding both the short side of the swap and the long side of the futures contracts upon which the swap is based, swap dealers are protected from financial risk whether futures prices go up or down. While they are not themselves speculators, they facilitate and act as a pass-through for the speculative bets placed by their clients, making money off the swap fees. At the same time, swap dealers' interests are fundamentally different from commodity producers and users, in that they are not interested in commodity prices as a business cost; they care only about buying futures to offset the financial risk attached to taking the short side of the swaps sold to their clients.

Sometimes referred to as "massive passives," commodity index funds have created a massive, ongoing demand for futures contracts unconnected to normal supply and demand for

the underlying commodities. Their steady purchases have created an artificial demand for futures contracts. In addition, the more index funds and their swap dealers push to buy long future contracts and outnumber the speculators seeking to buy shorts, the more their buying pressure, by the very nature of supply and demand, will drive up the price of the long contracts. The resulting higher futures prices then translate all too often into higher prices for the underlying commodities, in part because so many of the contracts for the underlying commodities use futures prices as the commodity selling prices. In those cases, higher futures prices translate directly into higher costs for consumers of the commodities. That's why so many American consumers and businesses continue to condemn the speculative money that commodity index funds bring to the commodity markets.

Commodity related Exchange Traded Products (ETPs) have added further fuel to the speculative fire. Hearing Exhibit 6 lists some of the many ETPs which offer securities that track the value of a designated commodity or basket of commodities, but trade like stocks on an exchange. ETPs are marketed to investors looking to make money off commodity price changes without actually buying any futures. The financial firms running the ETPs often support the value of the fund by purchasing commodity futures or using futures to offset risks. The result, as shown in this chart, Exhibit 1b, is that in 2011 alone, ETPs have poured over \$120 billion of speculative money into U.S. commodity markets.

That's not all. A third wave of commodity speculation has come from the \$11 trillion mutual fund industry which, since 2006, has turned its attention to U.S. commodities in a big way. Exhibit 7a identifies more than 40 commodity related mutual funds that, by 2011, as shown in this chart, Exhibit 1c, have accumulated assets of over \$50 billion. The sales materials from some of those mutual funds, included in Exhibit 7b, show that they are marketing themselves to average investors as commodity funds and delving into every kind of commodity investment out there, from swaps to futures, putting additional speculative pressures on commodity prices.

By law, mutual funds are supposed to derive 90% of their income from investments in securities and not more than 10% from alternatives like commodities. But the 40 commodity related mutual funds we've identified have found ways around that restriction by, among other steps, setting up offshore shell companies that do nothing but trade commodities.

Those offshore shells are typically organized as Cayman Island subsidiaries with no offices or employees of their own, and with their commodity portfolios run from the mutual fund's U.S. offices. This blatant end-run around the 90/10 restriction has nevertheless been blessed by the IRS which has issued dozens of private letter rulings, listed in Exhibit 7(d), deeming the offshore arrangements to be investments in securities rather than commodities, since the parent mutual funds hold all of the stock of their offshore subsidiaries. The IRS has recently put a moratorium on those private letter rulings while it studies the issues. In addition, the offshore shells are currently exempt from CFTC registration requirements, despite operating as commodity pools, a situation the CFTC is reviewing as a result of a petition filed by the National Futures Association, as indicated in Exhibit 7c.

I'm glad the IRS and CFTC are studying these offshore arrangements as well as the broader issue of mutual fund investment in commodities. If the mutual fund industry were to step up its commodities investments to even 10% of its overall assets, it would unleash another tidal wave of speculative money into the markets.

There's more. Over the last few years, high frequency traders have also invaded the commodity markets, seeking to profit from the increasing price volatility. They have revved up commodity trading with day trading strategies that further contribute to constantly changing prices.

Put together the swap dealers, hedge funds, ETPs, mutual funds, and high frequency traders, and the result is a tsunami of speculative money pouring into commodity markets at unprecedented levels. Today, speculators make up the bulk of the outstanding contracts in most commodity markets, providing typically more than 70% of the market. Producers and users of commodities now hold as little as 20 or 30% of the outstanding contracts in some markets. So it is no surprise that commodity prices have become increasingly volatile, with exaggerated swings that have little to do with hedging, little to do with supply and demand for the underlying commodities, and everything to do with folks betting and speculating on price changes.

Take the U.S. crude oil market as an example. In 2007, a barrel of crude oil started out the year costing \$50, but by the end of the year, had nearly doubled in price. In 2008, oil prices shot up in July to over \$145 per barrel and then, by the end of the year, crashed to \$35. In the beginning of 2011, oil prices took off again, climbing to over \$110 per barrel in May. Then they fell to a low of \$77 per barrel in early October, a drop of more than 30% over four months. Three weeks later, they are back up to \$92 per barrel, a 15% increase. This price volatility has taken place at the same time that world inventories were plentiful and basically matched world demand, as shown in this chart prepared for the Subcommittee by the Energy Information Agency, Exhibit 1d. In other words, the price changes in West Texas Intermediate, the benchmark crude oil contract for the United States, can't be explained simply as a function of supply and demand for oil.

During the same period crude oil prices went haywire, speculators have become the dominant players in the crude oil market. CFTC data indicates that speculators – traders who do not produce oil or use oil in their business – now hold over 80% of the outstanding contracts in the oil futures market. While speculation isn't necessarily the primary factor setting oil prices, the facts indicate that it is now a major contributor.

It's not just the numbers telling this story. Major players in the oil industry also point to the role of speculation in crude oil prices. For example, in May 2011, ExxonMobil CEO Rex Tillerson agreed that speculation was contributing to oil prices, estimating that the price of a barrel would be \$60 to \$70, instead of \$110, if governed exclusively by supply and demand.

The same complaint is heard with respect to other commodities. Recently, 450 economists from around the world stated in a joint letter to the G20 leaders, which we include in the hearing record as Exhibit 9: "Excessive financial speculation is contributing to increasing volatility and record high food prices exacerbating global hunger and poverty." The CEO of Starbucks, Howard Schultz, who tracks coffee prices, had this to say:

“[W]hy are coffee prices going up? [A]nd in addition to that, why is every commodity price going up at the same time? ... I think what's going on is financial engineering; that financial speculators have come into the commodity markets and drove these prices up to historic levels and as a result of that the consumer is suffering.”

Excessive speculation is not new. In fact, much of the law related to commodity markets can be understood as an effort to prevent excessive speculation and market manipulation from distorting prices.

Over the years, one of the most powerful weapons developed to combat the twin threats of excessive speculation and price manipulation has been the imposition of position limits on traders. But over the years, federal position limits have lost much of their punch due to a growing raft of loopholes, gaps, and exemptions. For example, prior to the Dodd-Frank Act, position limits didn't apply to some key futures contracts; they often applied only in the spot month, instead of other times; and multiple market participants were given exemptions. In addition, until recently, the entire commodity swaps market had no position limits at all.

The combination of increased speculation and weakened position limits has clobbered American consumers and businesses with unpredictable and inflated commodity prices. That's why, when Congress enacted the Dodd-Frank Act last year, Section 737 directed the CFTC to establish position limits on all types of commodity-related instruments, including futures, options, and swaps. The Dodd-Frank Act also directed the CFTC to issue a rule establishing the new position limits by January 2011, one of the earliest implementation dates in the entire law.

The CFTC missed that deadline, but two weeks ago, after reviewing over 15,000 public comments, at long last issued a final rule. The good news is that the agency complied with the law's requirements to establish position limits to “diminish, eliminate, or prevent” excessive speculation, and rejected unfounded claims that excessive speculation had to be proven for each commodity before a limit could be established to prevent damage to consumers and the economy. That has never been the law, and it has no basis in the Dodd-Frank Act which is aimed at preventing problems, not waiting for them to occur and cleaning up afterwards.

Also good news is that the CFTC rule applies position limits to 28 key agricultural, metal, and energy commodities; applies those limits to futures, options, and swaps; and covers all types of speculators.

The bad news, from my perspective, is that while the limits appear designed to prevent any one trader from amassing a huge position that could lead to price manipulation in a particular month, the limits do not appear to be designed to combat the type of excessive speculation caused by large numbers of speculative investment funds. In addition, exempting multi-commodity index swaps from any position limits, failing to apply effective position limits to commodity index swap dealers, and delaying implementation of the swap position limits for another year are troubling.

Roller coaster commodity prices and the growing flood of speculative dollars continue, while it will be another year before the full range of position limits in the new CFTC rule take effect. In the meantime, we are talking about ongoing gyrations in gasoline prices, heating and electricity costs, and food prices that affect every American family. We're talking about

unstable prices for copper, aluminum, and other materials essential to industry. At stake are energy, metal, and food costs key to inflation, business costs, and family budgets nationwide.

Until effective position limits are actually in place, the American economy will remain vulnerable to chaotic price swings that benefit speculators at the expense of American consumers and businesses.

Today's hearing is intended to shine a spotlight on the ongoing role of speculation in U.S. commodity markets and how the new position limits can combat excessive speculation. We will hear today from a panel of experts representing business, consumers, and academia, as well from CFTC Chairman Gary Gensler. But before that, I invite our Ranking Member, Dr. Coburn, to share his views.

**Opening Statement of Senator Tom Coburn, Ranking Member
Hearing of the Senate Permanent Subcommittee on Investigations
“Excessive Speculation and Compliance with the Dodd-Frank Act”
November 3, 2011**

I would like to thank Senator Levin for holding this important hearing today. He has been a leader for years in Congress’ efforts to better understand and monitor Commodity markets, which in turn make us more able to hold market regulators accountable in their efforts to ensure American exchanges remain the most dynamic, transparent, and desirable places to do business.

Commodity markets and pricing have profound effects on the people in my home state of Oklahoma, who are invested in virtually all of the commodities covered by the rules we will discuss today. Whether it is oil, natural gas, wheat, or any of the other twenty-eight commodities, market participants all the way from producer to end-user will be affected by recent and upcoming regulatory changes.

It is our obligation in Congress to make sure regulators act in the public interest, based on facts and data, rather than reflexively placing restrictions on unpopular market participants. While today’s hearing will focus on the concept of “excessive” speculation, it is imperative that we remember the fundamental truth, that futures markets **can not function without speculators who make markets, provide liquidity for hedgers, aid in price discovery, and take on risk.**

Two weeks ago, the Commodity Futures Trading Commission issued its long-awaited “position limits” rule, imposing limits on the number of futures contracts individuals or institutions can hold. Passed by a strictly party-line vote, the most recent version of the rule was rushed through the Commission and applied across the board to twenty-eight separate commodities. Much of this seems to have been done in response to intense political pressure, and the unfortunate result is likely to be a challenge in court.

In addressing commodities, the Dodd-Frank Act said the CFTC “shall by rule, regulation, or order establish limits on the amount of positions, **as appropriate.**” In at least two Commissioners’ views, those tests have not been met. Yet, now every participant in the commodities market must comply with a final rule that is over three-hundred pages long.

Commissioner O’Malia indicated in his dissenting opinion that the commission voted “**without the benefit of performing an objective factual analysis based on the necessary data** to determine whether these particular limits and limit formulas will effectively prevent or deter excessive speculation.”¹

Commissioner Sommers also worried that the CFTC “is setting itself up for an enormous failure” by issuing a position limits rule that “ironically, can result in increased costs to consumers.”²

¹ Dissenting opinion of Commissioner Scott O’Malia. October 18, 2011.

² Dissenting opinion of Commissioner Jill E. Sommers. October 18, 2011.

Position limits can be an effective regulatory tool, but must be used in the right way. For example, we have limits on cotton, yet the cotton number 2 futures contract has hit sixteen record-setting prices since December 1, 2010.

Position limits, if they are determined to be appropriate, must be set at the proper level for each individual commodity. Unfortunately, the CFTC chose the blunt weapon of across-the-board limits for nearly every commodity.

While today's hearing will be a good opportunity to discuss the effects of 'excessive' speculation, we need to be careful not to accuse investors of wrongdoing when none has occurred. Commodity index funds, exchange traded funds, and mutual funds are not diabolical schemes – they are simply financial instruments that some investors use as tools to hedge or gain exposure to commodity markets, thus protecting against inflation and other risks in their portfolios.

Lastly, I would like to address my strong concerns with the Dodd-Frank Act in general, which itself was rushed through Congress last year. The law that was supposed to help fix our financial system has instead wreaked regulatory havoc, increasing uncertainty and compliance costs, doing nothing to address unemployment. The act required over three-hundred new regulations and studies, and has overwhelmed our regulatory agencies, while causing widespread confusion in the marketplace.

As we move forward, we in Congress must improve our understanding of the markets being regulated, as well as the internal and external challenges facing our regulators. Continuous oversight and transparency through hearings like this are essential to ensure our regulators do not overreach their mandates, and that U.S. markets remain the envy of the world. The last thing we want to do is suffocate those markets and chase interested participants to other exchanges and trading venues abroad, many of whom would love nothing more than to take America's business.

Despite my concerns about Dodd-Frank, it must be implemented in a thoughtful, responsible manner by our regulators. I look forward to a healthy discussion at this hearing, Mr. Chairman. I thank our witnesses for attending, and I look forward to hearing your views and recommendations today.

Testimony of
Paul N. Cicio
Industrial Energy Consumers of America
Senate Permanent Subcommittee on Investigations
“Commodity Futures Trading Commission Proposal to
Implement Speculation Position Limits for Futures”
November 3, 2011
Washington, DC

Chairman Levin, Ranking Member Coburn and Subcommittee Members, thank you for the opportunity to testify before you.

My name is Paul Cicio and I am the President of the Industrial Energy Consumers of America (IECA) a non-profit non-partisan association of leading manufacturing companies with \$700 billion in annual sales and with more than 750,000 employees nationwide. It is an organization created to promote the interests of manufacturing companies through advocacy, and collaboration for which the availability, use and cost of energy, power or feedstock play a significant role in their ability to compete in domestic and world markets. IECA membership represents a diverse set of industries including: plastics, cement, paper, food processing, brick, chemicals, fertilizer, insulation, steel, glass, industrial gases, pharmaceutical, aluminum and brewing.

IECA has been a long time supporter of setting responsible speculative position limits. Levels of speculation and volatility have increased at an alarming rate in the commodities futures markets over the last eleven years.

For illustration, in 1998, physical hedgers represented 77 percent of the market, traditional speculators were 16 percent and index speculators were 7 percent. In 2008, physical hedgers were only 31 percent, while traditional speculators rose to 28 percent and index speculators rose to 41 percent of the total.

The futures market is special and unlike any other. It was created to serve the needs of buyers and sellers of consumable commodities and the managing of financial risk associated with these transactions.

Prior to year 2000, these markets worked well with prices reflecting the underlying supply versus demand of the physical commodity. Since then, the volume traded by speculators, especially passive speculators, has increased so significantly that it negatively impacts price discovery and has transformed this market from a "commodity" to an "asset" class investment. Unfortunately, the dollar inflows of these investments is now estimated at about \$300 billion and growing.

As an asset class investment, the retail investor doesn't really care about the supply or demand of the underlying commodity. Their priority is that they have made an investment in an area that diversifies their investment assets. And, when they invest in these passive index funds, the fund rolls the current month position to the next month without any regard to the price of the commodity. They are completely insensitive to price.

The distinction could not be greater. A well functioning market whose price reflects the supply and demand of the commodity is critical. Consumers like ourselves "must" buy

and depend upon this market to competitively produce the products that our customers require.

We need speculative position limits in all consumable commodity derivatives markets that will significantly reduce speculator dominance.

Questions Posed by the Subcommittee:

1. Please describe the extent to which excessive speculation has affected the price of oil and other commodities and the extent to which price increases or volatility have harmed members of your association, and provide specific examples where possible.

As manufacturers who compete globally, the cost of energy commodities that are used as a fuel or feedstock are very important to maintaining competitiveness and jobs. Some of our companies also purchase and hedge agricultural commodity products. IECA began to get concerned about the commodities markets in the 2002-2003 time period when our energy managers noticed that the natural gas market was changing rapidly, becoming more volatile.

What we found is ever increasing levels of non-commercial trading. As a reminder to the Subcommittee, physical hedgers are not traders. Physical hedgers consume the equivalent product that they hedge or more. So, when there is increasing non-commercial volumes and there is no commercial physical hedgers to trade with, speculators end up trading with other speculators.

Volumes of trades continue to increase even though volumes of natural gas consumption remain relatively low. For example, natural gas open interest in 1995 averaged about 169,000 contracts per month and in 2011 increased to about 997,000 contracts per month, a 590 percent increase even though U.S. consumption increased during that same time period by about only 6.5 percent.

Small speculative trading volumes are not a problem. Large volumes can be a problem because they can move the market price and increase volatility. For example, chart 1 on page 7 illustrates how only four traders controlled about 50 percent of the open interest in natural gas. That means that only a handful of companies can have an incredibly big role in what we pay for that commodity. Saying it another way, if these four companies decide to go long (herding) and prices rise, a handful of companies could be richly rewarded at the expense of every consumer of natural gas in the country. That is a lot of market power in the hands of few.

2. Please provide specific examples of how price volatility in the oil and other commodity markets has adversely impacted any of your members from hedging their risk in the futures market.

Speculative trading volume that outsize's the underlying commodity volume can create price volatility because traders end up trading with traders, not physical hedgers. This type of trading has little to do with the serving the function of hedging by producers and consumers of the commodity - which is the reason we have a commodity futures market. Speculators want volatility because it provides greater opportunities to profit. It is for that reason that banks and traders oppose speculative position limits.

High volatility increases costs:

For example, high volatility will increase the price of an option. There is a direct relationship between volatility and the option price premium. The higher the volatility - the higher the option premium. The higher premium increases the cost of hedging which may be a reason that fewer companies are hedging. Higher volatility also increases the bid-ask spread in the forward market. Because of the increased uncertainty, physical hedgers pay higher prices.

The more movement in price, the more volume trades occur on both sides of the transaction. The banks/funds sit in the middle and make the bid/ask spread. Because they sit in the middle and by holding such large positions, they can create volatility and increase profits.

Example of How Volatility Increases Costs

Using the closing Henry Hub Index price of natural gas on Friday, October 28, 2011 of \$4.04 per mm Btu, a call option for 100,000 MM Btus with a six month expiration of May 2012 at the money would cost \$36,498.50. The information below shows the increase in cost of that option (leaving all other parameters fixed) if the implied volatility increases.

Increases in Implied Volatility	Percent Increase in Premium
+5%	15%
+10%	31%
+15%	46%
+20%	61%

Higher margin requirement:

Volatility could result in a manufacturer's receiving a margin call on their hedged position and require the company to post higher levels of capital. This reduces working capital needed to operate the business.

Hedged price does not reflect fundamentals of supply and demand:

What makes the futures market different than all other markets is that the price of the underlying commodity should reflect the supply versus demand of the commodity. High levels of speculative volume results in traders speculating with other traders. When that happens, physical hedgers end up locking in prices that may not necessarily represent the underlying supply and demand. As a result, they could pay more for their product.

3. Please provide your views on the CFTC's proposed rule and any final rule issued prior to the hearing to establish position limits for certain commodity futures and option contracts, and equivalent commodity swaps.

The CFTC's recently released rule sets a speculative position limit at 25 percent of the estimated deliverable supply. It is too large and will do little to reduce excessive speculation. The CFTC rule also set a time frame for review or change in the level of the speculative position limits at every two years. This is not frequent enough and should be evaluated yearly. The CFTC should also have the ability to act anytime there is unusual volatility that is impacting the price of a commodity to the detriment of consumers.

The commodity futures market is different and special than any other market. It is a market created by producers and consumers to hedge price risk or purchase or sell the commodity. Unlike stocks and bonds, commodities are physical products that homeowners rely upon to feed their families, provide gasoline for their cars and heat and cool their homes. Manufacturers rely upon commodity futures for fuels, feedstock and a host of other commodities that we consume. We do not trade commodities.

The point is, what happens to the price of commodities has direct implications to real people in direct terms, not in theoretical terms. It is essential that policy makers place a high priority on ensuring that the futures commodity market works effectively and to the benefit of the producers and consumers of the underlying commodity – and not speculators.

Speculators play an important role of providing liquidity. However, the speculator's sole goal is to make money – lots of it – from commodity trading. Their fiduciary responsibility is to company profits and they do not care what impact their actions have on the price of food or fuel for U.S. citizens or manufacturing competitiveness.

The futures markets were not created to serve the interests of traders, banks, hedge funds, sovereign funds, index funds, pension funds and retail investors. It is for all of these reasons that without responsible restraints, speculators can and will take unfair advantage of everyone that consumes commodities.

The speculative position limit allows each speculator to control as much as 25 percent of the deliverable supply of the commodity, this is too large and will do nothing to reduce excessive speculation.

Illustration of Implication of 25 Percent Speculative Limit

Let's put in perspective what setting speculative position limits at 25 percent mean by looking at natural gas. Annual consumption in 2010 per month was 1,843,735 mm cubic feet. Twenty five percent would equal 460,933 mm cubic feet. There is an estimated 350 to 450 traders who report from time to time to the CFTC Large Trader Report. For purposes of simplicity, we will assume that only 100 traders will trade the limit. If so, traders/speculators will control 46,093,300 mm cubic feet or 25 times U.S. monthly demand. Two hundred traders would control 50 times the U.S. monthly demand. Three hundred traders would control 75 times the U.S. monthly demand and so on. All the while, the volume of producer and consumer volume traded will not change much at all and be dwarfed by speculative volume and potential volatility.

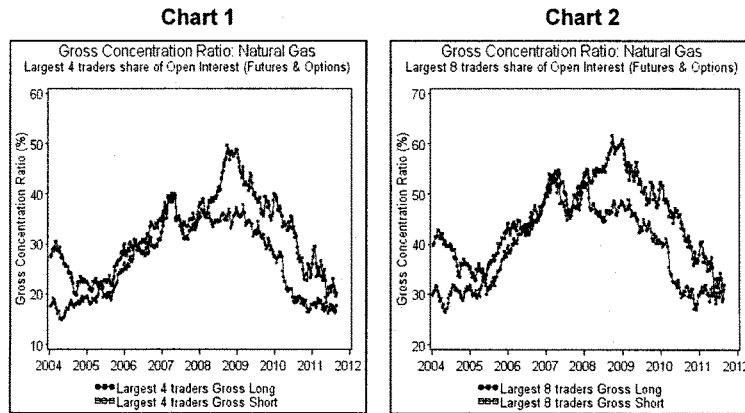
For example, if the physical market has plenty of supply versus demand, prices should remain in a relatively narrow trading range. Today's natural gas market is a good example. This narrow trading range is not as attractive for speculators as compared to other commodities because it is harder for them to make a profit.

The reverse is true if the physical market is in balance or if there is a perceived potential shortage. It is under these conditions that the high speculative position limits become lethal for consumers but not producers of the product. If prices rise, producers of the commodity benefit. Without exception, when there is a perceived short fall, speculative volumes and volatility increase. The number of speculative trades increases as do the number of traders. Combined, all of these factors drive up consumer commodity prices. It is under these conditions that tight speculative limits are needed.

Wall Street argues that speculative limits reduce liquidity. There has never been a case where a physical hedger had difficulty finding a speculator to take the other side of their position. What Wall Street is really saying is that speculative limits impact their trading and could potentially limit their profit generation.

Both of the CFTC charts below illustrates why speculative position limits at lower levels are needed. Chart 1 shows that the four largest traders controlled 50 percent of the short and 40 percent of the long futures and option open interest for natural gas during

2008 when commodity prices spiked. Chart 2 shows that the eight largest traders controlled 60 percent of the short and over 50 percent of the long futures and option open interest for natural gas.



4. Please provide your views concerning the CFTC's justification in postponing the establishment of positions limits for single month limits and all-months-combined limits until after a significant period of data analysis on physical commodity swaps.

We do not see a justification for not setting speculative position limits for single months and all-months combined – especially at the large speculative limit of 25% of deliverable supply.

5. Please describe the impact of commodity index funds and commodity-related exchange traded funds (ETFs) on commodity prices, and whether position limits ought to apply to swap dealers and ETF managers attempting to hedge their positions in the futures, options, or commodity swap markets.

Passive speculators should be banned from the futures market. At minimum, they should be subjected to individual speculative position limits. The next best action is to set speculative position limits on all commodity related ETFs and index funds. Swap dealers and ETF managers should be subject to speculative position limits except for hedges associated with transactions with producers and consumers of the commodity.

CFTC began reporting index investment data for natural gas on December 31, 2007. The data shows that index funds held a "long" position 82.6% of the time and only held "short" positions 17.4% of the time which confirms that index funds put upward pressure

on prices. The relationship between longs and shorts has remained relatively steady but the volumes continue to increase. Total open interest in December of 2007 was 194,000 contracts and in September of 2011 contracts increased to 571,000, a 294 percent increase.

Active traditional speculators add beneficial liquidity to the market by selling and buying with the objective of creating a profit. This is constructive until they control substantial volumes that damage price discovery and increase volatility. Passive speculators reduce liquidity by buying and then holding larger and larger quantities of futures contracts. They act as consumers who never take delivery of the commodity so the volumes continue to pile up. Their volumes are moved forward to the next month, every month, getting theoretically larger and larger. This is inconsistent with the functioning of a futures market that serves "consumable" commodities that have a prompt month that expires.

The objective of the passive investor is also inconsistent with a consumable futures product. We use it for price determination which impacts our profitability and our viability; they use it to diversify an asset class portfolio.

They do not care what the price of the underlying commodity is, we do. They buy regardless of whatever the price is. If the price goes up, they buy. If the price goes down, they buy. This means that their growing volumes of commodity purchases, without regard to supply and demand will impact the price that "we" and every homeowner and farmer will pay. If the American public fully understood how these passive speculative funds impact the cost of heating and cooling their homes, driving their cars and feeding their families, they would be outraged.

Passive commodity funds also publically communicate when they will roll their positions from the current month to the following month. Funds like the United States Natural Gas Fund (UNG), post the days that they will roll their positions from one month to another on their website. This is something that no producer, consumer or traditional speculator would do. Again, that is not how the futures market was created to work and damages price discovery.

Because passive index funds that include a basket of commodities and or single commodity passive funds like the United States Natural Gas Fund (USG) all predictably roll their futures positions forward in the exact same manner each month, should be subject to the position limit of a single person. Collectively, these funds outsize all other market participants, and as a result, can have market power.

The Commodity Exchange Act (CEA) says that "such limits upon positions and trading shall apply to positions held by, and trading done by, two or more persons acting pursuant to an expressed or implied agreement or understanding, the same as if the

position were held by, or the trading were done by, a single person." It appears to us that this CEA provision applies to passive funds. These funds all have written publically available documentation that describes the fund's methodology.

The CFTC appears to already have the authority to take action to prevent a single speculator or class of speculators from damaging these markets.

Thank-you.



Testimony of Tyson Slocum, Director

Public Citizen's Energy Program

Excessive Speculation & Compliance with the Dodd-Frank Act, Permanent Subcommittee on Investigations, U.S. Senate Committee on Homeland Security & Governmental Affairs

November 3, 2011

I am Tyson Slocum, Director of Public Citizen's Energy Program. Public Citizen celebrates its 40th Anniversary in 2011, and we advocate on behalf of our more than 250,000 members and supporters across the country for policies that provide households access to clean, reliable and affordable energy.

The occasion of this hearing is prompted by recent CFTC rules implementing Dodd-Frank instructions on curbing excessive speculation in energy commodity markets. These rules, long delayed, are the product of a sharply divided Commission and, while they will improve the wild west feature of these markets, simply do not go far enough to protect consumers. My testimony will review how excessive speculation by financial and energy corporation traders have pushed prices beyond the supply-demand fundamentals, and what additional steps Congress must take to protect households from high prices.

Public Citizen recommends the following reforms to address the harmful impact excessive speculation has for families:

- Enhance position limits – as articulated in S.1598 and HR 3006. This legislation not only defines excessive speculation, but establishes a statutory 5% position limit level. This statutory threshold provides greater certainty and better establishes strong consumer protections into law.
- Restrict communication between petroleum energy infrastructure affiliates and trading affiliates. A starting place for legislation could be 18 CFR §358,¹ which limits communications between natural gas pipeline and energy trading affiliates. Such rules do not exist for petroleum product pipelines/storage, and need to be.

¹ http://ecfr.gpoaccess.gov/cgi/t/text/text-idx?c=ecfr&tpl=/ecfrbrowse/Title18/18cfr358_main_02.tpl



- Improve trading market data disclosure by publishing trader-specific positions. This summer Public Citizen worked with the office of Senator Bernie Sanders to help make public trader-specific energy trading position data. Regular public disclosure of such data is essential for market transparency and to educate the public on who the individual traders are who help set energy prices.
- Modify SEC disclosure to require companies to detail energy trading activities in their financial reporting. Currently, companies are under no obligation to disclose commodity-specific information on their volumes, prices, or profits from energy trading.
- Impose financial disincentives to speculate, including the establishment of a Financial Transaction Tax or disallow favorable capital gains tax treatment for energy commodity trading (such as S.1588 from the 111th Congress).
- Disallow index funds and mutual funds from investing directly or indirectly (thru ETFs) from commodity markets.

Background

Despite flattening demand in industrialized countries due to the economic recession and ample global supplies and storage, world oil prices remain stubbornly high. Of course, longer-term trends do give some justification for higher prices than during the 1990s: easy- to-access and cheaper-to-produce, conventional oil fields are declining in production, leaving more expensive deepwater, oil shale and tar sands to fill in the gaps. Combine this with the US economy's continued reliance on oil consumption, and it is clear that Congress must take aggressive steps to detach our dependence on oil through the promotion of alternative fuels (namely the electrification of the transportation sector), greater sustainable planning of our communities, investments in distributed renewable e generation and investments in building energy efficiency.

But despite these longer-term trends, it is clear that oil prices have distanced themselves from the supply-demand fundamentals. The Commodity Futures Modernization Act of 2000 deregulated energy trading, undermining CFTC authority over broad swaths of the market and ushering an explosion in volume in unregulated OTC markets and underregulated electronic exchanges, or Exempt Commercial Markets (ECMs)—as evidenced by one such entity, ICE, which operates both as an ECM as an OTC market operator. ICE's electronic exchange volume increased 826% from 2004 to 2010 (from 35 million contracts to 329 million) and the company's OTC platform has seen volume grow 976%, from 31 million contracts in 2004 to 333 million in 2010.²

The bulk of the “speculators” are financial institutions, such as Goldman Sachs, JP Morgan Chase/Bear Stearns, Morgan Stanley and Bank of America/Merrill Lynch. Such firms have

² www.sec.gov/Archives/edgar/data/1174746/000119312511028245/d10k.htm The founding members of ICE include Goldman Sachs, BP, Shell and TotalFinaElf.



turned energy markets into lucrative profit centers for the firms, taking full advantage of the lack of regulatory oversight over their operations to maximize market power and control information. Specifically, banks dominate energy trading markets through their role as swaps dealers and as managers of index funds, which facilitates successful proprietary trading operations.

Index funds, which provide payments or shares based on the price movement of a basket of different commodities. These index funds purchase large volumes of commodity futures contracts in the OTC market on behalf of institutional investors and wealthy individuals and then typically seek hedge exemptions from regulated exchanges like NYMEX to purchase an offsetting portfolio of futures contracts to hedge their exposure in the OTC markets. Similarly, many of these same investment banks that operate index funds also function as swaps dealers, purchasing contracts on behalf of clients and then requesting similar hedge exemptions in regulated exchanges.

Dodd-Frank

On July 21, 2010, President Barack Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act into law. On that occasion, he declared that the reforms passed Congress despite “the furious lobbying of an array of powerful interest groups...[the legislation will] rein in the abuse and excess that nearly brought down our financial system. It will finally bring transparency to the kinds of complex and risky transactions that helped trigger the financial crisis...for these new rules to be effective, regulators will have to be vigilant...in the end, our financial system only works—our market is only free—when there are clear rules and basic safeguards that prevent abuse, that check excess...and that’s what these reforms are designed to achieve—no more, no less. Because that’s how we will ensure that our economy works for consumers.”³

Congress passed the Dodd-Frank Act, including mandatory position limits, with the understanding that unregulated derivatives play a significant role in encouraging excessive speculation on the part of Wall Street banks. Such speculation increases prices paid by households for staple goods such as food and gasoline, and also increases systemic risks to the financial system.

Section 737 of Dodd-Frank orders that the CFTC “shall by rule, regulation, or order establish limits on the amount of positions, as appropriate, other than bona fide hedge positions, that may be held by any person with respect to contracts of sale for future delivery or with respect to options on the contracts or commodities traded on or subject to the rules of a designated contract

³ www.whitehouse.gov/the-press-office/remarks-president-signing-dodd-frank-wall-street-reform-and-consumer-protection-act



market...[in order] to diminish, eliminate, or prevent excessive speculation...[and] to deter and prevent market manipulation, squeezes, and corners.”

Lobbyists for industry and some CFTC commissioners question whether the language mandates that the CFTC impose position limits or whether it provides some discretion. We believe the language cannot be clearer. The Commission is required to establish position limits as Congress intentionally used the word, “shall,” to impose the mandatory obligation.

Congress made the express decision to change the permissive language in an earlier version of the Wall Street Reform and Consumer Protection Act to a mandate. When the House version of the bill was introduced on December 2, 2009, Section 3113 on Position Limits stated: “The Commission may, by rule or regulation, establish limits (including related hedge exemption provisions) on the aggregate number or amount of positions in contracts based upon the same underlying commodity (as defined by the Commission) that may be held by any person, including any group or class of traders[.]” However, before the Act passed the House, the word “may” was replaced by “shall” pursuant to an amendment proposed by former House Agriculture Committee Chairman Collin Peterson. This language was incorporated into the bill, survived the conference negotiations, and was eventually enacted into law.

Not only did Congress mandate position limits, it specified the goals position limits were to fulfill. Section 4a(a)(3) of the Commodities and Exchange Act states that position limits shall serve to:

Diminish, eliminate or prevent excessive speculation as described under this section; Deter and prevent market manipulation, squeezes, and corners; Ensure sufficient market liquidity for bona fide hedgers; and Ensure that the price discovery function of the underlying market is not disrupted.

Note that this statement explicitly lists the prevention of excessive speculation and the protection of market price discovery as separate goals from the deterrence of direct market manipulation such as squeezes and corners. This indicates that Congress intended position limits to reduce the overall role of speculation in the market, not simply prevent direct market manipulation by individual traders.

Speculation Documentation



In our comments submitted to the CFTC on the position limits rulemaking, we summarize several studies finding that excessive speculation in energy commodity markets has increased prices to consumers.⁴ An excellent report by Dr. Mark Cooper of the Consumer Federation of America⁵ documents that speculation adds \$600 to the average family's gasoline expenditures for 2011 – heaping harm on an already troubled economy, and discusses how recent correlations between the cost of acquiring and refining crude oil and the market price have become detached in recent years as deregulation and speculative money have flooded the market. Jeff Rubin explains how high oil prices likely served as the trigger for the 2008 financial downturn.⁶

One Wall Street bank, Citigroup, was forced to divest its highly lucrative commodity trading division, Phibro, in 2009 (selling it to Occidental) after reports that the head of the unit's oil trading desk, John Hall, was due a \$100 million bonus triggered by the massive profits made speculating on crude oil during the record price run-up.

Better Markets establishes, after reviewing nearly 30 years of data, that the explosion of index funds into the market in just the last few years has pushed prices beyond the supply-demand fundamentals.⁷ Recent investigations, most notably one conducted by this Committee⁸ conclude that index funds are a major source of harmful speculation in commodity markets, resulting in higher prices to end consumers and reducing the ability of legitimate hedgers to manage their risk.

For example, Goldman Sachs operates the GSCI index fund, which held more than \$1.5 billion in assets as of June 30, 2011.⁹ At the end of 2010, nearly 2/3 of the 24 different commodities comprising the GSCI index are energy commodities, with agricultural commodities representing 22.6% and metals the remaining 11.4%. As of January 30, 2011, there were 49,120 entities which owned shares of GSCI – up from just 135 just 2 years earlier.

In the summer of 2006, Goldman Sachs announced it was radically changing its GSCI index's weighting of gasoline futures, selling about \$6 billion worth. As a direct result of this weighting

⁴ <http://ourfinancialsecurity.org/blogs/wp-content/ourfinancialsecurity.org/uploads/2011/03/AFR-CFTC-Position-Limits-Comment-Letter-3-28-11.pdf>

⁵ www.consumerfed.org/pdfs/SpeculationReportOctober13.pdf

⁶ http://research.cibcwm.com/economic_public/download/soct08.pdf

⁷ www.bettermarkets.com/reform-news/new-better-markets-research-report-shows-wall-street-driving-food-fuel-prices

⁸ Excessive Speculation in the Wheat Market, Majority & Minority Staff Report, Permanent Subcommittee on Investigations, June 24, 2009.

http://hsgac.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=fb439667-dcd3-4025-b95b-1b91f8ea29d1

⁹ www.sec.gov/Archives/edgar/data/1332174/000119312511214416/d10q.htm



change and sale, Goldman Sachs unilaterally caused gasoline futures prices to fall nearly 10 percent.¹⁰

Energy Infrastructure Affiliate Abuse Potential

Energy traders like Goldman Sachs are investing and acquiring energy infrastructure assets because controlling pipelines and storage facilities affords their energy trading affiliates an “insider’s peek” into the physical movements of energy products unavailable to other energy traders. *The Wall Street Journal* reported that financial speculators were snapping up leasing rights in Cushing, Ok.¹¹ Armed with this non-public data, a company like Goldman Sachs most certainly will open lines of communication between the affiliates operating pipelines and the affiliates making large bets on energy futures markets. Without strong firewalls prohibiting such communications, consumers would be susceptible to price-gouging by energy trading affiliates.

In January 2007, Highbridge Capital Management, a hedge fund controlled by JP Morgan Chase, bought a stake in an energy unit of Louis Dreyfus Group to expand its oil and natural gas trading. Glenn Dubin, co-founder of Highbridge, said that owning physical energy assets like pipelines and storage facilities was crucial to investing in the business: “That gives you a very important information advantage. You’re not just screen-trading financial products.”¹²

And in a story about leaked documents detailing Chevron’s \$360 million profit from energy trading in the first half of 2011, *The Wall Street Journal* reported that “companies’ traders take advantage of their inside view of the oil market to place speculative bets on the direction of prices. Commodities markets such as crude oil are not subject to the strict insider trading rules that govern equities trading.”¹³

Indeed, such an “information advantage” played a key role in allowing BP’s energy traders to manipulate the entire U.S. propane market. In October 2007, the company paid \$303 million to settle allegations that the company’s energy trading affiliate used the company’s huge control over transportation and storage to allow the energy trading affiliate to exploit information about energy moving through BP’s infrastructure to manipulate the market.¹⁴

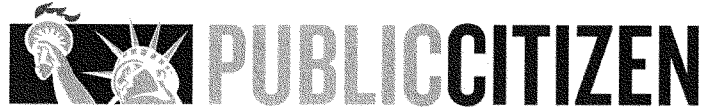
¹⁰ Heather Timmons, “Change in Goldman Index Played Role in Gasoline Price Drop,” *The New York Times*, September 30, 2006

¹¹ Ann Davis, “Where Has All The Oil Gone?” October 6, 2007, Page A1.

¹² Saijel Kishan and Jenny Strasburg, “Highbridge Capital Buys Stake in Louis Dreyfus Unit,” *Bloomberg*, January 8, 2007, www.bloomberg.com/apps/news?pid=newsarchive&sid=aBnQy1botdFo

¹³ Brian Baskin & Ben Lefebvre, “Chevron’s Email ‘Oops’ Reveals Energy Giant’s Sway Over Markets,” July 16, 2011, <http://online.wsj.com/article/SB10001424052702304521304576448202801087220.html>

¹⁴ www.cftc.gov/PressRoom/PressReleases/pr5405-07



BP is not alone. This Committee noted that a Morgan Stanley energy trader, Olav Refvik—"a key part of one of the most profitable energy-trading operations in the world...helped the bank dominate the heating oil market by locking up New Jersey storage tank farms adjacent to New York Harbor."¹⁵ Morgan Stanley committed \$313 million to lease petroleum storage facilities for this year alone. As the company notes: "In connection with its commodities business, the Company enters into operating leases for both crude oil and refined products storage and for vessel charters."¹⁶

In January 2009, investment banks like Morgan Stanley and Citigroup were the leaders in keeping 80 million barrels of oil in storage in tankers at sea—nearly enough oil to supply the world for a day.¹⁷

The Wall Street Journal suggested that the bankruptcy of a single firm, SemGroup, served as the initial trigger of crude oil's price collapse this summer. The company operated 1,200 miles of oil pipelines and held 15 million barrels of crude storage capacity, but was misleading regulators and its own investors on the extent of its hedging practices. Data suggests that SemGroup was taking out positions far in excess of its physical delivery commitments, becoming a pure speculator. When its bets turned sour, the company was forced to declare bankruptcy.¹⁸

This shows that the energy traders were actively engaging the physical infrastructure affiliates in an effort to glean information helpful for market manipulation strategies. And it is important to note that BP's market manipulation strategy was extremely aggressive and blatant, and regulators were tipped off to it by an internal whistleblower. A more subtle manipulation effort could easily evade detection by federal regulators, making it all the more important to establish firewalls between energy assets affiliates and energy trading affiliates to prevent any undue communication between the units.

In August 2006, Goldman Sachs, AIG and Carlyle/Riverstone announced the \$22 billion acquisition of Kinder Morgan, Inc., which controls 67,000 miles of crude oil, refined products and natural gas pipelines, in addition to 150 storage terminals, thanks in part to last month's

¹⁵ http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=109_cong_senate_committee_prints&docid=f:28640.pdf, page 26.

¹⁶ www.sec.gov/Archives/edgar/data/895421/000119312511050049/d10k.htm

¹⁷ Alaric Nightingale, "Morgan Stanley Hires Supertanker to Store Oil in Gulf," January 19, 2009, www.bloomberg.com/apps/news?pid=newsarchive&sid=albVHft2R3SE

¹⁸ Brian Baskin, "SemGroup Loses Bets on Oil; Hedging Tactics Coincide With Ebb in Price of Crude," July 24, 2008, Page C14



\$37.8 billion acquisition of El Paso Corp.¹⁹ Goldman has two managing partners on Kinder's Board.

Prior to this huge purchase, Goldman Sachs had already assembled a long list of oil and gas investments. In 2005, Goldman Sachs and private equity firm Kelso & Co. bought a 112,000 barrels/day oil refinery in Kansas operated by CVR Energy, and entered into an oil supply agreement with J. Aron, Goldman's energy trading subsidiary. Just days ago CVR Energy announced it would acquire a 70,000 barrel per day refinery in Oklahoma.²⁰

In December 2005, Goldman and Carlyle/Riverstone together invested \$500 million in Cobalt International Energy, an oil exploration firm run by former Unocal executives, and Goldman has two members on the Board.²¹

Goldman's Fixed Income, Currency and Commodities unit represented 53% of the company's revenues for the first half of 2011 (\$10.2 billion of \$19.2 billion), helping the company to enjoy \$2.5 billion in pre-tax earnings for this division.²²

Public Citizen Reforms

- The 25% threshold in the CFTC's final position limits rule is simply too high. Based on the data released by the office of Senator Bernie Sanders this summer, it appears as though the top 4 financial firms (Goldman Sachs, Vitol, Morgan Stanley, Barclays and Deutsche Bank) trading WTI crude on a single day in June 2008 (just as prices were spiking to an all-time high of \$147/barrel) each held long positions of between 5.3% and 8.7% of the outstanding contracts. As a result, Public Citizen endorses S.1598/HR 3006 which establishes a statutory position limit of 5%.
- Our documentation of major investments by financial firms with proprietary trading into owning or controlling energy infrastructure assets requires Congress to restrict communication between petroleum energy infrastructure affiliates and trading affiliates. A starting place for legislation could be 18 CFR §358,²³ which limits communications between natural gas pipeline and energy trading affiliates. Such rules do not exist for petroleum product pipelines/storage, and need to be.

¹⁹ www.bloomberg.com/news/2011-10-16/kinder-to-buy-el-paso-for-21-1-billion-making-biggest-u-s-pipe-company.html

²⁰ <http://phx.corporate-ir.net/phoenix.zhtml?c=203637&p=irol-newsArticle&ID=1625296>

²¹ www.cobaltintl.com/about-us/corporate-governance/board-of-directors

²² www2.goldmansachs.com/investor-relations/financials/current/10q/10-q-2q-2011.pdf

²³ http://ecfr.gpoaccess.gov/cgi/t/text/text-idx?c=ecfr&tpl=/ecfrbrowse/Title18/18cfr358_main_02.tpl



- Improve trading market data disclosure by publishing trader-specific positions. This summer Public Citizen worked with the office of Senator Bernie Sanders to help make public trader-specific energy trading position data. Regular public disclosure of such data is essential for market transparency and to educate the public on who the individual traders are who help set energy prices. We support a time delay in the release of such information to protect genuine proprietary concerns, but concealing such data from the public indefinitely simply aides the banks' control over a non-transparent market.
- Modify SEC disclosure to require companies to detail energy trading activities in their financial reporting. Currently, companies are under no obligation to disclose commodity-specific information on their volumes, prices, or profits from energy trading. Public revelation of such data will help shareholders and the general public assess the role and risks associated with firms' investments and income from commodity trading.
- Impose financial disincentives to speculate, including the establishment of a Financial Transaction Tax or disallow favorable capital gains tax treatment for energy commodity trading (such as S.1588 from the 111th Congress).
- Disallow index funds and mutual funds from investing directly or indirectly (thru ETFs) from commodity markets.

Testimony of Wallace C. Turbeville, Derivatives Specialist, Better Markets, Inc.
Permanent Subcommittee on Investigations

November 3, 2011

Good morning, Chairman Levin, Ranking member Coburn and Members of the Committee. Thank you for the invitation to Better Markets to testify today.

Better Markets is a nonprofit, nonpartisan organization whose mission is to promote the public interest in the domestic and global capital and commodity markets.

I am Wallace Turbeville and I serve as a Derivatives Specialist for Better Markets. Prior to working for Better Markets, I worked in the securities industry for 31 years, including work as a practicing attorney, as an investment banker at a large swap dealer, and finally managing companies as a principal.

SUMMARY

Your letter dated September 22, 2011 inviting our testimony requested that a number of questions be specifically addressed. (A copy of that letter is attached at the end of this testimony.) Let me begin with a very short answer to each of those questions:

1. Speculation has increased dramatically in the commodity derivatives markets and is excessive. This has caused not only greater price volatility, but has also increased absolute commodities prices in both the futures and physical markets.
2. Over the last ten years, CFTC data has demonstrated that the amount of speculation in the commodities futures markets has increased much faster than *bona fide* hedging. Before this period, commercial producers and purchasers, which are referred to as bona fide hedgers, constituted between 60-70% of the market activity, while speculators were the remainder. Today, those percentages have actually flipped, with speculators now representing a great majority of open interest, roughly 60-70% of most commodities futures markets, while hedgers are in the minority.
3. The CFTC's Final Rule on position limits has several important features and is a good first step, but it must be strengthened in the future if the commodity markets are to serve their dual intended functions of price discovery based on actual supply and demand for the underlying commodities and providing a mechanism for correspondingly appropriate hedging by commercial producers and purchasers. The following provisions in the rule should be particularly beneficial in achieving a position limits regime that will be effective in achieving the legislative goals enshrined in Dodd-Frank:
 - a. The individual trader limits for spot months and non-spot months establish an important principle. Specifically, they respond to the mandate in the Dodd-Frank Act that action be taken to curb speculation in the commodity

markets (though inadequately, as described below). They also incorporate a periodic review of the effectiveness of the level of the limits.

- b. The restriction of the *bona fide* hedge concept to physical hedge interests reflects the purpose for the exemption from position limits. The anticipatory hedging provisions appropriately limit its scope to merchandising, royalties and service contracts, and will properly define *bona fide* hedging so long as it is administered properly as individual circumstances are considered.
- c. The aggregation of trades limiting the account controller exemption to managed customer accounts is a workable regime that can function properly with adequate oversight. While the Proposed Rule was stronger, the loosening of the aggregation rules is at least narrow. This will, on balance, minimize the exception to the aggregation rule.
- d. The rule makes certain that the activities of commodity index fund sponsors, typically a few of the largest swap dealers, are captured in their position calculations and not avoided by irrational netting rules.

After years of hearings, review and consideration, Congress mandated position limits as a prophylactic measure **which did not require a finding by the CFTC that excessive speculation exists**. However, the Final Rule's focus on individual entity limits designed to prevent manipulation by a single trader, while necessary, is not enough. Excessive speculation, a different concept that is highlighted in the recent Dodd-Frank legislation, is not the focus of the Final Rule. This failure to better address excessive speculation is a missed opportunity.

While the limits imposed in the Final Rule could conceivably curb excessive speculation in the market as a whole, they are presently set at too high levels and unlikely to have strong effects. Market-wide limits, and also limits which are targeted at commodity index trading as a class, are what is primarily necessary to eliminate speculative distortions in the market, which include the reduction of price transparency and damage in the price formation process.

Between today and September 2012, the CFTC will gather and analyze trade data on the Over-the-Counter swaps and futures markets for physical commodities. The impact of excessive, market-wide speculation and also commodity index trading will presumably be analyzed and reviewed in this process. The CFTC has the authority to craft limits to be implemented so that these issues are properly addressed. **It must exercise this authority if the ultimate position limits regime is to ensure markets which allow bona fide hedgers to discover fair and reasonable prices and mitigate risk efficiently.**

This and other needed additions and changes to the Final Rule are described in the section below entitled "The CFTC's Position Limits under the Final Rule Must Be Stronger to Be Effective."

The impact of commodity index funds has been determined to cause or amplify boom/bust cycles in commodity prices and to increase those prices overall. The price inefficiencies caused by commodity index fund trading has also attracted other speculators to the market, further increasing the level speculative trading and generating increased volatility. Unfortunately, like many types of "financial innovation",¹ commodity index fund trading actually consumes liquidity and therefore promotes price volatility. Therefore, it's imperative that position limits should apply to swaps dealers financially hedging their commodity index positions as a class, which would significantly reduce this large scale speculation from current levels.

4. The impact of commodity-related exchange traded funds on commodity prices is almost identical to the negative effects of commodity index funds, thus position limits should apply to their activity on a **class basis as well**.
5. Mutual funds represent many trillions of dollars of potential investment into the relatively small commodities markets. An increase of ten percentage points of the maximum commodity-related holdings would represent an unprecedented amount of capital pouring into the much smaller commodity markets. Although research shows that commodity index investments have provided poor returns to their investors, they continue to be very lucrative products to the Wall Street swap dealers who aggressively promote them to large institutional investors. It is therefore very likely that this new source of mutual fund capital would be successfully exploited by dealers strongly motivated to sell lucrative commodity-related products (especially vs. the level of commissions in equity markets). **This would constitute a material additional speculative inflow to the commodity markets and would adversely affect them.** If this is allowed to happen, commodity prices and volatility should be expected to rise, probably quite substantially and detrimentally, hurting investors and consumers around the globe.
6. Commonly used tactics and trading methodologies of high-frequency and algorithmic trading already disrupt and degrade the price discovery functions of the commodity markets. While High Frequency Trading ("HFT") increases volume, greater volume, in this case, does not equal greater liquidity. In fact, when liquidity is most needed because of stressed conditions, HFTs almost uniformly exit the market, accelerating illiquid market conditions and volatility rather than mitigating

¹ Presentation of Dr. Andrei Kirilenko, CFTC Technical Advisory Committee Roundtable, October 12, 2010 available at <http://www.cftc.gov/PressRoom/PressReleases/pr5913-10>.

it.² Rules requiring minimum order durations, minimum position holding times, and/or charges for orders placed and cancelled would greatly benefit investors, the larger market, and the stability of the system as a whole.

The statements and conclusions set forth in the answers above are based on extensive data and analysis by staff at Better Markets, most of which is set forth in the comment letter filed by Better Markets with the CFTC regarding its Proposed Rule on Position Limits (the "Better Markets Comment Letter"), which we incorporate by reference here. (The Letter is available at <http://www.bettermarkets.com/assets/pdf/CL-CFTC-PL-Final.pdf>). I will first briefly mention our referenced data and then discuss the role of commodity index funds, which has developed a great deal since our initial Comment Letter was filed. The data and analysis regarding the role of commodity index is set forth in a Report released by Better Markets on October 14, 2011 (the "Commodity Index Trading Report" which is incorporated by reference here as well: the Report is available at <http://www.bettermarkets.com/reform-news/new-better-markets-research-report-shows-wall-street-driving-food-fuel-prices> and on SSRN at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1945570). I will then conclude with a further discussion of the CFTC's Final Rule regarding position limits.

DISCUSSION

In the last decade, we have witnessed a seismic shift in the worldwide mechanisms for pricing energy and agricultural commodities. This shift coincided with the extensive deregulation of commodities markets and the proliferation of electronic systems by which buyers and sellers of derivatives are matched directly, out of sight of exchanges, clearinghouses, and regulators.

These changes have profoundly affected the way that financial and fundamental forces interact to establish prices paid for gas in Detroit, bread in Tulsa and cereal in Dover, and for most other basic commodities in the global economy. In fact, the advent of commodity index funds, and excessive speculation in general, has significantly distorted the price discovery and hedging function of commodity futures markets. This fact in turn has directly affected physical commodity prices, introducing an independent persistent and upward financial pressure on commodities prices.

Excessive speculation today is increasing costs for virtually every business and consumer throughout the United States. It will likely continue to do so unless an effective position limits regime is put into effect.

The only way to effectively correct these market distortions and restore the commodity markets to their intended purpose is to take the following steps:

- Regulators must impose aggregate, market-wide position limits on excessive speculation.

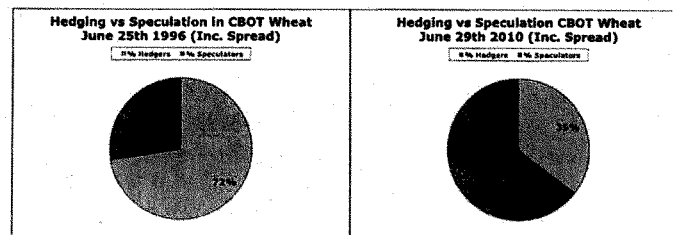
² Cartea, A. and Penalva, J., "Where is the Value in High Frequency Trading," Universidad Carlos II de Madrid, November 2, 2010; Better Markets, Inc., Comment Letter to the CFTC, Core Principles and Other Requirements for Designated Contract Markets, February 22, 2010, available at <http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=27994&SearchText=better%20markets>.

- In particular, limits must be applied to commodity index funds as a group or class.

Speculation in commodity markets has dramatically increased and is excessive

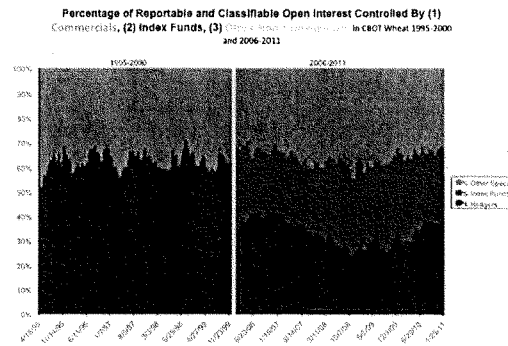
The facts demonstrate that, today, financial speculators have overwhelmed the commodity markets and also driven out many legitimate commercial physical hedgers. Historically, when commodity markets have worked well (i.e., when there is sufficient liquidity and meaningful price discovery for all physical hedgers who want to hedge), physical hedgers have constituted about 70% of the futures market and financial speculators have been the remainder, or about 30% of the market. Today, the ratio of participants has reversed in many commodities markets, with speculators now accounting for about 70% or more of the open interest in some markets while bona fide physical hedgers have declined to only about 30% participation (and much lower in some markets).

The overwhelming importance of these facts can only be realized by understanding the legitimate purpose for commodity markets. In sharp contrast to the much larger capital markets, commodity markets exist only for the purpose of providing a mechanism for producers and purchasers of physical commodities to hedge their risks. Financial speculators are tolerated as commodity market participants solely in order to ensure that physical hedgers have sufficient liquidity for their hedging operations. Recently however, speculation has been allowed to far exceed the levels necessary to facilitate hedging, which has damaged and distorted the commodity markets, and further, increased absolute commodities prices for all commodities consumers.



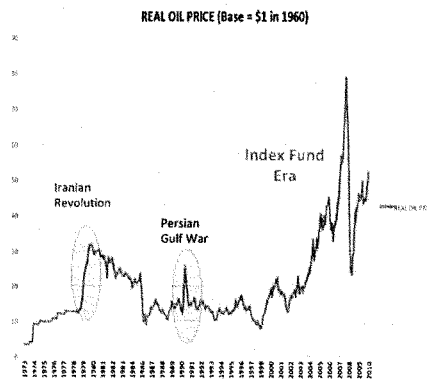
The diagrams above illustrate how the Speculation/Hedging ratios have reversed using the example of CBOT Wheat. (Full size copies of all diagrams are included at the end of this testimony.)

The diagram below shows how commodity index funds have been the force behind most of the increased financial speculation, here using the example of CBOT Wheat.



While I have used wheat as an example here, this type of open interest change is common across many commodities as Better Markets' illustrated in our comment letter and on our website.

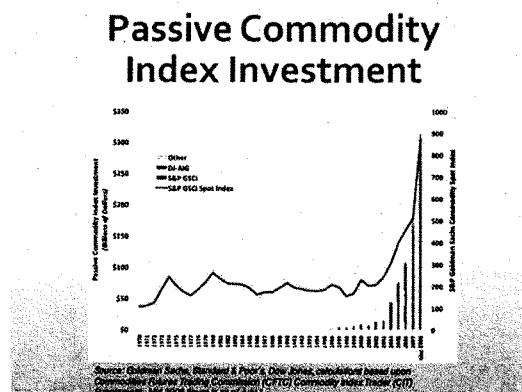
Excessive speculation has caused increased volatility and increased prices in the futures markets



The diagram above illustrates that the volatility and price levels seen since the advent of excessive speculation are unprecedented, here using the example of NYMEX WTI Crude Oil. Note the past effects of significant world events compared to the index fund era today.

Much of this, but certainly not all, has been caused by the creation and explosive growth of commodity index funds

Highly structured commodity index investment vehicles have become dominant forces in the commodities futures markets, with an associated dramatic impact in the physical markets. Commodity index investments were created to synthetically mimic ownership of market baskets of physical commodities valued according to indices derived from futures markets. By far the largest amount of this type of investment is transacted in funds sponsored by some of the largest banks who act as commodities swap dealers in the derivatives market. In past years, these kinds of "investments" were marketed to large institutional investors as "a new asset class" for diversifying investment portfolios (which hasn't turned out to be the case).³ Remarkably, these investors have injected capital estimated to be between \$200- 300 billion into the commodities futures markets over the last several years, with commodities prices not surprisingly rising in tandem, as the chart below highlights:



Commodity index funds are liquidity takers and not liquidity providers, and are depriving bona fide hedgers of sufficient market liquidity...

A common myth concerning index funds is that they "provide liquidity" to the market, thereby fulfilling an important role in providing commercial hedgers with needed counterparties. **However, commodity index funds do not trade on the basis of supply and demand fundamentals or in response to liquidity demands.** Rather, they trade on the basis of investment inflows and the need to perpetually roll contracts forward as they regularly expire.

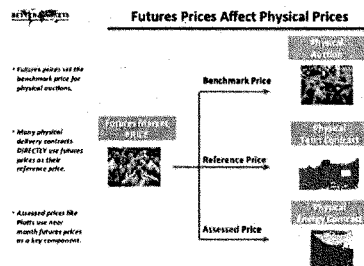
³ See, for example, Javier Blas, "Commodity Indices: Rollover Practice Hits Investors," Financial Times, November 1, 2009, available at <http://www.ft.com/intl/cms/s/0/453764e8-c586-11de-9b3b-00144feab49a.html#axzz1cMIFQSMR>; and Tang, K. (Princeton University) and Xiong, W. (Renmin University) (2010): Index Investment and The Financialization of Commodities, and the related discussion in the Better Markets Position Limits Comment Letter..

In some instances, this may accidentally provide hedging liquidity, but when it does so it is purely a coincidental phenomenon. It turns out that these commodities indexers actually have massive liquidity needs every month due to their need to constantly roll their positions forward in time. Thus, most of the time these giant funds compete directly with hedgers for market liquidity. They are, as a net result, liquidity takers, not liquidity providers, pursuing their investment strategy regardless of price and supply and demand fundamentals, while doing great damage the commodities markets with which they get involved.

Commodity index funds have disrupted the commodities futures and physical markets in ways that distort price discovery and increase commodities prices

Commodity index fund trading and other speculative activities have generated volatility in the commodity markets that is not associated with fundamental supply and demand forces.⁴ This volatility imposes direct costs on businesses legitimately using the markets to manage price risk. **These costs then become a cost of production, directly increasing prices paid by consumers.**

In addition, speculative distortions that contribute to artificially increasing prices of longer dated futures contracts are also directly linked to prices in the physical (or spot) markets. Energy and agricultural commodities are generally priced via contracts or auctions in which the reference price is **the next expiring futures contract price**. Where the futures price is not directly used, "reported prices," such as those published by price reporting services like Platts, are used. These "reported prices" are also calculated via methods that place a great emphasis on nearby futures prices.



Therefore, nearby futures prices have an immediate and direct impact on physical commodities prices. Higher prices and volatility in futures markets, induced by excessive speculation, thus cause **physical** prices to be pushed higher than they would otherwise, while directly passing on the associated futures-led price volatility to physical (spot) commodity markets.

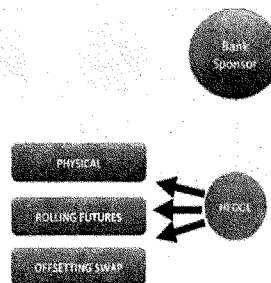
⁴ Fundamental forces refer to the price effects of supply and demand in the context of production and transportation costs and elasticity of demand.

In fact, the claim that futures prices have no impact on physical prices is simply wrong and is only asserted by self-interested entities seeking to continue their speculative activities in these markets-regardless of how much harm they cause.

Commodity Index Trading Distorts Futures Markets and Pushes Prices Up in Futures and Physical Markets

Index investors, often institutional investors managing large and diverse portfolios, often turn the mechanics of commodity index investing over to swap dealer counterparty. Institutional investors generally enter into OTC derivatives with a bank (acting as a swap dealer) that agrees to pay them the return of a market basket of commodities. This is done via a swap designed to be a synthetic replica of a perpetual ownership of that market basket of commodities.

Commodity Index Fund Structure



However, as a result of that swap, the bank acting as swap dealer that sold the swap now has to generate the future return over time of that specific market basket of commodities (which it is obligated to pay to the investor); additionally, it has to make a profit, and it has to protect itself so that its exposure in the commodities markets remains within its desired risk tolerances, which is often done by hedging their financial exposure. Thus, the direct market issue of index funds concerns the swap dealing banks and their trading, rather than the swap purchased by the commodities index investors themselves. The bank swap dealers can hedge precisely by acquiring the futures contracts reflected in the index; or (often) they **can buy and hold physical quantities of the commodities**, speculating on the difference between physical prices and futures prices or they can do a combination of the two. **In fact, through this latter practice, commodities futures prices are arbitrated directly to spot market commodities prices.**⁵

The timing of this bank trading is dictated by the structure of the index and the futures market so that the bank matches its hedge with the notional amount invested under the swap. As a result, the banks' trading occurs at a few pre-set times every month.

⁵ Swap dealers have accumulated large storage capacity for and holdings of physical commodities in recent years.

Moreover, **the banks are largely indifferent to price because futures prices are passed directly through to the investors** (as set forth in the original swap agreement with investors). That's why these investments are often defined as "passive," but they are only passive to the original institutional investors who contracted with the bank (the swap dealer). In sharp contrast, the bank swap dealer that sells the swap is and has to be a very active trader in the futures and physical markets, both to provide the promised return to the investor and crucially for the bank, profit from the sale of its products.

That required trading by swap dealers is the key to understanding how commodity markets have been distorted and why commodity prices have been (and are) subject to significant volatility. The obligation owed by the bank swap dealers to the investor is perpetual. Those banks guaranteed a return to the institutional investor as if the investor owned the commodities market basket until they ultimately sell it (although most institutional investors have bought commodities index products with the idea of buying and holding these investments for many years, if not perpetually). However, futures, like all derivatives, are executory contracts that have fixed terminations. The bank acting as swap dealer must offset its perpetual obligation with the futures contracts that regularly expire. As a result, the bank must repeatedly trade out of all expiring futures and replace them by buying other futures contracts having a later expiration. This is commonly referred to as the "Roll." Like the phoenix, the banks that sell index fund investments destroy the previously created index trades and recreate a new set of trades during each Roll period.

Predictable trading in large amounts always attracts other traders seeking to take advantage of and profit from that trading. It almost is the commodity market equivalent of shooting fish in a barrel. Thus, it should come as no surprise that the Roll is the highlight of the trading month for many other speculative traders since the potential for profit is large and relatively certain.⁶ Commodities index fund traders seem to be the perfect counterparties for others in the markets to exploit:

- The bank swap dealers engaged in index swaps are compelled by the structure of the index funds sponsored by index fund providers like S & P or Dow Jones to trade in the futures markets by selling the current, expiring contract, say October, and buying the next month contract, here November.
- Everyone knows this predictable pattern because the commodity index sponsor trading strategy and data are published publicly.
- The banks, for their part, care little about executed prices because they are just passed through to the institutional investor counterparty as per the original contract with the passive investor (a glaring example of agent vs. principal conflict).
- The trading volumes generated during the roll period are enormous, since the entire invested amount has to be regularly and predictably traded during a short window of time specified by the index fund sponsor.

⁶ See Mou, Y., "Limits to Arbitrage and Commodity Index Investment: Frontrunning the Goldman Roll," Columbia University (2010) and the related discussion in the Better Markets Position Limits Comment Letter.

As would be expected, a trading “ecosystem” has emerged, in which volatility and spread traders feed off of the price dynamics generated by the bank swap dealer index traders (i.e., the “perfect counterparties” to exploit). All of this trading (by the swap dealer banks and the associated trading by those exploiting the banks’ trading on behalf of institutional investors) is purely speculative and represents a significant amount of commodities market speculation. Importantly, this massive amount of trading done by the banks in roll trading amounts is estimated to equivocate to commodity index open interest amounts of between \$200 and \$300 billion. Moreover, an additional significant amount of speculative trading activity is done by other speculators feeding off this index fund roll activity.

Unsurprisingly, all of this speculative trading has changed the shape of the price curve for many commodities, which represent term prices for each commodity futures contract in each month into the future. Given that index traders are constantly and mechanically selling the expiring contract (i.e., October) and buying the next future month (i.e., November), month after month, whether the prices make sense relative to market fundamental forces such as supply and demand or not, longer dated contracts are repeatedly subjected to constant upward price pressure by index fund swap traders.

In fact, the forward commodities price curve is extraordinarily important. When it slopes upward – that is to say the price for the November futures contract is higher than the price for the October futures contract – the futures market is “signaling” to producers and consumers that prices are likely to rise. When it is flat or downward sloping, the corollary message is that prices will likely be stable or fall.

According to economic theories, when the price curve is set in the futures market, the market is perfectly basing its price “opinion” on equally shared and objectively sound information about supply, demand and production and transportation cost. This theoretical worldview is commonly known as the “efficient market hypothesis,” which, though it has been repeatedly and definitively discredited, still lives on among academics, market fundamentalists, and predatory traders like bank swap dealers that promote the claim that their massively profitable trading around the roll (for the agent) has no real impact on markets because markets are always “efficient”, with the actions of large market participants somehow meaningless to price formation.

But, if a price curve is sloping upward because of swap dealers trading the Roll, and thus the trading that happens around the Roll is done for reasons other than supply and demand (i.e., fundamental) information, then in this case the market is sending misleading price signals to other market participants. In fact, it means that a price signal is being sent by the commodities market that prices are on the rise, when fundamental commodity supply and demand dynamics are actually not signaling this situation. Thus, in this case, supply and demand market price information becomes obscured and/or displaced by price formation arising from swap dealers trading on behalf of their institutional investors who are replicating a commodities index, rather than from hedgers trading based on their own views of supply and demand.

Remarkably, prior to 2004, when the commodities indexing trend really took off, the commodities futures forward curve was **actually most often flat or downward sloping, a type of curve called “backwardation”**. **Since that time, however, commodities futures forward price curves have been upwardly sloping far more often than not**, a strong message for most of that period that prices were on the rise (a type of curve called

"contango"). Was this message due to fundamentals, was it influenced by the Roll, was it due to some combination of the two, or was it something else entirely?

In order to answer this important question, Better Markets undertook a study of historical futures price curve dynamics and the commodity index roll framework. In order to examine this closely, please see the Better Markets Commodity Index Trading Report, (available at <http://www.bettermarkets.com/reform-news/new-better-markets-research-report-shows-wall-street-driving-food-fuel-prices>). In this study, the predominant Roll period for each trading month over the last 27 years was isolated. Then any bias (delta) towards an upward sloping curve during each of these Roll periods was measured.

Our research found that before 2004, there was no bias related to what would later become the Roll period, i.e., the time of the month when the bank swap dealers would later roll large volumes of contracts from the expiring month to the future month. However, starting with 2004, this contango bias was much more pronounced. In fact, **the upward price bias in the West Texas Intermediate crude oil futures market was correlated at a 99% level with the Roll.**

Then the data was analyzed at every other 5 day period in every other month over the 27 years. Remarkably, there was no correlation between upward or downward prices for these other periods.

This analysis strongly demonstrates that the forces which signaled increasing prices were **specific** to the Roll period. In fact, **there were no supply and demand events peculiar to that period. As a result, it is clear that Roll trading behavior by swap dealers was the direct cause of the change in the shape of the forward price curve.**

Efficient markets ideologues could try to argue that other traders would have seen this phenomenon and squeezed this curve bias out immediately. However, the data shows that the bias caused by a given Roll persisted for days or weeks, depending on the market. Why didn't arbitrageurs immediately squeeze out the bias? For one thing, the Roll is large and the trading risk to the arbitrageur is very high, due both to the amount of funds required to commit to such a strategy and also the risks that arise from high volatility during the trading period. In this case, it wasn't feasible for the Roll effect to be arbitrated out efficiently by arbitrageurs competing against the much larger swap dealers in the intermediate term and under the extant market conditions. Put another way, it appears that arbitrageurs could only take advantage of the Roll in amounts at acceptable risk levels, which are significantly lower (both for individual arbitrageurs and in sum) than would be necessary to arbitrage out the entire or predominate affect.

However, there is another clear and profound reason other traders didn't arbitrage away the entire curve bias here. Markets are actually driven by the **perception** of fundamental forces, not perfect reference to some definitive supply and demand chart. Market participants generally expect other traders to behave rationally, motivated by the desire to make money. In this case, there is no way for other market players to know whether those traders have better or different information. Moreover, the actual perception of supply and demand information can be altered toward the view that fundamental prices will be on the rise. Arbitrageurs still exist, but the available fundamental information and the quality of the information that drives them is often unclear and/or incomplete. Thus, when the arbitrageurs estimate the price to which the forward curve should be theoretically driven, the large and (apparently rational) trading

activity associated with the Roll influences their perception of fundamental forces, **causing their own price perceptions to change or, at a minimum, seem less certain.**

Moreover, if a swap dealer is trading a commodity index position in which profit and loss is passed through to the investor, it may also be trading the market purely for its own account. Such a dealer enjoys substantial advantages of asymmetrical information in that it will know the amount of index positions and the allocation of hedges between futures and physical positions. Such a dealer is best positioned to trade the Roll for its own account.

The message that prices are on the rise is transmitted to current real prices in many ways, some described above. One of the key reasons is that current prices must rise to induce suppliers to commit product to the market rather than holding back supply.

The market as a whole reacts to the message that prices will rise and a price bubble emerges.

Eventually, fundamental supply and demand forces overcome the trading-driven sentiment that prices will rise. When this finally occurs the speculative bubble bursts.

While Better Markets' staff have not yet been undertaken to measure the cumulative effect of boom and bust cycles driven by Roll trading, **it is obvious that the commodities futures market price discovery function, necessary for businesses to manage their commodities price risk, has been undermined. It is equally obvious that the persistent bias toward higher prices and the dislocations associated with the boom and bust cycle have together adversely affected consumers, who are paying both higher and more volatile prices for commodities as a result of this new speculative trading activity and its associated consequences for the commodities markets.**

The CFTC's Position Limits under the Final Rule Must Be Stronger to Be Effective

In the Better Markets Comment Letter, a number of needed changes to the Proposed Rules are discussed in detail. These are briefly summarized here. (The letter is available in its entirety at <http://www.bettermarkets.com/assets/pdf/CL-CFTC-PL-Final.pdf>).

Excessive Speculation

After years of hearings, review and consideration, Congress mandated position limits as a prophylactic measure, which did not require a finding by the CFTC that excessive speculation exists. Nonetheless, position limits should be constructed so that they provide protection against excessive speculation under current market practices and conditions.

The basic structure of the Final Rule is that position limits are established for individual trading entities based on a percentage of the open interest in a market. This general approach is structurally focused on preventing the accumulation of positions by a speculator which could lead to **manipulation** of the market.

However, manipulation is not the only concern. Excessive speculation that distorts markets and prices are of equal concern.

As demonstrated in the Better Markets Comment Letter, excessive speculation is a market-wide phenomenon, as well as an individual trader issue. It is not, per se,

manipulation. It is a very different concept, as codified in the Commodity Exchange Act and the recent Dodd-Frank legislation. And it requires a very different response.

Using historic precedent and accepted analytics, it is possible to know the amount of speculative activity as a percentage of an entire commodity market that is needed so that it can function well. For commodity markets generally, this level has historically been about one-third of open interest.⁷ A level of speculation in excess of this percentage of market open interest is not required for bona fide hedgers to have liquidity. Moreover, if speculators en masse cause damage to the commodities market, they must be restricted; in fact, the data clearly shows that commodity index funds in particular are damaging price formation in commodities markets.

It is telling that Better Markets' staff knows of no bona fide hedgers complaining about the "lack of liquidity" in commodities markets just 10 years ago, prior to deregulation. Yet swap dealers constantly assert the claim that they are "providing more liquidity". **Even if that were true, and it is not, the question regulators should ask is why does society need more speculative "liquidity" in the commodities markets today when there was plenty of speculative liquidity for hedgers to transact efficiently 10 years ago (and with a proportion of speculative open interest less than half of today).** It is worth recalling again that the purpose of commodities derivatives markets is to provide a mechanism for hedging by bona fide hedgers, while also contributing to price formation. **Commodities futures markets do not exist to act as an unregulated casino that can be manipulated by Wall Street swap dealers.**

Individual market participant limits can, of course, also be effective to address this issue in a practical sense. Clearly, if individual limits are low enough relative to the size of the market, the gross amount of speculation will be affected since it is also the sum of individual positions. However, there is no basis for believing that an individual limit designed to protect against manipulation will be an effective deterrent against market-wide excessive speculation.

Therefore, a system for market-wide limits must be adopted. Different regulatory requirements necessitate different regulatory tools.

Commodity Index Limits

As described above, commodity index trading is a special issue. It is at the root of many commodity markets' problems. The Dodd-Frank Act empowers the CFTC to act with respect to a class of traders. Commodity index traders are and must be designated as a class.

A significant factor in the damage done by commodity index trading is its sheer size. The Final Rule fails to limit this class of trading as a percentage of the market. The CFTC must use the authority in the Dodd-Frank Act to limit trading which **pursues a common expressed or implied plan or agreement**. All trades based on a single index act in concert and affect the market just as if transacted by a single giant market participant. As such, all trades under a common index should be aggregated for position limits purposes. Otherwise, excessive speculation created by commodities index trading will continue

⁷ This is discussed in detail in the Better Markets Position Limits Comment Letter, referenced above.

unabated, with all the accompanying volatility, price swings, and ultimately boom/bust cycles that are evidenced in the research.

Abandonment of Class Limits

The original CFTC rule proposal had separate limits for the futures markets and the swap markets for each commodity. Under the Final Rule, swaps and futures markets will be lumped together. Combining these markets means that certain speculators who specialize in futures trading can apply their permitted percentage to a larger marketplace, effectively making the limits larger than in the proposed rule.

Such speculators specializing in the futures markets will not be limited to 2.5 % of the futures market, but can speculate in futures at a substantially higher level because these swaps and futures markets will be combined. Other speculators will be able to net swaps against futures, ignoring that the two markets perform much different roles, which in the case of futures, merits a higher level of scrutiny.

As data is gathered in the following year, the impact of eliminating class limits must be carefully analyzed. **When the limits are finally set, the CFTC must consider the need to re-establish class limits.**

Calculation Periods

In the Final Rules, position limits are reviewed and adjusted at the end of January of every other year, with adjustments going into effect in March. Under reporting requirements of the Dodd-Frank Act, comprehensive transaction data will be available in "real time" and this data can be analyzed continuously. **Markets change rapidly**, with the potential that new trading strategies or derivatives products can have sudden and detrimental impacts.

The Final Rules must be changed to provide for quarterly reviews when sufficient robust data is available. Since this will result in more fine-tuned adjustments to the position limits, a 30-day effective period should be adequate and appropriate.

This approach would allow smoother adjustments to limits as well as an opportunity for the CFTC to act promptly if warranted, a regulatory tool that could be highly effective.

Definition of "Referenced Paired Futures Contract, Option Contract, Swap or Swaption"

The purpose of this definition is to assure that the contracts in each position include all that are price-related and should be grouped together for calculating positions. This methodology is almost universally used by market participants in their database systems which track and analyze their portfolios.

The definition, however, is structured to establish these groupings by identifying characteristics which are common to such equivalent contracts, such as common reference prices. While these may be factors behind price relationships, they are certainly not an exhaustive list. The position limits regime would be more accurate if it relied on typical market practices as the guiding principle in establishing price-related groupings.

In the Better Markets Comment Letter, a layered approach to price-related groupings is outlined, which references both market practices and the objective factors outlined in the Final Rules.

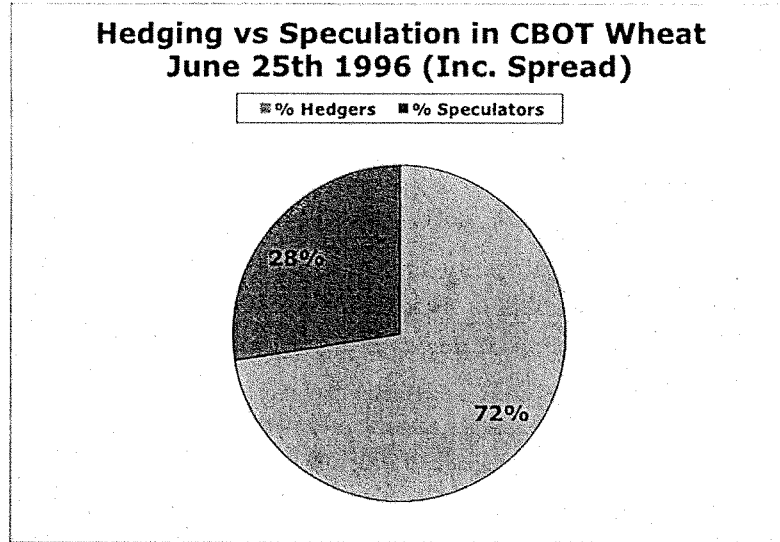
CONCLUSION

In conclusion:

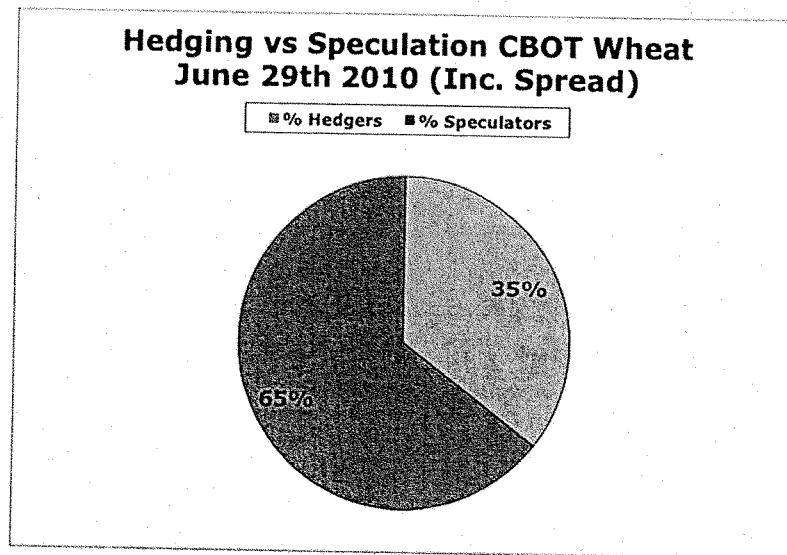
- Speculation in commodity markets has dramatically increased, has become excessive and far exceeds amounts necessary to facilitate legitimate commercial hedging;
- Excessive speculation has caused increased volatility and increased prices in the futures markets;
- Volatility and price increases in the futures markets directly increase hedging costs and, as a result, the cost of production, thereby increasing the prices of underlying commodities;
- Price increases in the futures markets are transmitted to and directly affect the prices in the physical markets by standard pricing methodologies of physical products;
- While increased volatility and prices have increased the need for hedging by physical producers and purchases, the increased costs to hedgers described above have caused many physical producers and purchasers to actually hedge less;
- Much of this, but certainly not all, has been caused by the creation and explosive growth of commodity index funds and their associated roll trading;
- Commodity index funds are liquidity takers and not liquidity providers, while also depriving legitimate commercial hedgers of sufficient market liquidity via competitive methods;
- Commodity index funds have disrupted the commodities futures and physical markets in ways that distort price discovery and increase commodities prices; and
- Producers and purchasers of commodities from the farms to the family table and gas pumps need strong, aggregate position limits imposed to reduce excessive speculation and volatility, including, in particular, applying such limits to commodity index funds as a group or class.

Thank you for your consideration of these very important matters.

[Full-Sized Version of All Charts Attached]

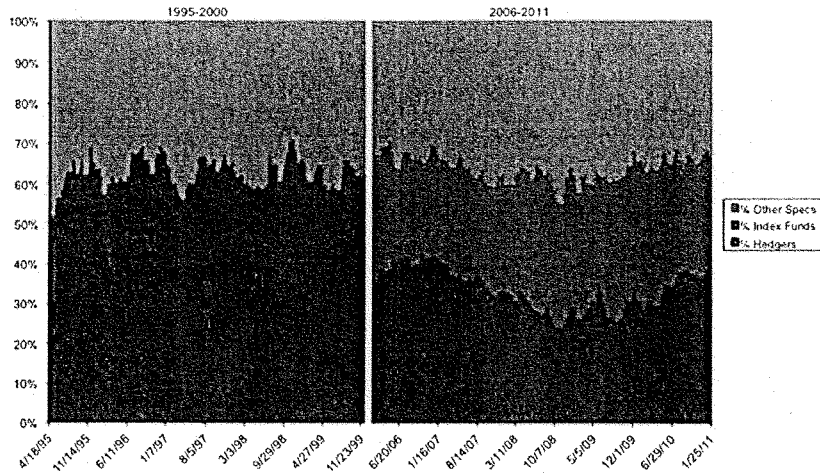


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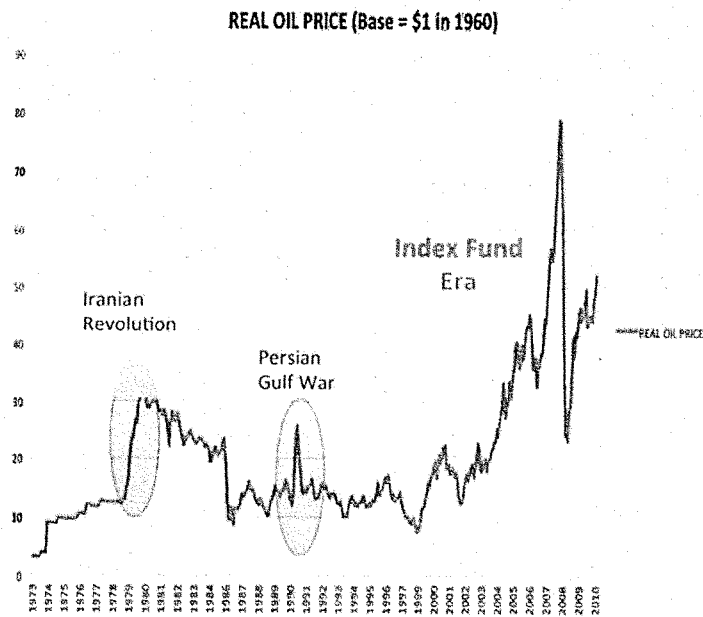


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Percentage of Reportable and Classifiable Open Interest Controlled By (1) Commercials, (2) Index Funds, (3) Other Speculators in CBOT Wheat 1995-2000 and 2006-2011

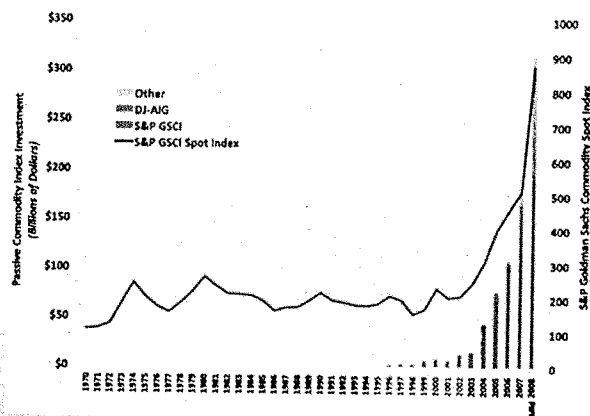


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Passive Commodity Index Investment



Source: Goldman Sachs, Standard & Poor's, Dow Jones, calculations based upon Commodities Futures Trading Commission (CFTC) Commodity Index Trader (CIT) Supplement. Mid 2008 figure is as of July 1.

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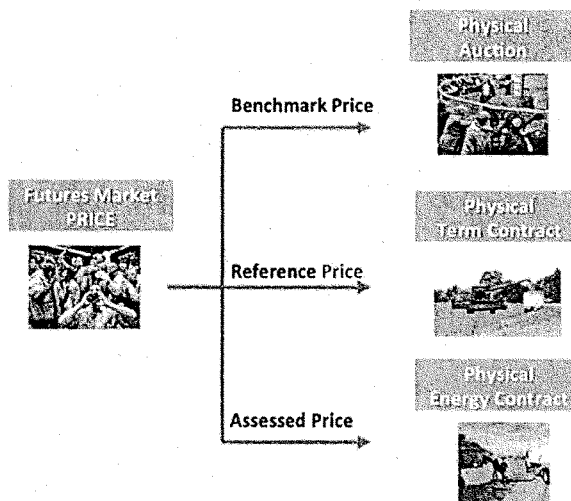
BETTER MARKETS

Futures Prices Affect Physical Prices

• Futures prices set the benchmark price for physical auctions.

• Many physical delivery contracts DIRECTLY use futures prices as their reference price.

• Assessed prices like Platts use near month futures prices as a key component.



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United States Senate

COMMITTEE ON
 HOMELAND SECURITY AND GOVERNMENTAL AFFAIRS

WASHINGTON, DC 20510-6250

September 22, 2011

VIA U.S. MAIL & EMAIL (wturbeville@bettermarkets.com)

Mr. Wallace Turbeville
 Derivatives Specialist
 Better Markets
 1825 K Street NW, Suite 1080
 Washington, D.C. 20006

Dear Mr. Turbeville:

Pursuant to its authority under Senate Resolution 73, Section 12(e), 111th Congress, the U.S. Senate Permanent Subcommittee on Investigations is holding a hearing on the Commodity Futures Trading Commission's (CFTC's) proposal to implement speculative position limits for futures, options, and swap contracts for oil and other commodities. The hearing will be held on October 6, 2011, at 9:30 a.m. in Room 342 of the Dirksen Senate Office Building in Washington, D.C.

The purpose of this letter is to invite you or another representative of Better Markets to testify on a panel at the hearing. To assist the Subcommittee's understanding of the issues, please have Better Markets prepared to address the following matters at the hearing.

- (1) Please describe the extent to which speculation has increased in the commodity markets and has been linked to increases or volatility in oil prices and other commodities in the futures and physical commodity markets.
- (2) Please describe the reversal in market participation between speculators and physical hedgers over the last ten years.
- (3) Please provide your views on the CFTC's proposed rule and any final rule issued prior to the hearing to establish position limits for commodity futures and option contracts and equivalent commodity swaps.
- (4) Please describe the impact of commodity index funds on commodity prices and market liquidity; whether position limits ought to apply to swap dealers hedging their positions with commodity index investors; and whether the CFTC should eliminate existing swap dealer exemptions from position limits.
- (5) Please describe the impact of commodity-related exchange traded funds (ETFs) on commodity prices, and whether position limits ought to apply to those funds or the fund managers.

- (6) Please describe the impact of mutual funds on the commodities markets, and whether mutual fund holdings in commodity ETFs and offshore entities investing in U.S. commodities may be contributing to commodity price speculation. Under existing law for a mutual fund to qualify for certain tax benefits, 90 percent of the investment revenues accrued by mutual funds must be realized through investments in securities, and no more than 10 percent may be realized through alternative investments, including commodity investments. Please provide your views on whether it would be appropriate to increase the percentage of alternative investments that a mutual fund may hold in commodities.
- (7) Please describe the impact of high frequency trading on the commodities markets, its effect on commodity prices and market liquidity, and any problems associated with this form of commodity trading.

Please provide a written statement addressing the above matters. This statement will be included in its entirety in the printed hearing record and will be provided to the public. Subcommittee rules require that this written statement be received by the Subcommittee no later than 9:30 a.m. on October 4, 2011. Please deliver the written statement to the Subcommittee's Chief Clerk, Mary Robertson, through electronic mail at mary_robertson@hsgac.senate.gov. In addition, you may provide an oral statement of up to seven minutes in length at the hearing, to be followed by questions from Subcommittee Members.

Thank you for your assistance in this matter. Please provide the name and title of your representative to Ms. Robertson by September 27, 2011. If you or your staff have any questions or would like additional information, please contact David Katz (Senator Levin) at 202/224-9505 or Anthony Cotto (Senator Coburn) at 202/224-3721.

Sincerely, *



Tom Coburn
Ranking Minority Member
Permanent Subcommittee on Investigations



Carl Levin
Chairman
Permanent Subcommittee on Investigations

TESTIMONY OF GARY GENSLE
CHAIRMAN, COMMODITY FUTURES TRADING COMMISSION
BEFORE THE
U.S. SENATE HOMELAND SECURITY AND GOVERNMENTAL AFFAIRS
PERMANENT SUBCOMMITTEE ON INVESTIGATIONS
WASHINGTON, DC
November 3, 2011

Good morning Chairman Levin, Ranking Member Coburn and members of the Subcommittee. I thank you for inviting me to today's hearing on position limits and the changing nature of the derivatives markets. I also thank my fellow Commissioners and CFTC staff for their hard work and commitment to implementing the Dodd-Frank Wall Street Reform and Consumer Protection Act and the CFTC's existing futures market oversight.

Before I get to the CFTC's position limits rulemaking, I would like to first discuss how markets have changed over time and update the Subcommittee on the CFTC's work to ensure our 21st century markets have 21st century regulations.

Changing Nature of the Derivatives Markets

The derivatives markets have changed significantly since the CFTC opened its doors in 1975.

A new unregulated derivatives market – the swaps market – developed in the 1980s. The swaps market has grown in size and complexity to the point where it now is more than seven times the size of the futures market.

The futures market has changed dramatically as well.

First, there has been a significant increase in electronic trading. Instead of being traded in trading pits, more than 80 percent of futures and options on futures were traded electronically in 2010.

Second, the makeup of the market has changed. In contrast with the early days of the CFTC, swap dealers now comprise a significant portion of the markets. Also, many investors today treat commodities as an asset class for investment. Based on published CFTC data, financial actors, such as swap dealers, managed money accounts and other non-commercial reportable traders, make up a significant majority of many futures markets.

For example, based upon CFTC data as of October 25, 2011, only about 12 percent of long positions and about 18 percent of short positions in the WTI crude oil market were held by producers, merchants, processors and users of the commodity. Similarly, only about 13 percent of gross long positions and about 31 percent of gross short positions in the Chicago Board of Trade wheat market were held by producers, merchants, processors and users of the commodity.

Third, CFTC data shows the vast majority of trading volume in key futures markets – more than 80 percent in many contracts – is day trading or trading in calendar spreads. Only a modest proportion of average daily trading volume results in reportable traders changing their net long or net short futures positions for the day. This means that about 20 percent or less of the trading is done by traders who bring a longer-term perspective to the market on the price of the commodity. This summer we published on our website historical data on net position changes to enhance market transparency. The data reflects trading that changes or creates an end-of-day position, as contrasted with trading that does not change a trader's end-of-day net position, such as spread or day trading.

Ensuring that Regulations Keep up with the Markets

The CFTC is focused on ensuring our regulations are responsive to today's markets. We are implementing the historic Dodd-Frank Wall Street Reform and Consumer Protection Act, which gives the Commission oversight of the nearly \$300 trillion swaps market. Dodd-Frank includes many important provisions, but includes two overarching goals of reform: bringing transparency to the swaps market and lowering the risks of this market to the overall economy. Both of these reforms will better protect taxpayers from again bearing the brunt of a financial crisis and will cut costs for businesses and their customers.

As the Commission considers Dodd-Frank rules, we have benefited from significant public input throughout the process. We have received more than 25,000 comment letters.

CFTC staff and Commissioners have met more than 1,000 times with members of the public to discuss the rules. We have conducted 14 public roundtables on Dodd-Frank.

This summer, the agency turned the corner and began finalizing rules to make the swaps marketplace more open and transparent for participants and safer for taxpayers. We have held 20 public meetings where we finalized 18 rules, and we have more public meetings scheduled this year and into next year.

While each rule is important for the public's protection, I will highlight a few important measures for you.

We approved a final rule to implement enhanced anti-manipulation and anti-fraud authority. These tools are similar to rules that the Securities and Exchange Commission, Federal Energy Regulatory Commission and Federal Trade Commission have for securities and certain energy commodities. The new authority expands the CFTC's arsenal of enforcement tools and strengthens its ability to effectively deal with threats to market integrity.

In addition, the CFTC on July 7 approved a final rule on large trader reporting for physical commodity swaps. Prior to the Dodd-Frank Act, the Commission only had limited authority to obtain large trader data regarding the swaps market. The rule requires position reports on economically equivalent swaps from clearing organizations, their members and swap dealers.

Pre-Trade Risk Filters and Controls

As electronic trading has grown, we have seen a significant rise in high-frequency trading, and the CFTC is working to ensure our regulations are a match for modern challenges.

The Dodd-Frank Act requires that regulated trading facilities have the capacity and responsibility to prevent manipulation, price distortion and disruptions of the delivery or cash-settlement process through market surveillance, compliance, and enforcement practices and procedures. This includes methods for conducting real-time monitoring of trading, and comprehensive and accurate trade reconstructions.

In December 2010, the CFTC proposed a rule that would require that risk controls include market restrictions that pause or halt trading under specified market conditions and that trading facilities coordinate their risk controls. The proposed rule contemplates that other appropriate risk controls, such as price collars or bands, maximum order size limits, stop loss order protections, kill buttons and others, may also be required.

The CFTC also has proposed regulations to require each swap dealer, major swap participant and futures commission merchant that is a clearing member to establish credit and market risk-based limits based on position size, order size, margin requirements and other similar factors. The proposed regulations would require use of automated means to screen orders for compliance with the risk-based limits.

In addition, the proposed regulations would require monitoring for adherence to the risk-based limits intra-day and overnight. A clearing member could monitor and mitigate risk with the ability to see all working and filled orders for intraday risk management, or with a “kill button” that cancels all open orders for an account and disconnects electronic access.

Testing and Supervision

CFTC staff also is working on a release concerning a principles-based testing and supervision regime designed to ensure that electronic trading systems are tested and supervised by trained personnel and that appropriate risk controls are in place. If approved by the Commission, the release would seek comment concerning proposals designed to ensure that those who provide market access to customers establish, implement and enforce rules and procedures to mitigate some of the risks of high-frequency trading.

Increased Transparency

The CFTC is using existing authorities to increase transparency in the derivatives markets. When markets are open and transparent, they are safer and sounder, and costs will be lower for companies and the people who buy their products.

In September 2009, the Commission began disaggregating its weekly Commitments of Traders (COT) reports to make the categories of traders more informative. Before then, the COT reports broke traders into two broad categories: commercial and noncommercial. The new

disaggregated reports improved upon the previous reports by breaking the data for physical commodities into four categories of traders: Producer/Merchant/Processor/User; Swap Dealers; Managed Money; and Other Reportables. The CFTC also released five years of historical data so that regulators and the public could identify trends in the makeup of the markets. This data informs the market about swap dealer and managed money positions on a weekly basis.

Also, the agency began periodically releasing data on index investment in the commodity futures markets. In September 2008, the CFTC published a Report on Swap Dealers and Index Traders that was based on data received pursuant to special call authority. Updated data is now released on a monthly basis and includes both gross long and gross short positions.

Position Limits

At our most recent public meeting, the CFTC finalized its rule to establish position limits for futures, options and swaps on 28 physical commodities as required by the Dodd-Frank Act. Before I discuss the specifics of the rulemaking, I will provide the historical and regulatory contexts for position limits.

Legislative and Regulatory History of Position Limits

Since 1936, the Commodity Exchange Act has prescribed position limits to protect against the burdens of excessive speculation, including those caused by large concentrated positions. Between the CFTC and the futures exchanges, there are currently position limits in

the spot month on physical delivery contracts in the agricultural, energy and metals markets. There also are a number of agricultural contracts that have single-month and all-months-combined position limits that apply to contracts beyond the spot month. The exchanges had set all-months-combined limits in energy markets until 2001 and in metals markets earlier; however, those limits were replaced with position accountability regimes.

When the CFTC set position limits in the past, the agency sought to ensure that the markets were made up of a broad group of participants with a diversity of views. At the core of our obligations is promoting market integrity, which the agency has historically interpreted to include ensuring that markets do not become too concentrated.

Position Limits Rulemaking

Position limits are a critical tool to ensure that a single trader does not accumulate an outsize position that could potentially affect integrity or liquidity in the marketplace. Position limits help protect markets both in times of clear skies and when there is a storm on the horizon. In 1981, the Commission said that “the capacity of any contract market to absorb the establishment and liquidation of large speculative positions in an orderly manner is related to the relative size of such positions, i.e., the capacity of the market is not unlimited.”

Though the CFTC does not set or regulate prices, volatile prices for basic commodities highlight the importance of effective market oversight that ensures integrity and transparency.

Public Hearings on Speculation and the 2010 Position Limits Rulemaking

In July and August 2009, the CFTC held three public meetings to gather input from the public and Members of Congress regarding position limits for energy markets. In January 2010, the Commission published a proposed rule to reestablish position limits on four energy contracts. In response to the proposal, the CFTC received more than 8,200 comments from the public. In March 2010, the Commission held an additional public meeting to consider the appropriateness of position limits in the metals markets.

Following the passage of the Dodd-Frank Act, the CFTC withdrew that proposal in August 2010 with plans to re-propose pursuant to the new law's specific requirements. To be properly informed during the Dodd-Frank position limits rule-writing process, the Commission and its staff reviewed the comments received in response to the January 2010 rulemaking as well as those received in response to the public meeting regarding metals markets.

Final Rulemaking to Set Position Limits

In the Dodd-Frank Act, Congress broadened the CFTC's position limits authority to include aggregate position limits on certain swaps and certain linked contracts traded on foreign boards of trade, in addition to U.S. futures and options on futures. Congress also narrowed the exemptions from position limits by modifying the definition of a bona fide hedging transaction in physical commodities.

After reviewing more than 15,100 public comments, the CFTC finalized a position limits rule on October 18 implementing the important new Dodd-Frank authorities to prevent excessive speculation and manipulation in the derivatives markets. The rule is designed to ensure sufficient market liquidity for bona fide hedgers as well as to protect price discovery from disruption. The final rule establishes position limits for 28 physical commodity futures and options contracts and physical commodity swaps that are economically equivalent. It applies on an aggregate basis across different trading venues, including certain foreign exchanges, to contracts based on the same underlying commodity.

The final rulemaking includes one position limits regime for the spot month and another regime for single-month and all-months combined limits. It will implement spot-month limits, which are currently set in agriculture, energy and metals markets, sooner than the single-month or all-months-combined limits.

Spot-month and non-spot month legacy limits will be implemented 60 days after the CFTC, jointly with the SEC, further defines the term "swap." Under the final rule, these limits will be implemented on an advanced schedule because they are based on current exchange spot-month limits and would be adjusted on a regular schedule, based on 25 percent of the underlying deliverable supply.

Single-month and all-months-combined limits, which the Commission currently only sets for certain agricultural contracts, will be re-established in the energy and metals markets and extended to certain swaps. The Commission will set the limits following the collection of

sufficient swaps positional data gathered under the CFTC's recently adopted swaps large trader reporting rule.

Consistent with the Dodd-Frank definition of "bona fide hedging," the final rulemaking provides that, to qualify, a transaction or position must serve to mitigate a risk in the cash market for a physical commodity. To provide clarity, the Commission's proposed rule provides a list of examples that may be classified as bona fide hedges.

The final rulemaking establishes an enhanced reporting regime for traders who, in certain energy and metals contracts, hold positions that are below the position limits but above a specified number of net long or net short contracts. Once a trader crosses a position visibility level, the trader will be required to file quarterly reports to the CFTC that generally capture the trader's physical and derivatives portfolio in the commodity. These reports will enhance the Commission's surveillance abilities and increase transparency in the marketplace.

International Coordination

In addition to working on the position limits rule at home, we also have been actively coordinating with international regulators. In September, the International Organization of Securities Commissions (IOSCO) adopted a commodity markets report that embraces a position management regime. The report also includes recommendations for more transparency on the international side, similar to our COT reports, and a stronger anti-manipulation regime that adds authorities to police against attempted manipulation.

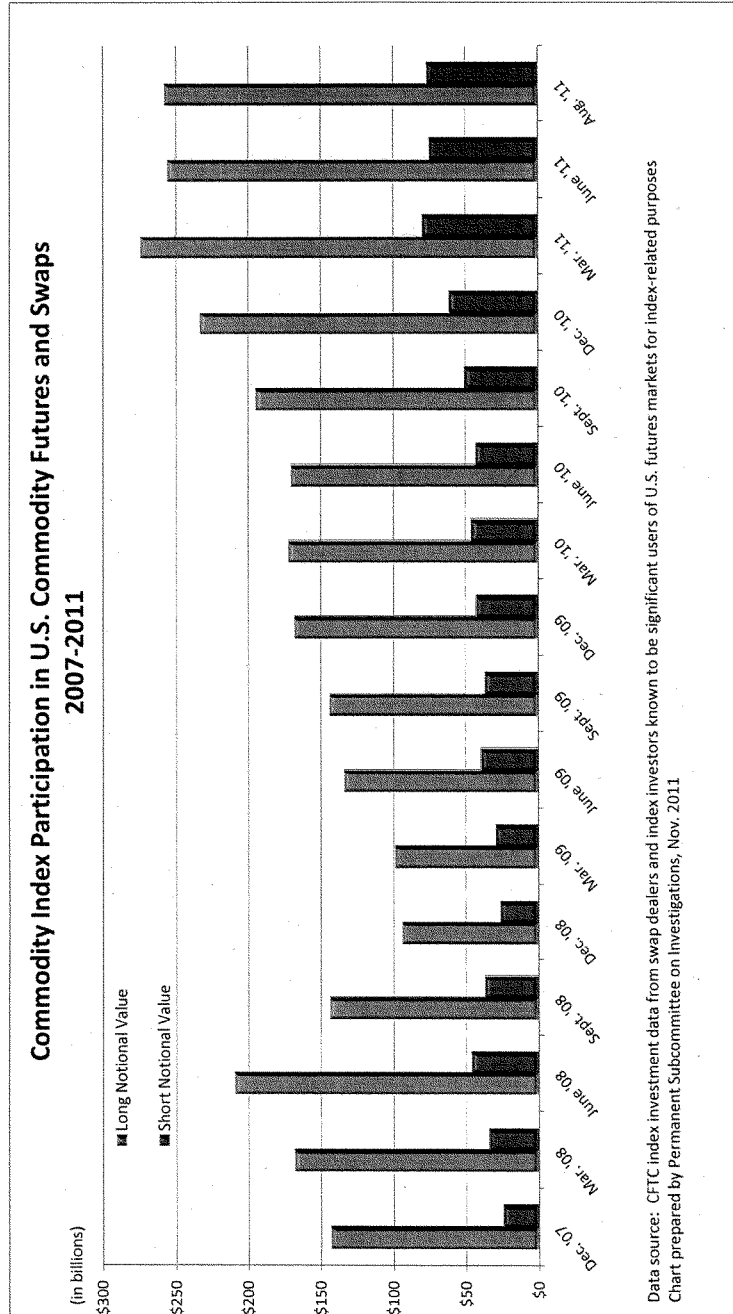
Resources

With the passage of the Dodd-Frank Act, the CFTC is taking on a significantly expanded scope and mission. As we continue to finalize rules, market participants will increasingly seek guidance from the CFTC. But only with sufficient funding will we be able to be as responsive to the public as we should be.

The agency must be adequately resourced to assure the nation that new market rules will be strictly enforced – rules that promote transparent markets, lower costs for consumers and protect taxpayers. We need sufficient resources to put enough cops on the beat for the public's protection.

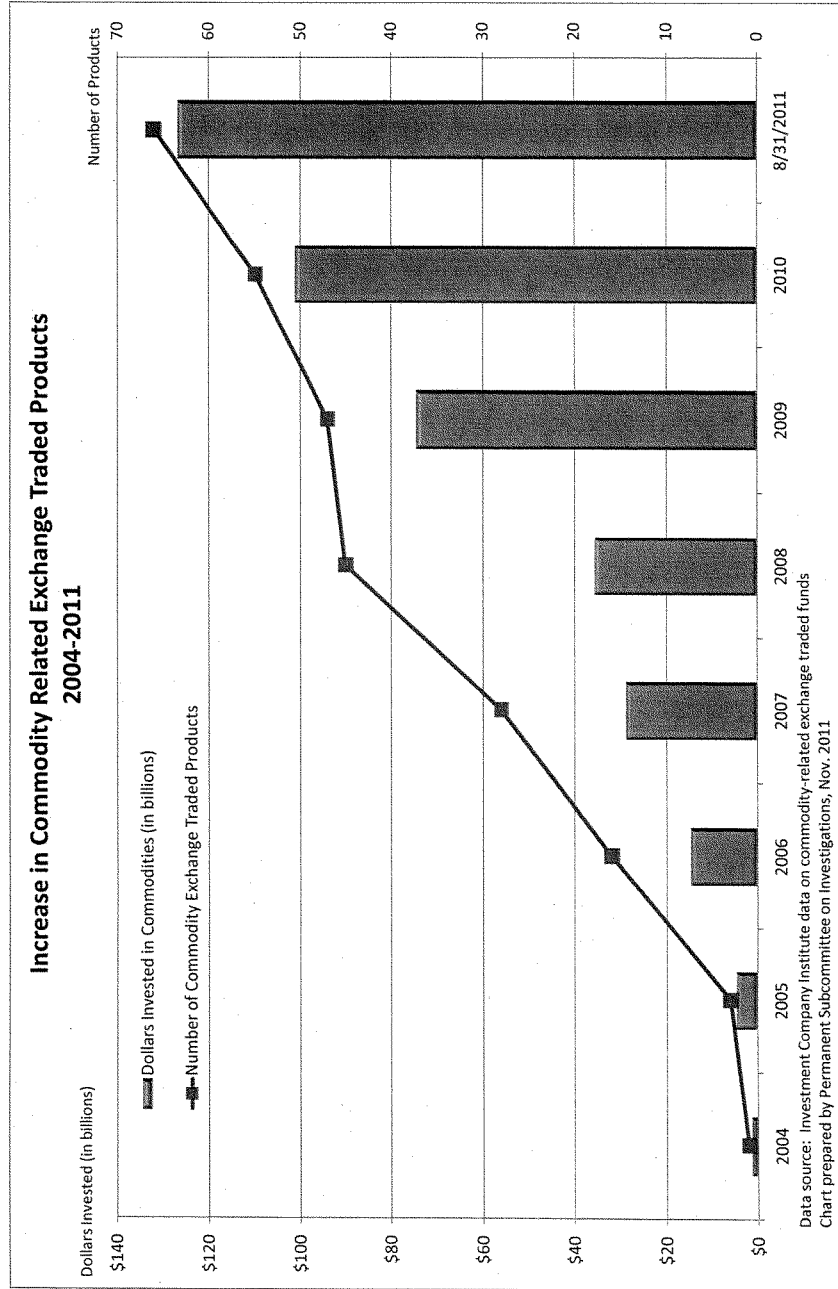
Closing

Thank you, and I'd be happy to take questions.



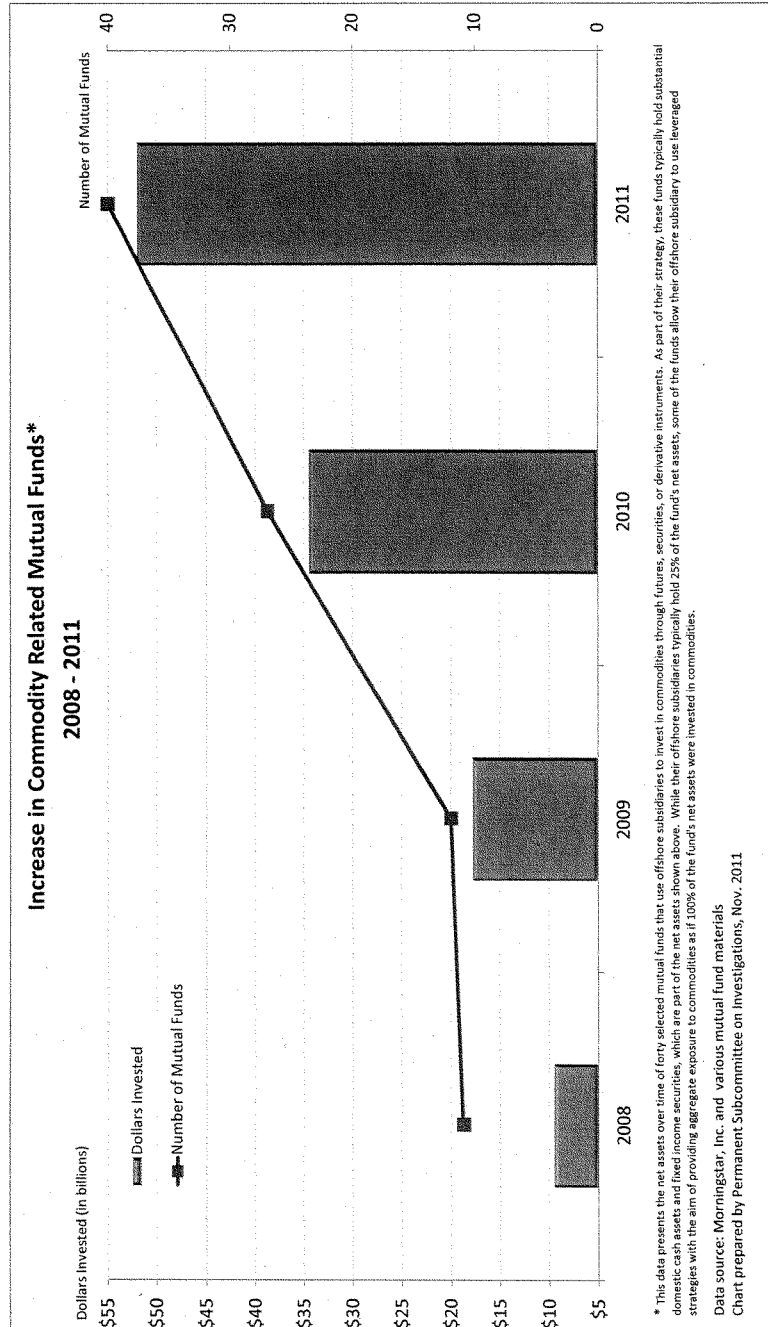
Permanent Subcommittee on Investigations

EXHIBIT #1a

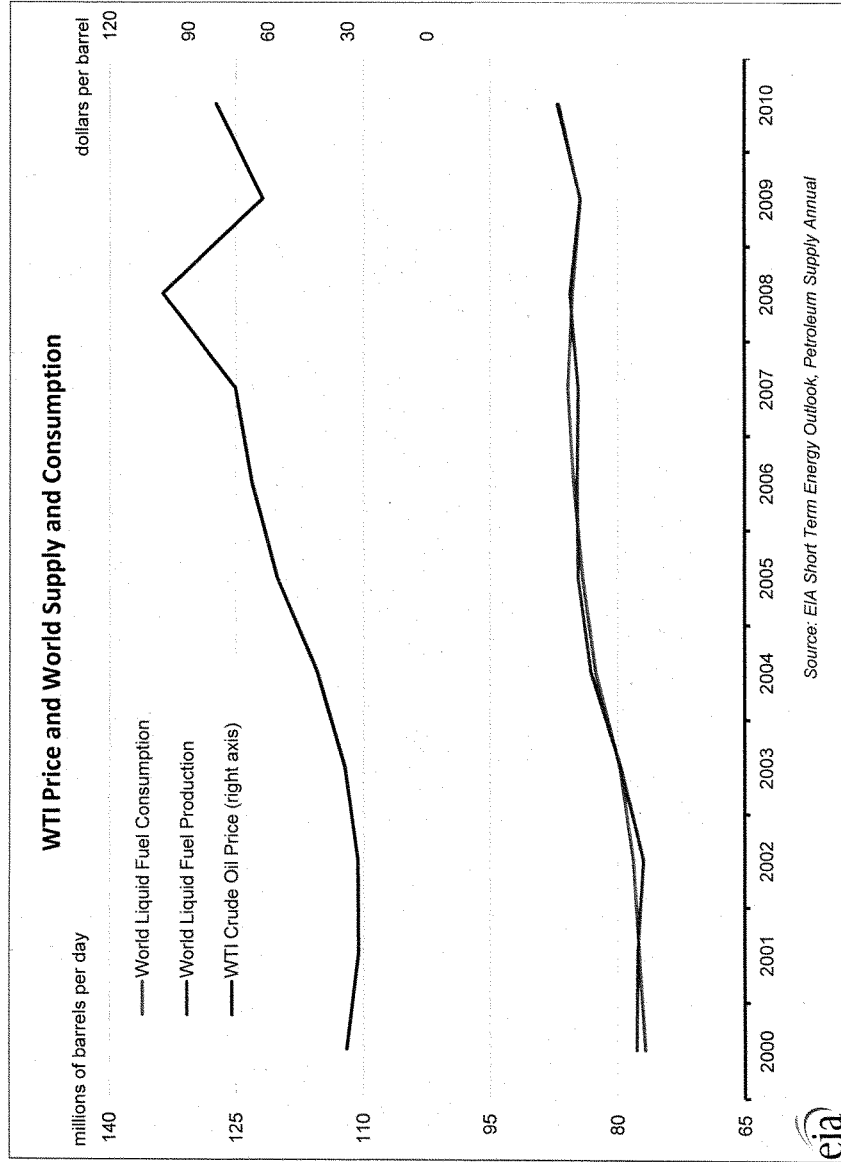


Permanent Subcommittee on Investigations

EXHIBIT #1b



Permanent Subcommittee on Investigations
EXHIBIT #1c



Permanent Subcommittee on Investigations
EXHIBIT #1d



Commodity Futures Trading Commission
Office of Public Affairs
 Three Lafayette Centre
 1155 21st Street, NW
 Washington, DC 20581
www.cftc.gov

Final Regulations on Position Limits for Futures and Swaps

The Commodity Futures Trading Commission announced the approval for publication in the Federal Register of final regulations concerning limits on speculative positions in 28 selected physical commodity futures and swaps. The regulations implement section 737 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act).

Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act)

On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act. Among other things, the Dodd-Frank Act amended the Commodity Exchange Act to:

- Require the Commission to limit the amount of positions, other than bona fide hedging positions, that may be held by any person with respect to physical commodity futures and option contracts in exempt and agricultural commodities traded on or subject to the rules of a designated contract market (DCM), as appropriate.
- Require the Commission to establish position limits, including aggregate position limits, for swaps that are economically equivalent to DCM contracts in exempt and agricultural commodities (collectively, "economically equivalent swaps"). Such limits must be imposed simultaneously with limits on DCM contracts.

Final Regulations on Position Limits

The Commission's final regulations call for:

- Commission administered limits on speculative positions in 28 core physical commodity contracts and their "economically equivalent" futures, options, and swaps (collectively "Referenced Contracts").
- Establishment of speculative limits on Referenced Contracts that will occur in two phases:
 - *Spot-month position limits.* Spot-month limits will be effective sixty days after the term "swap" is further defined under the Dodd-Frank Act. The limits adopted at that time will be based on the spot-month position limit levels currently in place at DCMs. Thereafter, the spot-month limits will be adjusted biennially for agricultural contracts and annually for energy and metal contracts. These subsequent limits will be based on the Commission's determination of deliverable supply (developed in consultation with DCMs).
 - *Non-spot-month position limits* (i.e., limits applied to positions in all contract months combined or in a single contract month). For the nine "legacy" agricultural Referenced Contracts that currently are subject to Commission administered limits, the new non-spot-month limits will go into effect sixty days after the term "swap" is further defined under the Dodd-Frank Act. These limits will be set

Commodity Futures Trading Commission ♦ Office of Public Affairs ♦ 202-418-5080

Permanent Subcommittee on Investigations

EXHIBIT #2a

equal to the levels described in the final rulemaking. For all other Referenced Contracts (that currently are not subject to Commission administered limits), the limits will be made effective by Commission order after the Commission has received one year of open interest data on physical commodity cleared and uncleared swaps under the swaps large trader reporting rule. The non-spot-month limits will be adjusted biennially based on Referenced Contract open interest.

- Spot-month position limit levels will be set generally at 25% of estimated deliverable supply. These spot-month limits will be applied separately for physical-delivery Referenced Contracts and cash-settled Referenced Contracts in the same commodity.
- Cash-settled NYMEX Henry Hub Natural Gas contracts, however, will be subject to a cash-settled spot-month position limit and an aggregate limit (extending across positions in both physical-delivery and cash-settled natural gas contracts), each set at five-times the limit that applies to the physical-delivery NYMEX Henry Hub Natural Gas contract.
- Non-spot-month position limits (i.e., limits applied to positions in all contract months combined or in a single contract month) will be set using the 10/2.5 percent formula: 10 percent of the contract's first 25,000 of open interest and 2.5 percent thereafter. These limits will be reset biennially based on two years open interest data.
- Open interest used in determining non-spot-month position limits will be the sum of futures open interest, cleared swaps open interest, and uncleared swaps open interest.
- Exemptions for bona fide hedging transactions based on the Dodd-Frank Act's new requirements for such transactions. These exemptions have been broadened to include certain anticipated merchandising transactions, royalties, and service contracts in the final rulemaking to reflect concerns by commercial firms.
- Exemptions for positions that are established in good faith prior to the effective date of the initial limits established by the regulations.
- Establishment of account aggregation standards consistent with the Commission's current position limits aggregation policy, including the Commission's long-standing independent account controller exemption.
- A position visibility reporting regime to assist the Commission in its surveillance program.
- Acceptable practices for DCMs and swap execution facilities for setting position limits for the 28 Referenced Contracts, as well as position limits or accountability rules in all other listed contracts, including excluded commodities.



Commodity Futures Trading Commission
Office of Public Affairs
 Three Lafayette Centre
 1155 21st Street, NW
 Washington, DC 20581
 www.cftc.gov

Q & A – Position Limits for Futures and Swaps

What is the goal of the final rulemaking?

The final rulemaking establishes limits on speculative positions in 28 physical commodity futures contracts traded pursuant to the rules of a designated contract market (“DCM”) as well as swaps that are economically equivalent to those contracts, as mandated by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. The final rulemaking on position limits will enable the Commission to meet its statutory responsibility to set such limits in order to prevent excessive speculation and manipulation while ensuring sufficient market liquidity for bona fide hedgers and protecting the price discovery process.

Which commodities are covered by the final regulations?

The final rule establishes speculative position limits for 28 physical commodity futures contracts (“Core Referenced Futures Contracts”) as well as futures and swaps that are economically equivalent to those contracts (collectively “Referenced Contracts”).

The 28 Core Referenced Futures Contracts include the following contracts, by commodity category:

- Nine “legacy” agricultural contracts: (1) CBOT Corn (C); (2) CBOT Oats (O); (3) CBOT Soybeans (S); (4) CBOT Soybean Meal (SM); (5) CBOT Soybean Oil (BO); (6) CBOT Wheat (W); (7) ICE Futures U.S. Cotton No.2 (CT); (8) KCBT Hard Winter Wheat (KW); and (9) MGEX Hard Red Spring Wheat (MWE).
- Ten non-“legacy” agricultural contracts: (1) CME Class III Milk (DA); (2) CME Feeder Cattle (FC); (3) CME Lean Hog (LH); (4) CME Live Cattle (LC); (5) CBOT Rough Rice (RR); (6) ICE Futures U.S. Cocoa (CC); (7) ICE Futures U.S. Coffee C (KC); (8) ICE Futures U.S. FCOJ-A(OJ); (9) ICE Futures U.S. Sugar No. 11 (SB); and (10) ICE Futures U.S. Sugar No. 16 (SF).
- Four energy contracts: (1) NYMEX Henry Hub Natural Gas (NG); (2) NYMEX Light Sweet Crude Oil (CL); (3) NYMEX New York Harbor Gasoline Blendstock (RB); and (4) NYMEX New York Harbor Heating Oil (HO).
- Five metal contracts: (1) COMEX Copper (HG); (2) COMEX Gold (GC); (3) COMEX Silver (SI), (4) NYMEX Palladium (PA); and (5) NYMEX Platinum (PL).

How will the speculative limits be set?

The final rules set forth two types of speculative limits: *spot-month position limits* and *non-spot-month position limits*. Spot-month position limits apply in the period immediately before delivery obligations are incurred for physical delivery contracts or a period immediately before contracts are liquidated by the clearinghouse based on a reference price for cash-settled contracts. The spot-month period is specific to each commodity contract, need not correspond to a month-long period, and may extend through the period when delivery obligations are incurred.

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Generally, *spot-month position limits* for Referenced Contracts will be set at 25% of estimated deliverable supply. These limits will be applied separately for positions in the physical-delivery and all cash-settled Referenced Contracts combined. For example, a trader's position in all cash-settled futures and swaps Referenced Contracts will be combined to determine whether the trader's position in cash-settled Referenced Contracts is below the limits.

The cash-settled NYMEX Henry Hub Natural Gas contracts will be subject to a cash-settled spot-month position limit and an aggregate limit (extending across positions in both physical-delivery and cash-settled natural gas contracts) set at five-times the limit that applies to the physical-delivery NYMEX Henry Hub Natural Gas contract.

The *non-spot-month position limits* apply to positions a trader may have in all contract months combined or in a single contract month. For each Referenced Contract, these limits will be set at 10 percent of open interest in the first 25,000 contracts and 2.5 percent thereafter. Open interest used in determining non-spot-month position limits will be based on futures open interest, cleared swaps open interest, and uncleared swaps open interest.

Generally, initial non-spot-month position limits will be set by Commission order using one year of open interest data and biennially thereafter.

The legacy agricultural contracts will be subject to non-spot-month limit levels that will be reset pursuant to future Commission rulemakings, consistent with the approach taken historically for establishing position limits for such contracts.

What makes a swap economically equivalent to a futures contract?

For the purposes of these regulations, a swap contract may be economically equivalent to a futures contract when: (1) it is a "look-alike" contract (i.e., it settles off of the Core Referenced Futures Contract or contracts that are based on the same commodity for the same delivery location as the Core Referenced Futures Contract); (2) it is a contract with a reference price based on only the combination of at least one Referenced Contract price and one or more prices in the same or substantially the same commodity as that underlying the relevant Core Referenced Futures Contract, provided that such a contract is not a locational basis swap; (3) it is an intercommodity spread contract with two reference price components, one or both of which are based on Referenced Contracts; or (4) it is priced at a fixed differential to a Core Referenced Futures Contract.

Why do these regulations provide for visibility levels in addition to position limits?

The final rule also requires quarterly position visibility reporting requirements for traders exceeding a non-spot-month position visibility level in energy and metal Referenced Contracts. These position visibility reports provide the Commission additional visibility into the physical and swaps portfolios of the largest traders. These position visibility reports will provide the Commission with a better understanding of trading activity in the physical commodity futures and swaps markets, allowing the Commission to make future adjustments, as necessary, to the position limit framework in order to better achieve the statutory objectives of position limits. In addition, these reports will improve the Commission's ability to enforce position limits.

How many market participants will be affected by the final regulations?

With respect to the *spot-month position limits*, the Commission estimates based on historical patterns that, on an annual basis, approximately 84 traders in legacy agricultural Core Referenced Futures Contracts, 50 traders in non-legacy agricultural Referenced Contracts, 85 traders in energy Referenced Contracts, and 12 traders in metal Referenced Contract would hold or control positions that could exceed these limits.

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With respect to the *non-spot-month position limits*, the Commission estimates, on an annual basis, approximately 84 traders in legacy agricultural Core Referenced Futures Contracts, 80 traders in non-legacy agricultural Referenced Contracts, 10 traders in energy Referenced Contracts, and 25 traders in metal Referenced Contracts would hold or control positions that could exceed these limits.

These estimates of traders with positions that may exceed spot-month or non-spot-month position limits do not take into account the number of traders that would be eligible for *bona fide* hedging or pre-existing position exemptions.

How many entities will be required to make reports under these regulations?

The Commission estimates that the final regulations may require reporting from approximately six entities with respect to deliverable supply estimates, 200 traders with respect to bona fide hedging exemptions, 48 traders with respect to visibility level reporting, and 90 entities with respect to account aggregation applications.

Why is the Commission implementing position limits in two phases?

The Dodd-Frank Act provides a timeframe for the Commission to establish position limits on exempt and agricultural commodity derivatives. The formula for determining Referenced Contract position limits outside of the spot-month is based on the overall size of the physical commodity futures and swap markets, as measured by open interest. Determining the applicable limits using this formula requires swaps position data.

Spot-month limits, in contrast, are based on estimates of deliverable supply, a measure of the size of the physical market underlying the futures and swap markets for a commodity. The Commission and DCMs currently estimate deliverable supply in determining existing DCM-administered spot-month position limits. The Commission, therefore, can implement spot-month limits expeditiously in the initial phase while waiting to receive the necessary data to implement non-spot-month limits in the second phase after obtaining swaps open interest data.

How will the regulations affect current Commission regulations?

The regulations replace the Commission's existing part 150 position limits regulations and amend regulation 1.3(z) to apply the *bona fide* hedging standard to excluded commodities. The proposed regulations retain, with certain modifications, current Commission position limits on legacy agricultural commodity DCM contracts. In addition to changing the size and scope of speculative position limits, the Commission has amended the scope of the *bona fide* hedging exemption, consistent with the definition of *bona fide* hedging transactions in the new Commodity Exchange Act. The Commission has also adopted a modified version of its existing account aggregation regulations, including the long-standing independent account controller exemption to aggregation.

Testimony of
Dan M. Berkovitz
General Counsel
Commodity Futures Trading Commission
July 28, 2009

POSITION LIMITS AND THE HEDGE EXEMPTION

A BRIEF LEGISLATIVE HISTORY

Today, I will provide a brief legislative history of the mandate in the CEA concerning position limits and the exemption from those limits for bona fide hedging transactions.

Overview

Since its enactment in 1936, the Commodity Exchange Act (CEA) has stated that “excessive speculation” in any commodity traded on a futures exchange “causing sudden or unreasonable fluctuations or unwarranted changes in the price of such commodity is an undue and unnecessary burden on interstate commerce” and has directed the Commodity Futures Trading Commission (CFTC) to establish such limits on trading “as the Commission finds are necessary to diminish, eliminate, or prevent such burden.” The basic statutory mandate in Section 4a of the CEA to establish position limits to prevent such burdens has remained unchanged over the past seven decades.

Due to the increase in the number of commodities traded on the regulated futures exchanges, as well as changes in regulatory philosophy over the years, this mandate to establish position limits is currently being implemented in a variety of ways. The CFTC directly fixes the position limits for cotton, certain grain commodities, and the soybean complex; specifies

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acceptable practices for the exchanges to establish position limits for other commodities; and also allows the exchanges to use “position accountability levels” rather than fixed position limits in months other than the spot month for commodities that meet certain liquidity requirements.¹

Since its enactment in 1936, the CEA also has exempted “bona fide hedging transactions” from any such position limits established under the Act. Initially, the CEA defined the term “bona fide hedging transactions” solely in reference to transactions in the cash market for a commodity. Since 1974, however, the Act has provided the Commission with discretion to define the term, provided that the Commission’s definition enables producers, middlemen, and users of a commodity to hedge their legitimate anticipated business needs.

Position Limits

The enactment of the CEA of 1936 and the direction in Section 4a for the Commission to establish position limits was the culmination of a fierce debate that had raged for nearly twenty years—ever since the collapse in grain prices following the end of the First World War—over whether the Federal Government should impose limits on the trading of futures contracts.² The reasons for and purposes of Section 4a as it was enacted in 1936 are illuminated by examining not only the legislative history of the 1936 Act itself, but also the key aspects of the preceding twenty-year debate.

¹ See 17 C.F.R. §150.5 (2009).

² The debate over whether and how to control speculation in the U.S. grain markets can be traced back to the emergence of the organized markets for grain in the mid-19th century. See William G. Ferris, *The Grain Traders, The Story of the Chicago Board of Trade* (Michigan State University Press, 1988). It was not until the First World War, however, that the Congress actually passed legislation imposing limits on speculation in a commodity market.

Food Control Act of 1917

The first exercise of Federal authority to limit trading in the commodity futures markets occurred when the Congress enacted emergency legislation to stabilize the U.S. grain markets during the First World War. Under the Food Control Act of 1917 the trading in wheat futures was suspended and the U.S. Food Administration "secur[ed] a voluntary limitation" of 500,000 bushels on the trading of futures contracts for corn.³ After the war, Herbert Hoover, the wartime director of the U.S. Food Administration, testified that the limits on the trading of corn futures were "well carried out and during that period there was no manipulation of the market and no substantial interference with the normal processes of the hedging market."⁴

Future Trading Act of 1921

Many farmers and others blamed speculators, particularly the short sellers, for the continued depression in grain prices after the war. Many of these farmers sought the reimposition of limits on trading. A number of bills were introduced in the Congress to regulate the grain markets, and the issue of whether to impose limits on the amount of speculative trading was vigorously debated.⁵ Herbert Hoover, as the former director of the U.S. Food Administration, testified that "my own inclination is to believe that as long as those speculative transactions are in comparatively small quantities they neutralize each other; it is only when a preponderant amount is handled by one hand that it can be made the instrument of

³ Frank M. Surface, *The Grain Trade During the World War* (Macmillan, 1928), at p. 224; Testimony of Herbert Hoover, Hearing Before the House Committee on Agriculture, Future Trading, 66th Cong., 3d Sess (Jan. 20, 1921), at pp. 895-923.

⁴ *Id.*, at p. 895.

⁵ Many bills to regulate the grain futures markets had been introduced and debated over the previous thirty years, but none had ever made it into law. In 1894 both the House and the Senate passed legislation that would have imposed a prohibitive tax on the trading of futures contracts. The bill died in the final days of the 52nd Congress after the bill's supporters were unable to muster a two-thirds majority in the House to suspend the rules to concur in the Senate version. See Cedric B. Cowing, *Populists, Plungers, and Progressives* (Princeton University Press, 1965), at p. 21.

manipulation.”⁶ Hoover supported position limits, and proposed to give the power to limit the size of individual speculative traders to a regulatory board under the Secretary of Agriculture.⁷ The Secretary of Agriculture also supported regulation of the grain trade and limits on speculative trading.⁸

On the other hand, grain merchants, the grain exchanges and others in the grain industry believed that any regulation of the futures markets, including the setting of position limits, was not only unnecessary but would be harmful to the trade. One merchant urged Congress to resist “the phantom hope that the depression [in grain prices] was manipulative and temporary and could be checked.”⁹ The President of the Kansas City Board of Trade testified that “the organized grain exchange to-day is the most finely balanced commercial machine in America,” that it was “as nearly separated from a selfish interest as it is possible to imagine in any organization where the human agency is involved,” and that “any sort of legislation that is enacted will tend so greatly to reduce speculation as to make hedging a most difficult thing.”¹⁰

In May 1921, the House of Representatives passed a bill requiring commodity exchanges to impose limitations on speculative trading as a condition of designation as a contract market.

⁶ Testimony of Herbert Hoover, at pp. 900, 902.

⁷ Hoover suggested a regulatory board “because there are more or less judicial questions to be determined.” He noted that “it is a very, very difficult thing to set down rightful trade practices or prohibitions of trade practices with precision, and warned that legislation “may lead to wholly unexpected difficulties if the act attempts to get precision and too little flexibility.” *Id.* at p. 896

⁸ Chester Morrill, Assistant Secretary of Agriculture, testified that the position limit provision in the House bill was included “as a result of suggestions made by the Secretary of Agriculture, “the thought being that the control of the market by speculative interests may occur through the volume of trading that may be concentrated in the hands of one person at one time, or, rather, not so much the volume of trading as the volume of open trades that may be concentrated in the hands of one person at one time, or, rather, not so much the volume of trading as the volume of open trades that may be concentrated.” Hearings Before the Senate Committee on Agriculture, 67th Cong., 1st Sess., at pp. 17-18 (May 27, 1921).

⁹ Testimony of Julius Barnes, Grain Exporter, Hearing Before the Senate Committee on Nutrition and Forestry, Future Trading in Grain, at p. 72 (May 31, 1921).

¹⁰ Testimony of B.L. Hargis, President, Kansas City Board of Trade, 1921 Senate Hearing, at p. 239.

But the Senate rejected this proposal, and it was not included in the final bill that became the Future Trading Act in August 1921.

The 1921 Act proved to be short-lived. It was successfully challenged by members of the Chicago Board of Trade when the Supreme Court, in *Hill v. Wallace*,¹¹ declared Section 4 unconstitutional as an improper use by Congress of its taxation power. Chief Justice Taft's opinion, however, suggested that such legislation might pass constitutional muster under the interstate commerce clause.¹²

Grain Futures Act of 1922

Within days of the court's decision, the Congress began the legislative process to remedy the constitutional defects identified by the Supreme Court. The Grain Futures Act of 1922 was nearly identical to the prior legislation, but, following the Supreme Court's cue, was based upon the commerce clause rather than the taxation power. In Section 3 of the Grain Futures Act Congress found that "sudden or unreasonable fluctuations" in the price of these transactions in grain futures that "frequently occur as a result of speculation, manipulation, or control" are "an obstruction to and a burden on interstate commerce," and thereby "render regulation imperative . . . in the national public interest."¹³ Like its unconstitutional predecessor, however, the Grain Futures Act of 1922 did not provide the Federal Government with any authority to impose limits on trading.¹⁴

¹¹ *Hill v. Wallace*, 259 U.S. 44 (1922).

¹² Chief Justice Taft's opinion stated: "[S]ales for future delivery on the Board of Trade are not in and of themselves interstate commerce. They cannot come within the regulatory power of Congress as such, unless they are regarded by Congress, from the evidence before it, as directly interfering with interstate commerce so as to be an obstruction or a burden thereon." 259 U.S., at 69.

¹³ Grain Futures Act of 1922, § 3.

¹⁴ The basic regulatory framework established by the Grain Futures Act remains in effect today. The Act required all grain futures contracts to be traded on a designated contract market, and set forth the conditions that the Secretary

Congressional Debates and Studies, 1920s and 1930s

The debate over position limits continued throughout the 1920s and into the 1930s.

Senator Capper, one of the original sponsors of the legislation that became the Futures Trading Act, introduced bills in each of the Congresses from 1925-1931 to amend the Grain Futures Act to impose limits on the positions that could be held by a single trader.

In 1926, as part of its comprehensive multi-year study of the grain markets, the Federal Trade Commission (FTC) concluded:

The very large trader by himself may cause important fluctuations in the market. If he has the necessary resources, operations influenced by the idea that he has such power are bound to cause abnormal fluctuations in prices. Whether he is more often right than wrong and more often successful than unsuccessful, and whether influenced by a desire to manipulate or not, if he is large enough he can cause disturbances in the market which impair its proper functioning and are harmful to producers and consumers.¹⁵

The FTC recommended that limits be placed on trading, particularly on the amount of open interest that could be held by any one trader.¹⁶

The Department of Agriculture repeatedly urged the Congress to provide the Grain Futures Administration (GFA), which had been created by the Grain Futures Act, with the authority to impose position limits. In its study of the fluctuations in wheat prices during the early part of 1925, the GFA found that five large traders, each of whom were trading more than

of Agriculture had to find were met in order to designate a board of trade as a contract market. Designation as a contract market was contingent upon a board of trade's providing for the prevention of manipulative activity and the prevention of dissemination of false information, upon providing for certain types of recordkeeping and for admission into exchange membership of cooperative producer associations, and upon location of the contract market at a terminal cash market. The Act authorized a Commodity Exchange Commission (CEC), consisting of the Secretary of Agriculture, the Secretary of Commerce, and the Attorney General, to revoke the designation of any board of trade that failed to comply with these conditions.

¹⁵ Report of the Federal Trade Commission on the Grain Trade, Vol. VII, *Effects of Future Trading* (1926), at pp. 293-4.

¹⁶ The FTC stressed, "Limitation of the individual open interest is the most important point." *Id.* The FTC also identified the need to exempt hedgers from the limits: "Any proposed limitation of the size of the open interest, of course, does not apply to hedges. As regards quantity, hedges are self-limiting." The FTC also recommended reporting of large trades and the daily publication by the exchanges of volume and open interest.

two million bushels of grain, were responsible for “wide and erratic price fluctuations” in the wheat futures market. Although the GFA’s report emphasized the investigation “did not reveal any concentrated action for the deliberate purpose of manipulating the market,” it stated that most of the wide and erratic price fluctuations “were largely artificial and were caused primarily, either directly or indirectly, by heavy trading on the part of a limited number of professional speculators.”¹⁷ In the letter of transmittal to the Senate, the Secretary of Agriculture and the Chief of the GFA reported that the harmful effect that these five large traders had on grain prices demonstrated the “the need for the development of some plan of limiting excessive speculative transactions.”¹⁸

The 1926 Report was a pivotal development. Not only did it presage the distinction between manipulation and excessive speculation that survives in commodity regulation to this day,¹⁹ it also marked the beginning of a series of recommendations by the GFA to Congress that the law be amended to require limits on speculative trading.²⁰ The finding in the 1926 study that trades in excess of two million bushels caused “wide and erratic” price fluctuations became the

¹⁷ *Fluctuations in Wheat Futures*, 69th Cong., 1st Sess., Senate Document No. 135 (June 28, 1926).

¹⁸ *Id.*

¹⁹ The FTC report drew a similar distinction.

²⁰ For example, in 1931 Dr. J. W. T. Duvel, Chief of the GFA, testified as to his view of what constituted “excessive speculation”:

[W]ith these large-scale operations you may have a thousand traders outside scattered all over the entire country who may be buying and selling, but yet an individual speculator may come and sell more than the entire thousand combined and do it all in one day. In other words, the individual speculator may be entirely right in his own judgment as to values . . . yet he has no choice. . . .

We find a great many cases where individual traders may do 8, 10, and sometimes 15 percent of the total day’s business. . . . We do not think that anybody is entitled to do 10 percent of the day’s business if it is to be a free and open world market. . . .

When large traders come into the market and buy or sell four or five million bushels one day or two days, that is excessive speculation and serves no useful purposes. In fact, it is detrimental. That is the reason we favor some limitations.

Dr. Duvel again recommended a position limit of two million bushels. Hearings Before the Senate Agriculture Committee, 71st Cong., 3d Sess., at pp. 37, 42, 52 (February 10, 1931). See also Rodger R. Kaufman, *Legislative History of the Commodity Exchange Act* (November 1964), at p. 41 (unpublished manuscript).

basis for a number of proposals to establish a position limit of two million bushels, which eventually became the position limit for wheat that was established under the Commodity Exchange Act of 1936.

Another key legacy of the GFA's 1926 report, as well as the FTC's report of that same year, is the identification of the concept that large speculative positions, even without manipulative intent, can cause "disturbances" and "wild and erratic" price fluctuations. Both reports recommended that limits on trading be imposed to prevent large speculative positions regardless of the trader's intent.

Commodity Exchange Act of 1936

The stock market crash that began in 1929, the Great Depression, and the election in 1932 of Franklin Roosevelt as President brought significant new momentum to the efforts to impose speculative position limits on the trading of commodities. In 1934, President Roosevelt sent a formal message to the Congress recommending the regulation of the securities and commodities markets to protect investors, safeguard values, and prevent "destructive speculation":

It is my belief that exchanges for dealing in securities and commodities are necessary and of definite value to our commercial and agricultural life. Nevertheless, it should be our national policy to restrict, as far as possible, the use of these exchanges for purely speculative operations.

I therefore recommend to the Congress the enactment of legislation providing for the regulation by the Federal Government of the operations of exchanges dealing in securities and commodities for the protection of investors, for the safeguarding of values, and so far as it may be possible, for the elimination of unnecessary, unwise, and destructive speculation.²¹

²¹ Reprinted in Report of the House Committee on Interstate and Foreign Commerce, Securities Exchange Bill of 1934, H. Rep. No. 1383, 73d Cong., 2d Sess., at pp 1-2 (April 27, 1934). The Congressional findings in the Securities Exchange Act of 1934 and the Commodity Exchange Act of 1936 were very similar; both were modeled after the findings in Section 3 of the Grain Futures Act. In Section 2 of the Securities Exchange Act the Congress found that the prices of securities "are subject to manipulation and control, and the dissemination of such prices gives rise to excessive speculation." It also found:

National emergencies, which produce widespread unemployment and the dislocation of trade, transportation, and industry, and which burden interstate commerce and adversely affect the general

After passing the Securities Act of 1933 and the Securities Exchange Act of 1934, the Congress considered legislation to strengthen the regulation of commodity markets, including whether to impose position limits on speculative trading in the futures markets for grain. Like the debates throughout the 1920s, opinions sharply differed as to whether regulation could better be accomplished by the exchanges rather than by a federal agency,²² whether speculators were to blame for depressing grain prices, and whether the imposition of limits on speculation would impair the ability of grain merchants and others in the grain business to hedge. By the mid-1930s, however, the tide of opinion had turned. In addition to the depression in farm prices,²³ the inability of the exchanges and federal authorities to challenge the activities of a few

welfare, are precipitated, intensified, and prolonged by manipulation and sudden and unreasonable fluctuations of security prices and by excessive speculation on such exchanges and markets, and to meet such emergencies the Federal Government is put to such great expense as to burden the national credit. Securities Exchange Act of 1934, June 6, 1934, c. 404, Title I, § 2, 48 Stat. 881.

²² For example, the Chicago Board of Trade, testified that it “cannot accept under any circumstances in principle” any of the following: (1) limitations on speculation; (2) “The delegation of practically unlimited power to the Secretary of Agriculture, through rules and regulations to be promulgated as he sees fit;” (3) “The effort to put into effect a complete licensing system for the grain trade under the guise of registration;” and (4) special privileges for farm cooperatives. When asked why the Board of Trade supported delegation of virtually unlimited power to one of its own committees while at the same time objecting to the bill on the grounds that it delegated limited and defined authority to the Secretary of Agriculture, Mr. C.D. Sturtevant, testifying on behalf of the Board, stated, “We think we can do a better job.” Hearing Before the Senate Committee on Agriculture and Forestry, To Amend the Grain Futures Act, 74th Cong., 1st Sess. (April 21, 1936), at p. 26. Senator Capper framed the issue: “I take it that your position all hangs on this point, that you want the board of trade to make all the rules and regulations governing the grain trade rather than an impartial agency of the Government that will function in the interest of all parties interested?” *Id.*, at p. 36. Siebel C. Harris, Vice President of the CBOT, sought to clarify that he had no objection to government regulation, but that the uncertainty in the market over what the government might do would be harmful to the market. “It is not my objection to what this Grain Futures Administration will do but it is the traders’ objection to what they think any commission may do.” *Id.*, at p. 37.

²³ In 1932, President Hoover blamed short sellers for the price declines on the grain exchanges:
It has come to my attention that certain persons are selling short in our commodity markets, particularly in wheat . . . I refer to a limited number of speculators. . . . It has but one purpose, and that is to depress prices. It tends to destroy returning public confidence. The intent is to take a profit from the losses of other people. Even though the effect is temporary, it deprives many farmers of their rightful income. If these gentlemen have that sense of patriotism that outruns immediate profit, and a desire to see their country recover, they will close these transactions and desist from their manipulations.
William G. Ferris, *The Grain Traders, The Story of the Chicago Board of Trade*, at p. 195 (Michigan State University Press, 1988).

prominent large traders fueled the reform movement, and the Congress finally provided a federal regulatory authority with the mandate and authority to establish and enforce limits on speculative trading.²⁴ In Section 4a of the 1936 Act (CEA), the Congress found that excessive speculation in the commodity futures markets created an “undue and unnecessary burden” on interstate commerce and directed the Commodity Exchange Commission to establish such limits on trading “as the commission finds is necessary to diminish, eliminate, or prevent” such burdens:

Sec. 4a. (1) 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 causing sudden or unreasonable fluctuations or unwarranted changes in the price of such commodity, is an undue and unnecessary burden on interstate commerce in such commodity. For the purpose of diminishing, eliminating, or preventing such burden, the commission shall, from time to time, after due notice and opportunity for hearing, by order, proclaim and fix such limits on the amount of trading under contracts of sale of such commodity for future delivery on or subject to the rules of any contract market which may be done by any person as the commission finds is necessary to diminish, eliminate, or prevent such burden.²⁵

Congress exempted “bona fide hedging transactions” from any such limits. Congress statutorily defined a bona fide hedging transaction as sales or purchases of futures contracts that were offset by purchases or sales of the same cash commodity.²⁶

²⁴ Perhaps the most notorious large trader during this period was Arthur Cutten. To avoid the GFA’s requirement to report positions in excess of 500,000 bushels of grain, Cutten established 32 separate accounts, with seven different firms, in the names of friends and relatives, in amounts up to a maximum of 495,000 bushels. On a number of occasions Cutten bought or sold several million bushels of wheat; at one point Cutten held a short position of about 7 million bushels. In 1932, Cutten wrote, “The notion that I could buy or sell not more than 500,000 bushels without having my trades subjected to the scrutiny of government clerks was to me galling beyond my powers of expression.” Ferris, at p. 192. Cutten’s victory in the Supreme Court, rejecting the GFA’s attempt to bring an after-the-fact criminal prosecution against Cutten for manipulation, *Wallace v. Cutten*, 298 U.S. 229 (1936), spurred Congress to include a strengthened anti-manipulation provision in the Commodity Exchange Act so as to allow prosecutions for manipulation or attempted manipulation even after they have occurred.

²⁵ Commodity Exchange Act of 1936, P.L. 74-675, 49 Stat. 1491, § 5. For an explanation of the Commodity Exchange Commission, see footnote 12.

²⁶ Section 4a(3) provided:

(3) No order issued under paragraph (1) of this section shall apply to transactions which are shown to be bona fide hedging transactions. For the purposes of this paragraph, bona fide hedging transactions shall mean sales of any commodity for future delivery on or subject to the rules of any board of trade to the extent that such sales are offset in quantity by the ownership or purchase of the same cash commodity or, conversely, purchases of any commodity for future delivery on or subject to the rules of any board of trade

Implementation of 1936 Act

After the passage of the 1936 Act, the Commodity Exchange Commission held hearings and in December 1938 promulgated both position limits and trading limits for grains—at the time the definition of “grain” included wheat, corn, oats, barley, flaxseed, grain sorghums, and rye.²⁷ The CEC imposed a “position limit” of two million bushels for any single grain futures contract, as well as for “all futures combined” for any one grain. At the same time, it imposed a “daily trading limit” of two million bushels on the amount of grain that any person could buy or sell in any one business day.²⁸

The CEC established a federal position limit for cotton in August, 1940, and for soybeans in August 1951. The CEC also established limits for fats and oils, including soybean oil, in April 1953, but later suspended the enforcement of those limits and subsequently revoked them in May 1968. The CEC also established speculative limits on lard, onions, eggs, and potatoes.

to the extent that such purchases are offset by sales of the same cash commodity. There shall be included in the amount of any commodity which may be hedged by any person --

(A) the amount of such commodity such person is raising, or in good faith intends or expects to raise, within the next twelve months, on land (in the United States or its Territories) which such person owns or leases;

(B) an amount of such commodity the sale of which for future delivery would be a reasonable hedge against the products or byproducts of such commodity owned or purchased by such person, or the purchase of which for future delivery would be a reasonable hedge against the sale of any product or byproduct of such commodity by such person.

Id.

²⁷ 3 Fed. Reg. 3145 (Dec. 24, 1938).

²⁸ The CEC's new regulation established higher position limits and trading limits for “spreading in the same grain between markets.” The position limit for spread positions read as follows:

To the extent that the net position held or controlled by any one person in all futures combined in any one grain or any one contract market is shown to represent spreading in the same grain between markets, the limit on net position in all futures combined set forth in paragraph 1 hereof [relating to position limits] may be exceeded on such contract market, but in no case shall the excess result in a net position of more than 3,000,000 bushels in all futures combined nor more than 2,000,000 bushels in any one future.

The daily trading limit for spread trading was very similar. *Id.*

The establishment of position limits for these commodities under the CEA did not require the CEC to find that an undue burden on interstate commerce had actually occurred in order to establish position limits, and the CEC did not make any such findings as it implemented the statute. Rather, the statute enabled the CEC to establish position limits based upon its reasonable judgment that such limits were necessary to “diminish, eliminate, or prevent” the burdens on interstate commerce resulting from excessive speculation. Accordingly, the CEC imposed position limits on commodities without finding that an undue burden on interstate commerce had actually occurred.

The CEC never established position limits for many of the agricultural commodities subject to its jurisdiction, such as butter, wool, wool tops, livestock, and livestock products. The Chicago Mercantile Exchange (CME) began trading pork belly futures in 1961, live cattle futures in 1964, and live hog futures in 1966. Even before those contracts were added in 1968 to the list of enumerated commodities subject to regulation under the CEA, the CME, acting under its own authority, established speculative limits for trading in those contracts. The existence of these exchange-set speculative limits helps explain why the CEC and the CFTC never set federal speculative limits for trading in livestock futures, and foreshadows a trend toward the use of exchange-set limits that would emerge in the 1980s.²⁹

1968 Amendments

The Salad Oil debacle of 1963 exposed ambiguity in the authority of the Commodity Exchange Authority to enforce its position limits.³⁰ The 1936 provision spoke in terms of

²⁹ At the time the CFTC began operating in 1975, “various contract markets [had] voluntarily placed speculative position limits on 23 contracts involving 17 commodities.” 45 Fed. Reg. 79831 (Dec. 2, 1980).

³⁰ In the Salad Oil scandal, Anthony DeAngelis attempted to corner the soybean market, among other fraudulent activities. At one point, DeAngelis accounted for three quarters of the nation’s exports of soybean and cottonseed oil. As part of his scheme, DeAngelis filled tankers with water and topped off the tanks with soybean and cottonseed oil, falsely representing as collateral for loans that the tankers were filled with vegetable oil. Numerous

trading, not positions. In 1968, Congress responded by clarifying the law and amending the second and third sentences of Section 4a(1) to clarify the CEA's authority to enforce position limits in addition to daily trading limits.

1974 Amendments

In 1974, Congress overhauled the CEA to remove the regulation of the futures markets from the Department of Agriculture and created the CFTC as an independent regulatory agency. It also expanded the CFTC's regulatory authority to include futures contracts in any commodity, not just the enumerated agricultural commodities. At the same time as it expanded the scope of the CFTC's authority, it reiterated the purpose of the Act to prevent fraud and manipulation and to control speculation:

A fundamental purpose of the Commodity Exchange Act is to insure fair practice and honest dealing on the commodity exchanges and to provide a measure of control over those forms of speculative activity which too often demoralize markets to the injury of producers and consumers and the exchanges themselves.³¹

The addition of many new commodities to the CFTC's jurisdiction presented the new agency with the question of how to determine the speculative position limits for all of these additional commodities. As a first step, it chose to retain the limits for the agricultural commodities that previously had been established by the CEC.³²

In August 1975, the CFTC initiated an advisory committee program to advise it on how it should perform its duties in view of the recent amendments to the CEA. As part of this advisory program, the CFTC formed an Advisory Committee on the Economic Role of Contract Markets.

lawsuits ensued once the fraud was discovered and about 16 firms were bankrupted by the scandal. *The Man Who Fooled Everybody*, Time, June 4, 1965.

³¹ S. Rep. No. 93-1131, 93rd Cong., 2d Sess. (1974).

³² In 1987, the CFTC imposed position limits for soybean oil and soybean meal contracts at the request of the Chicago Board of Trade.

In 1976, this Committee held eight meetings on its own, as well as several joint public hearings with the CFTC, on the issues of speculative trading, the definition of hedging, and delivery points. The Advisory Committee found that speculative position limits were of limited usefulness, and recommended they be “supplanted by an improved monitoring and surveillance program designed to achieve orderly liquidation of expiring contract months.”³³

In 1977, following its own study of the issue, the CFTC’s Office of the Chief Economist (OCE) arrived at different conclusions and recommendations. The OCE study found that, “Other things equal, sufficiently large positions and trades can become a perceptible market factor.”³⁴ It therefore recommended position limits in those markets “where the characteristics of the commodity, its marketing system, and the contract lend themselves to undue influence from large speculative positions,” and that the purpose of such limits would be to “curtail extraordinary speculative positions which are not offset by comparable commercial positions.”³⁵

Exchange-Set Limits

In 1979 the CFTC repealed all daily trading limits, but one year later, in the aftermath of the manipulation of the silver market by the Hunt brothers, it rejected the Advisory Committee’s recommendations that position limits be replaced by a flexible monitoring and surveillance system. In the Notice of Proposed Rulemaking to require exchanges to set position limits for all futures contracts not subject to Commission-imposed limits, the CFTC articulated the need for and purpose of position limits:

³³ *Report of the Commodity Futures Trading Commission Advisory Committee on the Economic Role of Contract Markets*, at 7 (July 17, 1976).

³⁴ *Speculative Limits*, staff paper prepared by the CFTC Office of Chief Economist, cited at 45 Fed. Reg. 79831, at 79832 (Dec. 2, 1980).

³⁵ *Id.*

Recent activity in the silver markets, however, has caused the Commission to reconsider the intended purpose of speculative limits and the markets in which limits might serve that purpose. In silver, extraordinarily large futures positions were held by a few speculative accounts and may have contributed to the rapid rise and subsequent collapse in the price of that commodity. Further, the concentration of disproportionately large numbers of futures contracts in the hands of one group of speculators was responsible for certain adverse consequences arising from the collapse in the silver market. Had limits on the amount of total open commitments which any trader or group can own or control been in effect, such occurrences may have been prevented.

More generally, the Commission believes that a trader's net position has a continued effect on price, and if sufficiently large can become a perceptible market factor. In this context, the Commission observes that speculative position limits serve to decrease the potential for positions to influence the general price level. Moreover, by limiting the ability of one person or group of persons to obtain extraordinarily large positions, speculative limits diminish the possibility of accentuating price swings if large positions must be liquidated sharply in the face of adverse price movements or for other reasons.³⁶

In promulgating the final rule, the Commission addressed comments submitted in opposition to the rule, including comments raising questions whether the Commission "had demonstrated that speculative limits provided necessary market protection," "whether such price movements could in any event be prevented by the imposition of such limits," and whether the proposed rule was appropriate "for markets with broad dependable deliverable supplies and was premised on recent events in the silver market."³⁷

In response, the Commission reiterated the findings in the notice of proposed rulemaking as to the need for position limits:

As stated in the proposal, the prevention of large and/or abrupt price movements which are attributable to extraordinarily large speculative positions is a Congressionally endorsed regulatory objective of the Commission. Further, it is the Commission's view that this objective is enhanced by speculative position limits since it appears that the capacity of any contract market to absorb the establishment and liquidation of large speculative positions in an orderly manner is related to the relative size of such positions, i.e., the capacity of the market is not unlimited.³⁸

³⁶ 45 Fed. Reg. 79831, at 79833 (Dec. 2, 1980).

³⁷ 46 Fed. Reg. 50938 (Oct. 16, 1981).

³⁸ *Id.*

The Commission dismissed the general objections regarding the effectiveness and need for position limits:

The Commission believes that the observations concerning the general desirability of limits are contrary to Congressional findings in sections 3 and 4a of the Act and considerable years of Federal and contract market regulatory experience.³⁹

In this rulemaking, the Commission adopted Rule 1.61 (now Rule 150.5), which required exchanges to have position limits for all commodities that did not have Commission-set limits.

In 1982, Congress ratified the CFTC's regulatory policy by enacting Section 4a(e), which stated that nothing in the CEA prohibited the exchanges from establishing positions limits themselves, provided that such limits are not higher than any limits the Commission may have established.⁴⁰

Position Accountability

In January 1992, the CFTC approved the CME's request for an exemption from the requirement to establish position limits for all commodities and instead permitted the CME to establish "position accountability" for certain financial contracts traded on the CME.⁴¹ Position accountability permitted exchanges to substitute accountability standards in lieu of position limit rules for both futures and options on futures contracts on three-month Eurodollars and several foreign currencies. The CFTC cited the continued growth in the depth and liquidity of futures and option contracts on foreign currencies and in certain financial futures or options contracts,

³⁹ *Id.*

⁴⁰ 7 U.S.C. § 6a(e) (2008). The Commission has continued to apply regulatory requirements and provide guidance for the exchanges on exchange-set position limits. In 1992, the Commission required position limits to be adjusted to reflect increases in the size of a contract's open interest. The 1992 formula has generally been incorporated into the Commission's regulations in 17 C.F.R. 150.5(c) (2009).

⁴¹ See 56 Fed. Reg. 51687 (Oct. 15, 1991) (Notice of proposed exchange rule changes; request for comments).

and noted that this continuing growth had “implications” calling into question the need for position limits, as traditionally structured, in those markets.

Initially, the CFTC stated that the position accountability program would apply to three categories of financial instruments: (1) futures contracts on foreign currencies and options thereon; (2) futures contracts and options thereon on “certain financial instruments which exhibit the highest degree of liquidity in both the futures and cash markets,” and (3) financial instruments “having a highly liquid futures or cash market, but not of the same magnitude as those in the highest class.”⁴² For futures contracts and options on financial instruments that exhibit the highest degree of liquidity in both the futures and cash markets, and which are readily arbitrated, the CFTC required that any exemption deleting an absolute position limit should include a level that would trigger distinct reporting requirements by a trader at the request of the applicable exchange. And, for contract markets on financial instruments having a highly liquid futures or cash market, but not of the same magnitude as those in the highest class, the CFTC permitted exemptions from the absolute, fixed limit standard on very large speculative positions but stated that the exchanges should include, in addition to the specified reporting requirements, a rule providing for the automatic consent of the trader, when so ordered by the exchange acting in its discretion, not to increase further those positions which exceed the triggering level. Consistent with the CME accountability program, later in 1992, the CFTC approved similar position accountability programs for the Finex Division of the New York Cotton Exchange for its futures and options contract in the U.S. Dollar Index, and Chicago Board of Trade for several of its futures and option contracts on financial instruments.

Six months later, the CFTC determined it would grant additional exemptions from the requirement to establish position limits, in order to permit the use of position accountability for

⁴² *Id.*

trading in energy commodity contracts.⁴³ In June 1992, the CFTC stated that exchanges would be permitted to substitute for position limits a position accountability rule meeting specified criteria for the non-spot months of futures and option contracts on certain metals and energy products. The Commission stated it “notes that certain of these metals and energy contracts generally are characterized by a high degree of liquidity, at least equivalent to, and in some cases greater than, certain of the financial futures and options contracts which the Commission would exempt [from the requirement to set position limits].” The standards for this category of exemptions required the exchange to include a reporting requirement at a specified triggering level and the authority to order a trader whose position exceeds the triggering level to halt further increases in the position. The CFTC also stated that, for physical commodities, this exemption from position limits would be appropriate only for the deferred trading months, and spot-month limits would continue to apply.

In 1999, the Commission formally recognized the practice of accountability by promulgating a rule that specifically allowed exchanges to establish position accountability levels, under certain conditions, rather than continue to permit position accountability through the exemptive process. The 1999 rule allowed exchanges to submit a position accountability rule rather than a numerical limit in circumstances in which a contract had been listed for trading for at least 12 months and met certain open interest and volume thresholds.⁴⁴ The rule also provided that the exchanges could not use position accountability levels for the spot month; the exchanges were still bound by the regulatory requirement to set numerical spot month position limits at a level no greater than one-quarter of the estimated spot month deliverable supply.

⁴³ See *Speculative Position Limits—Exemptions from Commission Rule 1.61*, 57 Fed. Reg. 29064 (June 30, 1992).

⁴⁴ 17 C.F.R. 150.5(e) (2009).

Commodity Futures Modernization Act of 2000 (CFMA)

In the Commodity Futures Modernization Act of 2000 (CFMA), the Congress expressly authorized the use of position accountability as an alternative means to limit speculative positions. Among the “core principles” enacted as part of the CFMA, Designated Core Principle 5 addresses position limitations and 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.”⁴⁵

Pursuant to the CFMA, the CFTC adopted its Part 38 regulations to apply the new core principle regime to designated contract markets. In Appendix B to its Part 38 regulations, the CFTC provided guidance as to “acceptable practices” for the exchanges to be in compliance with the various core principles. The Part 38, Appendix B guidance for Core Principle 5, “Position Limitations or Accountability,” states:

In order to diminish potential problems arising from excessively large speculative positions, and to facilitate orderly liquidation of expiring futures contracts, markets may need to set limits on traders’ positions for certain commodities.⁴⁶

The acceptable practices provide that spot-month limits should be adopted for markets based on commodities having more limited deliverable supplies or where otherwise necessary to minimize the susceptibility of the market to manipulation or price distortion. The guidance also allows markets to provide for position accountability rather than position limits “for contracts on financial instruments, intangible commodities, or certain tangible commodities. Markets appropriate for position accountability rules include those with large open-interest, high daily

⁴⁵ 7 U.S.C. §7(d)(3) (2009).

⁴⁶ 17 C.F.R. Part 38, Appendix B (2009).

trading volumes and liquid cash markets.”⁴⁷ The guidance also provides that contract markets could elect not to provide all-months-combined and non-spot individual month limits.⁴⁸ In addition, under Part 38, the existing provisions governing the establishment of exchange-set speculative position limits contained in Rule 150.5 could continue to serve as acceptable practices.

The CFMA also amended Section 3 of the CEA so as to remove the language pertaining to the burdens on interstate commerce that arise from manipulation, excessive speculation and control that originally had been included in 1922 to provide a constitutional grounding for the Act in the commerce clause. The CFMA did not alter, however, the Commission’s mandate in Section 4a to establish position limits as it finds are necessary to prevent such undue burdens on interstate commerce. Hence, although the CFMA did not include in the core principles an explicit direction that the exchanges must apply position limits or accountability as necessary to

⁴⁷ *Id.*

⁴⁸ The Part 38 “Acceptable Practices” for Core Principle 5 states, in part:

- (1) In order to diminish potential problems arising from excessively large speculative positions, and to facilitate orderly liquidation of expiring futures contracts, markets may need to set limits on traders’ positions in certain commodities. . . .
- (2) Provisions concerning speculative position limits are set forth in part 150. In general, position limits are not necessary for markets where the threat of excessive speculation or manipulation is nonexistent or low. Thus, contract markets do not need to adopt speculative position limits for futures markets on major foreign currencies, contracts based on certain financial instruments having very liquid and deep underlying cash markets, and contracts specifying cash settlement where the potential for distortion of such price is negligible. . . .
- (3) A contract market may provide for position accountability provisions in lieu of position limits for contracts on financial instruments, intangible commodities, or certain tangible commodities. Markets appropriate for position accountability rules include those with large open interest, high daily trading volumes and liquid cash markets.
- (4) Spot-month limits should be adopted for markets based on commodities having more limited deliverable supplies or where otherwise necessary to minimize the susceptibility of the market to manipulation or price distortions. The level of the spot limit for physical-delivery markets should be based upon an analysis of deliverable supplies and the history of spot-month liquidations. Spot-month limits for physical-delivery markets are appropriately set at no more than 25 percent of the estimated deliverable supply. . . . Markets may elect not to provide all months-combined and non-spot month limits.

17 C.F.R. Part 38, Appendix B.

prevent the undue burdens of excessive speculation, at the same time it retained the Commission's explicit responsibility to establish such limits.

The CFTC Reauthorization Act of 2008 contained two provisions regarding speculative limits. It amended CEA Section 4a(e) to give the CFTC enforcement authority over rules certified by exchanges. It also added core principle language regarding position limitations and accountability for derivatives transaction execution facilities.⁴⁹

Bona Fide Hedge Exemption

Since it first directed the Commission to establish position limits in 1936, Congress has made it clear that such position limits should not apply to the legitimate use of the futures markets by commodity producers, merchants, or end-users to price their goods efficiently or to manage their price risks. Section 4a provided a hedge exemption, but narrowly defined bona fide hedging as sales or purchases of futures contracts that were offset by purchases or sales of the same cash commodity.

Legislative and Regulatory Developments: 1956-1974

By the mid-1950s, there was concern that the statutory hedge exemption criteria were too restrictive. In 1956, Congress responded by permitting anticipatory hedging. Congress acted again when in the early 1970s concerns were again raised that speculative limit exemptions continued to be too restrictive. Congress responded to these concerns in the Commodity Futures Trading Act of 1974. First, it expanded the CFTC's exemptive authority by directing the CFTC to treat arbitrage in the same manner as spreads or straddles. Second, because the definition of commodity under the CEA was expanded by the 1974 Act beyond agricultural commodities, Congress was concerned that statutory definition failed to take into account the risk-shifting needs that were emerging at that time. Accordingly, Section 4a(3) was repealed, and the CFTC

⁴⁹ See 7 U.S.C. §2(h)(7) (2009).

was given broad administrative authority to define the type of activity that constituted bona fide hedging, subject only to the conditions that any such definition be “consistent with the purposes of the Act” and that “such terms may be defined to permit producers, purchasers, sellers, middlemen, and users of a commodity or a product derived therefrom to hedge their legitimate anticipated business needs”⁵⁰

In 1977, following up on the recommendations of the Advisory Committee on the Economic Role of Contract Markets, the CFTC fashioned a definition of hedging and a process for granting hedge exemptions that remains in place today. This definition is found in Rule 1.3(z) of the Commission’s regulations.⁵¹

Futures Trading Act of 1986

By the early-1980s, however, new questions concerning the CFTC’s hedge exemption standards emerged. As Congress considered what eventually became the Futures Trading Act of 1986, the House Agriculture Committee urged the CFTC to consider expanding the hedge

⁵⁰ 7 U.S.C. §4a(c) (2009).

⁵¹ This rule contains three parts. First is a general description of transactions or positions which the Commission considers to be bona fide hedging under economically appropriate circumstances, and specifies that no transaction or position shall be classified as bona fide hedging for purposes of exceeding federal speculative limits unless, among other requirements, it can be established and liquidated in an orderly manner. The first part states that an entity may hedge inventory or fixed price sales or purchases without prior approval of the Commission, but must file monthly reports with the agency for positions in excess of the position limits.

The second part, “Enumerated Hedging Transactions,” specifies one of the two other types of transactions that may qualify for the exemption, but that require prior Commission approval. Section 1.3(z)(2) states that a bona fide hedge exemption may be granted for purchases or sales for future delivery of unsold anticipated production or unfilled anticipated requirements. The various types of such anticipatory hedges are “enumerated” in this subsection.

The third part of the definition—the “non-enumerated” cases—provides that for purposes of exemptions from federal speculative limits the Commission may recognize as bona fide hedging purchases or sales other than those enumerated in the second part of the definition. This is intended to avoid the very type of inflexibility that Congress sought to avoid by deleting CEA §4a(3) and giving the Commission regulatory authority. It requires persons requesting permission to classify transactions as hedging to provide the Commission with evidence that such 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 the positions are consistent with orderly markets and other requirements of the CEA.

17 C.F.R. §1.3(z) (2009).

exemption to include financial firms using the futures markets to manage various types of financial risks.⁵² The report of the Senate Committee on Agriculture, Nutrition and Forestry noted the then-current definition of a bona fide hedge transaction “may not cover certain important new uses of financial futures and options by institutional investors.” The report urged the Commission to review its practices to ensure they were “consistent with the legitimate needs and practices of the industry.”⁵³ The Committee determined, however, that statutory changes were not necessary:

The Committee agrees that the Act provides the Commission with the power to make any needed revisions in the hedging definition and that no statutory changes are needed for this purpose. The only limit section 4a(3) places [on] the Commission’s power to define hedging is that the definition must be consistent with the purposes of the Act. In this context, a principal purpose of the Act, as set forth in section 4a(1), is that of preventing excessive speculation which causes sudden or unreasonable fluctuations or unwarranted changes in commodity prices. Within this broad parameter, the Commission clearly has the necessary power, as well as the responsibility, to define hedging in a way that is consistent with the current needs and practices of the industry.⁵⁴

Although the Committees urged Congress to review the definition of a bona fide hedge transaction, Congress chose not to amend the statute, instead leaving the CFTC with discretion to determine the contours of the bona fide hedge exemption.

There have been no further changes to the statutory provisions regarding bona fide hedging. Although the Commission has issued a number of interpretations to its regulatory definition, and has proposed a new risk management exemption on several occasions, these interpretations and proposals have not been directed by the Congress, but rather have occurred as a result of the Commission’s application of the statute.

⁵² H. Rept. 624, 99th Cong., 2d. Sess., at 45-6 (1986).

⁵³ S. Rept. 291, 99th Cong., 2d. Sess., at 21-2 (1986).

⁵⁴ *Id.*, at p. 22.

Application of Bona Fide Hedge Exemption to Risk Management Activities

In 1987, the CFTC issued a statement clarifying its interpretation of its bona fide hedging rule. The CFTC stated that various users and potential users of financial futures had expressed concern that the link to transactions in the physical commodity markets is overly restrictive and precludes the classification as hedging of numerous strategies that are otherwise risk reducing.⁵⁵ The CFTC explained that the definition should not be construed to apply only to firms using futures contracts to reduce their exposure to risks in the cash market. It stated that the Commission's original intent in promulgating the definition of a bona fide hedge was to provide a general definition to describe the broad scope of risk-shifting transactions that may be possible in the diverse types of futures contracts now under regulation. The CFTC concluded that to qualify as a bona fide hedge, a transaction in the futures market did not need to be a temporary substitute for a later transaction in the cash market, but also included all balance sheet and other trading strategies that are risk reducing and otherwise consistent with this interpretation.

Several months later, the CFTC issued a new interpretation of its definition of bona fide hedge transactions to permit exchanges to grant hedge exemptions for various risk management transactions. The CFTC stated that the exemption of certain risk-management positions from exchange speculative limits would be consistent with the objectives of the hedge exemption. The CFTC explained that it adopted this broader view of the hedge exemption so that any futures or option positions involved in such risk reducing strategies currently would be eligible for exemption from exchange speculative limits pursuant to exchange rules. The CFTC specified that such exemptions be granted on a case-by-case basis, subject to a demonstrated request and showing by the applicant of the need for the exemption. The CFTC also required that applicants for such risk management exemptions be typically engaged in buying, selling or holding cash

⁵⁵ See Clarification of Certain Aspects of the Hedging Definition, 52 Fed. Reg. 27195 (July 20, 1987).

market instruments. Additionally, the CFTC required the exchanges to monitor the exemptions it granted to ensure that any positions held under the exemption did not result in any large futures or options position that could disrupt the relevant futures market.⁵⁶

In accordance with the 1987 clarification and the following interpretation, in 1991 the Commission staff granted a bona fide hedge exemption to a swap dealer who was seeking to manage price risk on its books as a result of swaps it planned to enter into with various investors seeking exposure to commodity indexes. Similar hedge exemptions were subsequently granted in other cases where the futures positions offset risks related to swaps or similar OTC positions involving both individual commodities and commodity indexes. These exemptions have been subject to specific conditions to protect the market, including: (1) the futures positions must offset specific price risk; (2) the dollar value of the futures positions must be no greater than the dollar value of the underlying risk; and (3) the futures positions must not be carried into the spot month.

Although the CFTC staff has granted several hedge exemptions to a number of swap dealers for their commodity index-related swaps, it has determined that it was not appropriate to grant such exemptions to exchange traded funds (ETFs) for their investments in futures contracts to ensure that the net asset value of the fund tracked the commodity index upon which the fund was based. On two occasions, however, the CFTC staff determined it was appropriate to provide no-action relief from the position limits for agricultural commodities to the managers of index-based funds. In 2006, the CFTC staff issued a letter stating that it would not enforce the position

⁵⁶ See Risk Management Exemptions From Speculative Position Limits Approved Under Commission Regulation 1.61, 52 Fed. Reg. 34633 (Sept. 14, 1987).

limits with respect to Deutsche Bank's operation of a commodity-related ETF.⁵⁷ Later that year it provided similar relief to another firm.⁵⁸

The topic of hedge exemptions continues to be a major topic of interest to the CFTC. In November 2007, the CFTC proposed to amend its regulations to create a new type of exemption from the standard position limits.⁵⁹ Called a "risk management exemption," it would permit ETF managers to apply for permission to exceed established position limits, rather than have to continue to rely upon no-action letters. The CFTC noted that the last substantive changes to its position limits had been made in 1991, and the intervening 16 years have seen significant changes in trading patterns and practices in derivatives markets. The proposed risk management exemption would have allowed an exemption from position limits for: (1) intermediaries, such as index funds, who pass price risks on to their customers; and (2) pension funds and other institutional investors seeking to diversify risks in portfolios by including an allocation to commodity exposure. This proposed rulemaking was withdrawn in 2008.⁶⁰

In September 2008, the CFTC released a Staff Report on Commodity Swap Dealers and Index Traders with Commission Recommendations, which included several preliminary recommendations. One such recommendation directed CFTC staff to develop an advance notice of proposed rulemaking to 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, an obligation to report to the CFTC and applicable self-regulatory organizations when certain noncommercial swap clients reach a certain position level and/or a certification that

⁵⁷ CFTC Letter 06-09 (May 5, 2006).

⁵⁸ CFTC Letter 06-19 (Sept. 6, 2006).

⁵⁹ 72 Fed. Reg. 66097 (Nov. 27, 2007).

⁶⁰ 73 Fed. Reg. 32260 (June 6, 2008).

none of a swap dealer's noncommercial swap clients exceed specified position limits in related exchange-regulated commodities. In March 2009, the CFTC published a concept release on whether to eliminate the bona fide hedge exemption for certain swap dealers and create a new limited risk management exemption from position limits.⁶¹

⁶¹ 74 Fed. Reg. 12282 (March 24, 2009).

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United States Senate
PERMANENT SUBCOMMITTEE ON INVESTIGATIONS
Committee on Homeland Security and Governmental Affairs
Carl Levin, Chairman
Norm Coleman, Ranking Minority Member

EXCESSIVE SPECULATION IN THE NATURAL GAS MARKET

STAFF REPORT
WITH ADDITIONAL MINORITY STAFF VIEWS

**PERMANENT SUBCOMMITTEE
ON INVESTIGATIONS
UNITED STATES SENATE**



**RELEASED IN CONJUNCTION WITH THE
PERMANENT SUBCOMMITTEE ON INVESTIGATIONS
JUNE 25 AND JULY 9, 2007 HEARINGS**

Permanent Subcommittee on Investigations

EXHIBIT #4

EXCESSIVE SPECULATION IN THE NATURAL GAS MARKET

JUNE 25, 2007

I. EXECUTIVE SUMMARY

Since 2001, the U.S. Senate Permanent Subcommittee on Investigations (“the Subcommittee”) has been examining the structure and operation of U.S. energy markets. In June 2006, the Subcommittee issued a bipartisan staff report, *The Role of Market Speculation in Rising Oil and Gas Prices: A Need to Put the Cop Back on the Beat*,¹ analyzing the extent to which the increasing amount of financial speculation in energy markets has contributed to the steep rise in energy prices over the past few years. The report concluded: “Speculation has contributed to rising U.S. energy prices,” but also that “gaps in available market data” made quantification of the speculative component problematic.² The report endorsed the estimate of various analysts that the influx of speculative investments into crude oil futures accounted for approximately \$20 of the then-prevailing crude oil price of approximately \$70 per barrel. The report’s analysis was based entirely on publicly available data about the overall level of financial investments in energy markets and publicly available data on energy prices and supplies.

The Subcommittee’s staff report recommended that the Commodity Futures Trading Commission (“CFTC”) be provided with the same authority to regulate and monitor electronic energy exchanges, such as the Intercontinental Exchange (“ICE”), as it has with respect to the fully regulated futures markets, such as the New York Mercantile Exchange (“NYMEX”), to ensure that excessive speculation did not adversely affect the availability and affordability of vital energy commodities through unwarranted price increases. Congress has not taken any action since then to authorize CFTC oversight of unregulated energy markets like ICE.

Shortly after the Subcommittee issued the report in 2006, the natural gas market entered a period of extreme price volatility punctuated by the collapse in September 2006 of Amaranth Advisors LLC (“Amaranth”), one of the largest hedge funds in the natural gas market. From the last week in August until the middle of September 2006, Amaranth’s natural gas positions lost over \$2 billion in value, precipitating the liquidation of the entire portfolio of the \$8 billion fund.

¹ S. Prt. 109-65, 109th Congress, 2nd Session (June 27, 2006).

² *Id.*, at p. 6.

In late summer, natural gas prices began falling. For example, the price of the NYMEX futures contract to deliver natural gas in October 2006 fell from a high of \$8.45 per MMBtu in late July to just under \$4.80 per MMBtu in September, the lowest level for that contract in two and one-half years. The difference in price between the NYMEX natural gas futures contract for March 2007 and for April 2007 – called the price spread – fell from a high of nearly \$2.50 per MMBtu in July to less than 60 cents in September, a drop of 75 percent. The price for the immediate delivery of natural gas, called the spot price, fell from \$7.49 per MMBtu in late August to \$3.66 per MMBtu in early October, the lowest level in four years.³ The Electric Power Research Institute described this price collapse as “stunning . . . one of the steepest declines ever.”⁴

Throughout this period, the market fundamentals of supply and demand were largely unchanged. Natural gas supplies were plentiful, and the amount of natural gas in storage remained higher than average throughout the summer and into the early fall. The large price variations in the face of steady supply and demand trends raises several questions: If the underlying supply and demand factors were unchanged, what was causing the large price swings? To what extent was the collapse of Amaranth related to the fall in prices? If Amaranth’s collapse either caused or accelerated the price drops, then were Amaranth’s positions responsible for the higher prices and large spreads that prevailed throughout the summer? Was there adequate market oversight to ensure that large hedge funds were not distorting natural gas prices?

In October 2006, the Subcommittee began its investigation into the behavior of natural gas prices earlier in the year. The Subcommittee analyzed millions of natural gas transactions from trading records obtained from NYMEX and ICE, the two principal exchanges for energy commodities, and from Amaranth and other traders. In addition, the Subcommittee conducted numerous interviews of natural gas market participants, including natural gas traders, producers, suppliers, and hedge fund managers, as well as exchange officials, regulators, and energy market experts. NYMEX, ICE, Amaranth, and many traders cooperated with detailed inquiries. The Subcommittee also reviewed commodity market statutes and regulations, and researched a variety of legal issues.

The trading records examined by the Subcommittee disclosed that from early 2006 until its September collapse, Amaranth dominated trading in the U.S. natural gas financial markets. Amaranth bought and

³ Federal Energy Regulatory Commission (FERC), Winter 2006-07 Energy Market Assessment, Item No.: A-3, October 19, 2006, at p. 2.

⁴ Electric Power Research Institute, Natural Gas Issues: Turnaround Prospects, Energy Markets and Generation Response, October 2006, at p. 1.

sold thousands of natural gas contracts on a daily basis, and tens of thousands of contracts on certain days. It accumulated tens of thousands of natural gas holdings, or "positions," on both NYMEX and ICE. The CFTC defines a "large trader" for reporting purposes in the natural gas market as a trader who holds at least 200 contracts; NYMEX examines a trader's position if it exceeds 12,000 natural gas contracts in any one month. Amaranth held as many as 100,000 natural gas contracts in a single month, representing 1 trillion cubic feet of natural gas, or 5 percent of the natural gas used in the entire United States in a year. At times Amaranth controlled 40 percent of all of the outstanding contracts on NYMEX for natural gas in the winter season (October 2006 through March 2007), including as much as 75 percent of the outstanding contracts to deliver natural gas in November 2006.

Amaranth's large positions and trades caused significant price movements in key natural gas futures prices and price relationships. For example, Amaranth's purchases of contracts to deliver natural gas in the winter months, in conjunction with Amaranth's sales of natural gas contracts for delivery in the summer months, drove winter prices far above summer prices. These differences between winter and summer prices, called "price spreads," were far higher in 2006 than in previous years - until the collapse of Amaranth, when the price spreads returned to more normal levels. On several specific dates, Amaranth's massive trades were responsible for large jumps in the price differences between the futures contracts for March and April 2007. Traders interviewed by the Subcommittee said that during the spring and summer of 2006 the differences between winter and summer prices were "clearly out-of-whack," at "ridiculous" levels, and unjustified by supply or demand.

Purchasers of natural gas during the summer of 2006 for delivery in the following winter months paid inflated prices due to Amaranth's large-scale speculative trading. Businesses such as utilities had to either absorb this added expense or pass the higher costs onto the ultimate consumer, such as residential users who paid higher home heating bills.

The current regulatory system was unable to prevent Amaranth's excessive speculation in the 2006 natural gas market. Under current law, NYMEX is required to monitor the positions of its traders to determine whether a trader's positions are too large. If a trader's position exceeds pre-set "accountability levels," the exchange may require a trader to reduce its positions. The Amaranth case history demonstrates two critical flaws. First, NYMEX has no routine access to information about a trader's positions on ICE in determining whether a trader's positions are too large. It is therefore impossible under the current system for NYMEX to have a complete and accurate view of a trader's position in determining whether it is too large.

Second, even if NYMEX orders a trader to reduce its positions on NYMEX, the trader can simply shift its positions to ICE where no limits apply. This is precisely what Amaranth did after NYMEX finally told Amaranth, in August 2006, to reduce its positions in two contracts nearing expiration, contracts to deliver gas in September and October 2006. In response, Amaranth reduced its positions on NYMEX and increased them on ICE, maintaining the same overall positions in the market. Within a few days, Amaranth resumed increasing its positions, mostly on ICE. By the end of August, Amaranth held nearly 100,000 short positions in the September contract, mostly on ICE, and a total of nearly 90,000 short positions for the October contract on both ICE and NYMEX. These were huge positions - each variation of one cent in a position of 100,000 contracts changes a trader's profit or loss by \$10 million. As a result, NYMEX's instructions to Amaranth did nothing to reduce Amaranth's size, but simply caused Amaranth's trading to move from a regulated market to an unregulated one.

The data analyzed by the Subcommittee, together with trader interviews, show that NYMEX and ICE are functionally equivalent markets. Natural gas traders use both markets, employing coordinated trading strategies. In many instances the volumes on ICE are comparable to or greater than the volumes on NYMEX. Traders use the natural gas contract on NYMEX, called a futures contract, in the same way they use the natural gas contract on ICE, called a swap, for risk management and economic purposes. The data show that prices on one exchange affect the prices on the other. Given their equivalence, there is no sound basis for one exchange to be regulated and the other not.

The disparity in regulation between NYMEX and ICE results from the so-called "Enron loophole" in the Commodity Exchange Act. The Enron loophole, which was inserted into the law in 2000 at the request of Enron and others, exempts electronic energy exchanges such as ICE from CFTC oversight and regulation. Unlike NYMEX, there are no limits on the trading on ICE, and no routine government oversight. The Amaranth case history demonstrates that the disparity in regulation of the two markets prevents the CFTC and the exchanges from fully analyzing market transactions, understanding trading patterns, and compiling accurate pictures of trader positions and market concentration; it requires them to make regulatory judgments on the basis of incomplete and inaccurate information; and it impedes their authority to detect, prevent, and punish market manipulation and excessive speculation.

Natural gas traders are well aware of the consequences of this limitation. For example, when Amaranth's lead energy trader predicted in an email that "boy I bet you see some CFTC inquiries" into a price

spike that affected the final price of the September 2006 futures contract, another trader reminded him that most of the trades had taken place on ICE using swaps. The trader wrote: "Until they monitor swaps no big deal." His comment captures the problem – current law requires our regulators to oversee U.S. energy markets with incomplete information and inadequate authority.

To repair the broken regulatory system, Congress needs to require currently unregulated exchanges, such as ICE, to comply with the same statutory obligations as regulated markets, such as NYMEX, and operate under the same rules to prevent market manipulation and excessive speculation from affecting the price of vital energy commodities.

Some market observers contend that Amaranth's collapse proved the energy markets are functioning well because an overly risky trader met its demise without harming other traders or the natural gas market as a whole. In fact, however, many other market participants were harmed by Amaranth's massive speculative trading. For example, utilities that provide gas-powered electricity or heating to homes, schools, hospitals, and industries that use natural gas in manufacturing paid inflated prices. Many of their costs were passed onto consumers. Some companies told the Subcommittee that extreme price swings in the natural gas futures market make it more difficult and expensive to use the futures market for hedging. Still others told the Subcommittee that they have lost confidence in the natural gas market, viewing it not as a mechanism to set prices reflecting supply and demand, but as a market increasingly responsive to a few dominant traders with sufficient capital to affect prices.

If given authority to police all U.S. energy commodity markets, the CFTC should use this authority to monitor aggregate positions taken by traders on both NYMEX and ICE, and to analyze trading data from both exchanges. Regulators should also strengthen their monitoring and oversight to prevent excessive speculation for all of the months in which contracts are traded, not just contracts near expiration. The Amaranth experience demonstrates how excessive speculation can distort prices of futures contracts that are many months from expiration, with serious consequences for other market participants. To prevent excessive speculation from causing unwarranted price changes, commodity regulators need to conduct oversight over both a broader market and for a longer time horizon than the next few months.

A final major problem is the inadequate oversight capabilities of the CFTC. The CFTC suffers from antiquated technology systems, a shrinking staff, and flat budgets. In part, these budgetary woes have occurred because Congress has never authorized the CFTC, as it has

virtually every other federal financial regulator, to collect user fees from the markets it oversees. Congress needs to provide the CFTC with adequate resources to do its job, and authorize user fees to pay for the additional expense.

Energy is a critical factor in the future of the U.S. economy. How it is priced is of vital concern. The Amaranth case history is not just the story of a single hedge fund dominating the market, but of a broken regulatory system that has left our energy markets vulnerable to any trader with sufficient resources to alter energy prices for all market participants.

The remainder of this Report details the Amaranth case history. Section II presents the staff findings and recommendations from the Subcommittee's investigation. Section III provides general information on the importance of natural gas to the U.S. economy, its production, economic uses, and the fundamentals of natural gas supply and demand. Section IV provides general information on the cash and financial markets for natural gas, and an overview of the regulatory structure for the various types of energy exchanges. Section V describes the unusual and extreme behavior of natural gas prices in the spring and summer of 2006, and analyzes the role of Amaranth and other hedge funds in forming those prices. Section V also describes the impact of Amaranth's trading on other market participants. Sections VI and VII offer recommendations to restore the integrity of energy commodity markets in the United States and protect them against market manipulation and excessive speculation. Section VIII contains additional Minority Staff views on the Report.

II. FINDINGS AND RECOMMENDATIONS

A. FINDINGS

(1) A single hedge fund, Amaranth Advisors LLC, dominated the U.S. natural gas market in 2006.

(a) Amaranth accumulated massive natural gas holdings on NYMEX and ICE spanning five years, from 2006-2010.

(b) Amaranth accumulated such large positions and traded such large volumes of natural gas in 2006, on both NYMEX and ICE, that it had a direct effect on U.S. natural gas prices and increased price volatility in the natural gas market. The larger than usual differences between winter and summer futures prices that prevailed during the spring and summer of 2006 were largely the result of Amaranth's large-scale trades rather than the normal market interaction of many buyers and sellers.

(c) Amaranth's 2006 positions in the natural gas market constituted excessive speculation.

(2) In August 2006, Amaranth traded natural gas contracts on ICE rather than on NYMEX so that it could trade without any restrictions on the size of its positions.

(a) When NYMEX directed Amaranth to reduce its positions in September 2006 and October 2006 natural gas futures contracts, Amaranth simply transferred those positions to ICE, an unregulated market, thereby maintaining its overall speculative position in the natural gas market.

(b) NYMEX's attempt to limit speculative trading during the last day of trading on the September 2006 natural gas futures contract failed, because neither NYMEX nor the CFTC had any authority, mandate, or ability to limit trading on ICE that affected the pricing of the NYMEX futures contract.

(3) Amaranth's actions in causing significant price movements in the natural gas market demonstrate that excessive speculation distorts prices, increases volatility, and increases costs and risks for natural gas consumers, such as utilities, who ultimately pass on inflated costs to their customers.

(a) Purchasers of natural gas during the summer of 2006 for delivery in the following winter months paid inflated prices due to Amaranth's speculative trading.

(b) Many of these inflated costs were passed on to consumers, including residential users who paid higher home heating bills.

(4) The two major U.S. exchanges that trade natural gas – NYMEX and ICE – affect each other's prices.

- (a) Significant volumes of natural gas are traded on both NYMEX and ICE, and both markets play a key role in setting U.S. natural gas prices.
- (b) The contracts used on NYMEX and ICE to trade natural gas, called futures contracts on NYMEX and swaps on ICE, are equivalent financial products that serve the same risk-management purposes.
- (c) Traders routinely buy and sell natural gas contracts on both NYMEX and ICE, and hold positions in both markets.
- (d) The price of NYMEX futures and ICE swaps are virtually identical up until the final half hour of the last trading day of the NYMEX contract, when NYMEX and ICE prices typically differ by a few cents at most.

(5) Current restraints on speculative trading to prevent manipulation and price distortions are inadequate.

- (a) The CFTC lacks statutory authority to establish or enforce speculative position limits on the trading of natural gas on ICE or other Exempt Commercial Markets.
- (b) When large traders choose to trade on ICE rather than NYMEX, it is difficult, if not impossible, for NYMEX to prevent price manipulation or excessive speculation from distorting NYMEX prices, because NYMEX does not have information regarding, or the jurisdiction to limit, trading on ICE even though ICE trades affect NYMEX futures prices.
- (c) The CFTC's primary strategy to stop excessive speculation has been to prevent manipulation of the final price of a futures contract that is about to expire, rather than to generally review speculative trades affecting a range of futures contract prices.

(6) The CFTC is unable to meet its statutory mandate to prevent market manipulation and excessive speculation from causing sudden, unreasonable, or unwarranted energy prices.

- (a) The CFTC lacks statutory authority to effectively oversee U.S. energy commodity markets, because the "Enron Loophole" prevents the CFTC from overseeing ICE.
- (b) The CFTC lacks budgetary, staff, and technological resources to effectively monitor energy commodity markets.

(c) As a result of the lack of legal authority and budgetary resources, the CFTC was unable to prevent excessive speculation in the natural gas market in 2006.

(d) If the CFTC is not provided with additional legal authority and resources, the CFTC will remain unable to accomplish its statutory mission.

(e) The inability of the CFTC to accomplish its statutory mission with respect to the trading of energy commodities presents a threat to the energy and economic security of the United States.

B. RECOMMENDATIONS

(1) Congress should eliminate the "Enron Loophole" that exempts electronic energy exchanges from regulatory oversight. Experience since passage of the Commodity Futures Modernization Act of 2000, demonstrates there is no sound rationale for exempting electronic energy exchanges from regulatory oversight. Excessive speculation that occurred on electronic exchanges in 2006 contributed to the overall distortion of energy prices in the natural gas market, to the detriment of American consumers, businesses, industry, and utilities. Exempt Commercial Markets, such as ICE, should be required to comply with the same statutory obligations as Designated Contract Markets, such as NYMEX, and should be regulated in the same manner by the CFTC to prevent market manipulation and excessive speculation. To ensure fair energy pricing, it is time to put the cop back on the beat in all U.S. energy commodity markets.

(2) If given additional legal authority, the CFTC should monitor aggregate positions on NYMEX and ICE. The CFTC and exchanges should strengthen their monitoring and oversight to prevent excessive speculation for all of the months in which contracts are traded, not just for contracts near expiration.

(3) Congress should increase the CFTC budget and authorize CFTC user fees to help pay for the additional cost. The CFTC's budget should be increased to provide the staff and technology needed to monitor, integrate, and analyze real-time transactional data from all U.S. commodity exchanges, including NYMEX and ICE. Needed funding should be obtained from user fees imposed on commodity markets.

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United States Senate
PERMANENT SUBCOMMITTEE ON INVESTIGATIONS
Committee on Homeland Security and Governmental Affairs
Carl Levin, Chairman
Tom Coburn, Acting Ranking Minority Member

**EXCESSIVE SPECULATION
IN THE WHEAT MARKET**

**MAJORITY AND MINORITY
STAFF REPORT**

**PERMANENT SUBCOMMITTEE
ON INVESTIGATIONS
UNITED STATES SENATE**



JUNE 24, 2009

Permanent Subcommittee on Investigations
EXHIBIT #5

EXCESSIVE SPECULATION IN THE WHEAT MARKET

I. EXECUTIVE SUMMARY

For several years, the U.S. Senate Permanent Subcommittee on Investigations has been examining the role of speculation in the commodity markets and failures of the federal regulatory structure to prevent excessive speculation from causing unwarranted changes in commodity prices and an undue burden on interstate commerce.

In 2006, the Subcommittee released a report showing how the injection of billions of dollars from speculation into the commodity futures markets had contributed to rising energy prices.¹ In 2007, the Subcommittee released a report and held a hearing showing how excessive speculation by a single hedge fund named Amaranth had distorted natural gas prices and contributed to higher costs for natural gas consumers.² These and other reports offered a number of recommendations for legislative and regulatory actions to enable the Commodity Futures Trading Commission (CFTC) to fulfill its mission under the Commodity Exchange Act to prevent excessive speculation from “causing unreasonable or unwarranted fluctuations in the price of commodities in interstate commerce.”

¹In its 2006 Report, *“The Role of Market Speculation in Rising Oil and Gas Prices: A Need to Put the Cop Back on the Beat,”* S. Prt. 109-65 (June 27, 2006), the Subcommittee investigation found that influx of billions of dollars into the U.S. energy markets through commodity index funds had contributed to the rise in energy prices, and that the large influx of speculative investments in these markets had altered the traditional relationships between futures prices and supplies of energy commodities, particularly crude oil. The Report recommended that Congress enact legislation to “close the Enron loophole,” the provision in the Commodity Futures Modernization Act of 2000 (CFMA), which exempted from regulation the trading of futures contracts and swaps for energy and metals commodities on electronic exchanges. It also recommended legislation to ensure the CFTC had sufficient authority to monitor U.S. traders trading in U.S. commodities on foreign exchanges. See the 2006 Subcommittee Report at <http://hsgac.senate.gov/public/ files/SenatePrint10965MarketSpecReportFINAL.pdf>.

²In its 2007 Report, *“Excessive Speculation in the Natural Gas Market,”* reprinted in S. Hrg. 110-235 (June 25 and July 9, 2007), at pp. 196-710, the Subcommittee investigation found that Amaranth had distorted the price of natural gas futures contracts as a result of its large purchases of contracts on the regulated New York Mercantile Exchange (NYMEX) and “look-alike” swap contracts on the then-unregulated Intercontinental Exchange (ICE). As a result of several provisions in the CFMA, the CFTC did not have authority to limit the positions of traders using ICE rather than NYMEX. Based on this finding, the Report recommended that Congress enact legislation to close the Enron loophole in order to fully regulate electronic exchanges, like ICE, that are the functional equivalent of futures markets. In the 2008 Farm Bill, Congress enacted legislation to close the Enron loophole by providing that commodity contracts traded on over-the-counter electronic exchanges that perform a significant price discovery function be regulated in the same manner as futures contracts. As a result of this legislation, the CFTC now has the authority – and responsibility – to regulate and monitor these electronic markets to prevent excessive speculation. See the 2007 Subcommittee Report at <http://hsgac.senate.gov/public/ files/REPORTExcessiveSpeculationintheNaturalGasMarket.pdf>.

In the Amaranth investigation, the Subcommittee examined how the activities of a single trader making large trades on both a regulated futures exchange and an unregulated electronic energy exchange constituted excessive speculation in the natural gas market. To prevent this type of excessive speculation, the Subcommittee Report recommended that limits on the number of contracts that a trader can hold at one time, known as position limits, be applied consistently to both markets in which the same type of natural gas contracts are traded.

In the current investigation, the Subcommittee has examined how the activities of many traders, in the aggregate, have constituted excessive speculation in the wheat market. To prevent this type of excessive speculation, this Report recommends that the CFTC phase out waivers and exemptions from position limits that were granted to commodity index traders purchasing wheat contracts to help offset their sales of speculative financial instruments tied to commodity indexes.

A commodity index, like an index for the stock market, such as the Dow Jones Industrial Average or the S&P 500, is calculated according to the prices of selected commodity futures contracts which make up the index. Commodity index traders sell financial instruments whose values rise and fall in tune with the value of the commodity index upon which they are based. Index traders sell these index instruments to hedge funds, pension funds, other large institutions, and wealthy individuals who want to invest or speculate in the commodity market without actually buying any commodities. To offset their financial exposure to changes in commodity prices that make up the index and the value of the index-related instruments they sell, index traders typically buy the futures contracts on which the index-related instruments are based. It is through the purchase of these futures contracts that commodity index traders directly affect the futures markets.

The Subcommittee investigation examined in detail how commodity index traders affected the price of wheat contracts traded on the Chicago Mercantile Exchange. CFTC data shows that, over the past three years, between one-third and one-half of all of the outstanding wheat futures contracts purchased ("long open interest") on the Chicago exchange are the result of purchases by index traders offsetting part of their exposure to commodity index instruments sold to third parties. The Subcommittee investigation evaluated the impact that the many purchases made by index traders had on prices in the Chicago wheat futures market. This Report finds that there is significant and persuasive evidence to conclude that these commodity index traders, in the aggregate, were one of the major causes of "unwarranted changes" – here, increases – in the price of wheat futures contracts relative to the price of wheat in the cash market. The resulting unusual, persistent, and large disparities between wheat futures and cash prices impaired the ability of participants in the grain market to use the futures market to

price their crops and hedge their price risks over time, and therefore constituted an undue burden on interstate commerce. Accordingly, the Report finds that the activities of commodity index traders, in the aggregate, constituted "excessive speculation" in the wheat market under the Commodity Exchange Act.

The futures market for a commodity provides potential buyers and sellers of the commodity with prices for the delivery of that commodity at specified times in the future. In contrast, the cash market provides potential buyers and sellers with the price for that commodity if it is delivered immediately. Normally, the prices in the futures market follow a predictable pattern with respect to the cash price for a commodity. Typically, as a contract for future delivery of a commodity gets closer to the time when the commodity is to be delivered under the contract (the expiration of the contract), the price of the futures contract gets closer to the price of the commodity in the cash market. The prices are said to "converge." In recent years in the wheat market, however, the futures prices for wheat have remained abnormally high compared to the cash prices for wheat, and the relationship between the futures and cash prices for wheat has become unpredictable. Oftentimes the price of wheat in the Chicago futures market has failed to converge with the cash price as the futures contracts have neared expiration.

The result has been turmoil in the wheat markets. At a time when wheat farmers were already being hit by soaring energy and fertilizer costs, the relatively high price of wheat futures contracts compared to the cash price, together with the breakdown in the relationship between the two prices and their failure to converge at contract expiration, have severely impaired the ability of farmers and others in the grain business to use the futures markets as a reliable guide to wheat prices and to manage price risks over time.

Participants in the grain industry have complained loudly about the soaring prices and breakdowns in the market. "Anyone who tells you they've seen something like this is a liar," said an official of the Farmers Trading Company of South Dakota. An official at cereal-maker Kellogg observed, "The costs for commodities including grains and energy used to manufacture and distribute our products continues to increase dramatically." "I can't honestly sit here and tell who is determining the price of grain," said one Illinois farmer, "I've lost confidence in the Chicago Board of Trade." "I don't know how anyone goes about hedging in markets as volatile as this," said the president of MGP Ingredients which provides flour, wheat protein, and other grain products to food producers. "These markets are behaving in ways we have never seen," said a senior official from Sara Lee. A grain elevator manager warned, "Eventually, those costs are going to come out of the pockets of the American consumer."

The inability of farmers, grain elevators, grain merchants, grain processors, grain consumers, and others to use the futures market as a reliable guide to wheat prices and to manage their price risks over time has significantly aggravated their economic difficulties and placed an undue burden on the grain industry as a whole.

This Report concludes there is significant and persuasive evidence that one of the major reasons for the recent market problems is the unusually high level of speculation in the Chicago wheat futures market due to purchases of futures contracts by index traders offsetting sales of commodity index instruments. To diminish and prevent this type of excessive speculation in the Chicago wheat futures market, the Report recommends that the CFTC phase out existing exemptions and waivers that allow some index traders to operate outside of the trading limits designed to prevent excessive speculation.

A. Subcommittee Investigation

To prepare this Report, the Subcommittee conducted a year-long, bipartisan investigation. As a first step, the Subcommittee obtained and analyzed price and trading data from a variety of agricultural futures and cash markets. The Subcommittee obtained, for example, daily and monthly wheat futures and cash price data from the CFTC, U.S. Department of Agriculture, Chicago Mercantile Exchange, Kansas City Board of Trade, and Minneapolis Grain Exchange. The Subcommittee also examined numerous historical materials on the operations and performance of the grain futures markets, and on the development and application of relevant statutes, regulations, and guidance. The CFTC provided extensive data on index trading, as well as information on the application of position limits and the granting of exemptions. The Subcommittee appreciates the cooperation and responsiveness of the exchanges and federal agencies.

To understand the issues, the Subcommittee interviewed numerous experts and persons familiar with the wheat markets, agricultural commodity markets as a whole, and commodity indexes. The interviews included persons familiar with grain trading and actual traders from a wide range of organizations in the grain industry: farm organizations, grain elevator operators, grain merchants, grain processors, food manufacturers, and agricultural trade groups. The Subcommittee also interviewed farmers, market analysts, agricultural economists, academic experts, financial institutions, and exchange officials. The Subcommittee also benefited from a number of meetings and presentations provided by the CFTC. The Subcommittee appreciates the cooperation and assistance of these individuals, organizations, and agencies.

B. The Cash and Futures Markets for Wheat

Wheat crops change hands primarily through cash transactions. There is no centralized cash market for wheat or other grains; the cash market exists wherever a grain elevator, grain merchant, grain consumer, or other participant in the grain industry posts a price to purchase or sell grain. Cash transactions take place all over the country, at all times of the day, either with or without the use of standardized contracts. In a common transaction, a grain elevator purchases wheat from a farmer for cash and then stores the wheat for sales throughout the year to grain processors.

Wheat futures are sold on three regulated exchanges: the Chicago Mercantile Exchange (CME), the Kansas City Board of Trade (KCBOT), and the Minneapolis Grain Exchange (MGEX). Wheat traded on the Chicago exchange, known as "soft red winter" wheat, is used mainly for crackers, pie crusts, cakes, and biscuits. Wheat traded in Kansas City, known as "hard red winter" wheat, is primarily used to make flour for bread. The Minneapolis exchange trades "hard red spring" wheat, which also is used to make bread, biscuits, and rolls.

All three of these futures exchanges offer standardized contracts to buy or sell standard amounts and types of wheat for which the only negotiated variable is the price. In the vast majority of cases, traders of wheat futures contracts do not take physical delivery of the wheat being bought or sold on the futures market. Rather, the primary purpose of the futures market is to enable market participants to "discover" the price of wheat for delivery at specified times in the future, to purchase or sell such contracts for future delivery at such prices, and thereby to enable wheat market participants to protect their business activities against the risk of future price changes.

C. Increasing Commodity Index Speculation

A commodity index is calculated using the prices of the futures contracts for the commodities that make up the index. Each commodity within a commodity index is assigned a "weight," and the contribution of each commodity toward the value of the index is calculated by multiplying the current price of the specified futures contract for that commodity by the assigned weight. All of the major, broad-based commodity indexes include soft red winter wheat futures contracts traded on the Chicago exchange as one of their component commodities.

The purchase of a financial instrument whose value is linked to a commodity index offers the buyer the potential opportunity to profit from the price changes in futures contracts for a broad spectrum of commodities, without having to actually purchase the referenced commodities. Typically, hedge funds, pension funds, and other large

institutions purchase these financial instruments with the aim of diversifying their portfolios, obtaining some protection against inflation, and profiting when commodity prices are rising. Since they are not involved in selling or buying actual commodities, and do not use these instruments to hedge or offset price risks regarding the actual use of the underlying commodities, the purchasers of commodity index instruments are making a speculative investment.

The large growth in commodity index speculation is a recent phenomenon. It is only over the past six years that financial institutions have heavily marketed commodity index instruments as a way to diversify portfolios and profit from rising commodity prices. The total value of the speculative investments in commodity indexes has increased an estimated tenfold in five years, from an estimated \$15 billion in 2003, to around \$200 billion by mid-2008.³

The amount of speculation in the wheat market due to sales of commodity index instruments has, correspondingly, grown significantly over the past five years. CFTC data indicates that purchases by index traders in the largest wheat futures market, the Chicago Mercantile Exchange, grew sevenfold from about 30,000 daily outstanding contracts in early 2004, to a peak of about 220,000 contracts in mid-2008, before dropping off at year's end to about 150,000 contracts. (Figure ES-1). The data shows that, during the period from 2006 through 2008, index traders held between 35 and 50% of the outstanding wheat contracts (open long interest) on the Chicago exchange and between 20 and 30% of the outstanding wheat contracts on the smaller Kansas City Board of Trade.

The presence of index traders is greatest on the Chicago exchange compared to the other two wheat exchanges, and is among the highest in all agriculture markets. In addition, neither of the other two wheat markets, nor any other grain market, has experienced the same degree of breakdown in the relationship between the futures and cash markets as has occurred in the Chicago wheat market. Accordingly, the Subcommittee focused its investigation on the role of index trading on the Chicago exchange and the breakdown in the relationship between Chicago wheat futures and cash prices.

³ This estimate reflects both the actual amounts invested in commodity index related instruments and the appreciation in value of those investments due to increasing commodity prices.

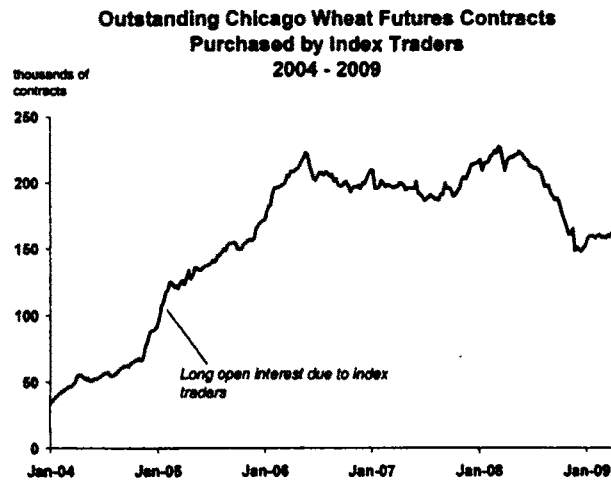


Figure ES-1. Growth in index fund purchases of Chicago wheat futures contracts. Chart prepared by Permanent Subcommittee on Investigations. Data source: CFTC.

D. Impact of Index Instruments on the Wheat Futures Market

Commodity indexes have an indirect but significant impact on futures markets. A commodity index standing alone is a computational device unsupported by any actual assets such as futures or commodity holdings. Financial institutions that sell index investments, however, have created three basic types of financial instruments tied to commodity indexes: commodity index swaps, exchange traded funds (ETFs), and exchange traded notes (ETNs). Commodity index swaps are sold by swap dealers and are the most common index instrument; ETFs and ETNs offer index-related shares for sale on a stock exchange. The value of commodity index swaps, index-related ETFs, and index-related ETNs rises and falls with the value of the commodity index upon which each is based.

Speculators who buy index instruments do not themselves purchase futures contracts. But the financial institutions who sell them the index instruments typically do. In the case of commodity index swaps, for example, swap dealers typically purchase futures contracts for all commodities on which an index is based to offset their financial exposure from selling swaps linked to those futures contracts. CFTC data shows that, over the past five years, financial institutions selling commodity index instruments have together purchased billions of dollars worth of futures contracts on the Chicago Mercantile Exchange.

The Subcommittee investigation has found that the large number of wheat futures contracts purchased by swap dealers and other index traders is a prime reason for higher prices in the wheat futures market relative to the cash market. Commodity traders call the difference between the futures prices and the cash price "the basis." Index traders typically do not operate in the cash market, since they have no interest in taking delivery or making use of a wheat crop. Instead, index traders operate in the futures markets, where they buy futures contracts to offset the index instruments they have sold. The additional demand for wheat futures resulting from these index traders is unrelated to the supply of and demand for wheat in the cash market.

In the Chicago wheat market, the result has been wheat futures prices that are increasingly disconnected from wheat cash prices. Data compiled by the Subcommittee shows that, since 2006, the daily gap between Chicago wheat futures prices and wheat cash prices (the basis) has been unusually large and persistent. Figure ES-2 presents this data for the last eight years.

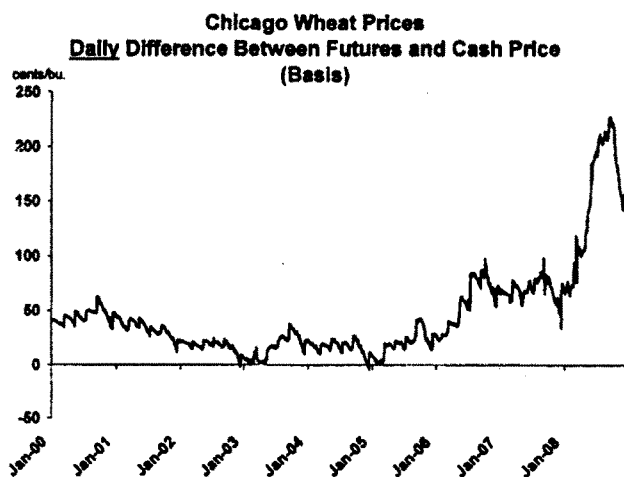


Figure ES-2. Increase in daily difference between futures and cash prices for Chicago wheat. Chart prepared by Permanent Subcommittee on Investigations. Data sources: CME (daily futures prices); MGEX (average daily cash prices).

From 2000 through 2005, the average daily difference between the average cash and the futures price for soft red winter wheat traded on the Chicago exchange was about 25 cents. During the second half of 2008, in contrast, the price of the nearest wheat futures contract on the Chicago exchange was between \$1.50 and \$2.00 per bushel higher than the

average cash price, an unprecedented price gap (basis).⁴ During that period, the average cash price for soft red winter wheat ranged from \$3.12 to \$7.31 per bushel, while the futures price ranged from \$4.57 to \$9.24. The fundamentals of supply and demand in the cash market alone cannot explain this unprecedented disparity in pricing between the futures and cash markets for the same commodity at the same time.

In addition, increasingly, the wheat futures prices on the Chicago exchange have not converged with the cash prices at the expiration of the futures contracts. Figure ES-3 shows the extent of this price gap (basis).

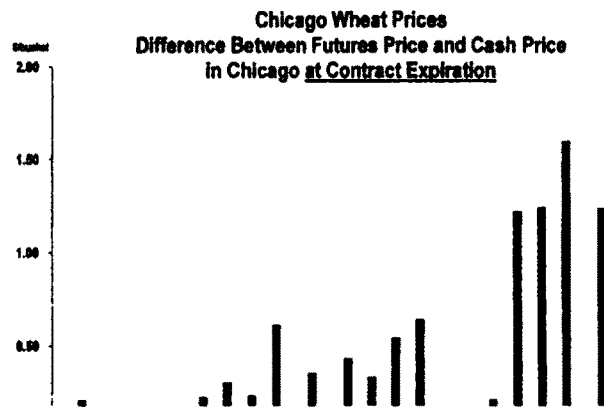


Figure ES-3. Increase in difference between futures and cash prices for Chicago wheat at futures contract expiration. Chart prepared by Permanent Subcommittee on Investigations. Data sources: CME (daily futures prices) and USDA (cash prices at Chicago).

The data underlying this chart shows that the average difference between the cash and futures price at contract expiration at the delivery location in Chicago for the Chicago wheat futures contract rose from an average of about 13 cents per bushel in 2005 to 34 cents in 2006, to 60 cents in 2007, to \$1.53 in 2008, a tenfold increase in four years.

In the same period during which these pricing disparities occurred, CFTC data shows a very large presence of index traders in the Chicago wheat market. Since 2006, index traders have held between one-third and one-half of all of the outstanding purchased futures contracts ("long open interest") for wheat on the Chicago exchange. For most of 2008, the demand for Chicago wheat futures contracts from these index

⁴ Typically, traders define basis as the difference between the cash and futures price (basis = cash – futures). In this Report, the basis is defined as the difference between the futures and cash price (basis = futures – cash) in order to give a positive value to the basis when the futures price is higher than the cash price, as it typically is in the wheat market.

investors was greater than the supply of wheat futures contracts from commercial firms selling grain for future delivery. During July 2008, for instance, index traders buying wheat futures contracts held, in total, futures contracts calling for the delivery of over 1 billion bushels of wheat, while farmers, grain elevators, grain merchants, and other commercial sellers of wheat had outstanding futures contracts providing for the delivery of a total of only about 800 million bushels of wheat. Under these circumstances, the additional demand from index traders for contracts for future delivery of wheat bid up the futures prices until prices were high enough to attract additional speculators willing to sell the desired futures contracts at the higher prices.

The investigation found that, in 2008, the greater demand for Chicago wheat futures contracts generated by index traders was a significant factor in the relative increase in the wheat futures price compared to the cash price (the basis) during that period. In addition, a significant cause of the resulting price disparity between the futures and cash markets, which was far greater than the normal gap between futures and cash prices, was the purchases of Chicago wheat futures by index traders.

E. Undue Burden on Interstate Commerce

The ongoing pricing discrepancy between wheat futures and cash market prices has exacerbated many of the recent economic difficulties facing farmers, grain elevators, grain merchants, and grain end-users.

Over the past few years, the prices of many agricultural commodities -- like the prices of commodities in general -- experienced an unprecedented spike and subsequent collapse. For example, the cash price of wheat rose from just over \$3 per bushel in mid-2006, to over \$11 per bushel in early 2008, before collapsing to about \$3.50 per bushel at the end of 2008. Figure ES-4 shows the average daily cash price of wheat from 2000 to 2008, including the spike in the price of wheat during 2007 and 2008.

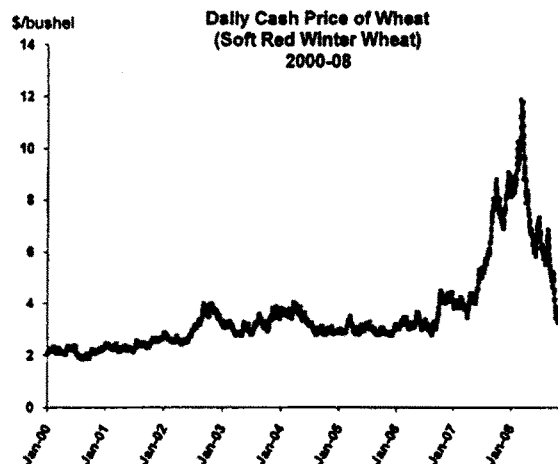


Figure ES-4. The average daily cash price of soft red winter wheat, the type of wheat traded on the Chicago Mercantile Exchange. Chart prepared by Permanent Subcommittee on Investigations. Data source: MGEX (daily cash index price).

A wide variety of factors contributed to the price volatility in the cash market for wheat, including poor weather, changes in agricultural productivity, an increasing demand for commodities in developing countries, changing dietary habits, increasing energy prices, and changes in the value of the dollar compared to other currencies.

Wheat prices in the cash market rose steadily from 2004 to 2008, in part due to steep increases in the price of energy, particularly oil, gasoline, natural gas, and diesel fuel, which sharply increased the costs of farming, transporting grain to markets, and grain processing. Although grain prices in the cash market eventually rose to record highs, farmers and grain merchants often were unable to realize the benefits of those higher prices due to the higher costs. In March 2009, for example, USDA reported that although wheat was selling for very high prices by historical standards, the increase in fuel and fertilizer costs had “offset this unprecedented runup in wheat prices for producers.”

During this same period, futures prices also rose. The steep increases in cash and futures prices severely affected the grain industry in several ways. First, higher futures prices resulted in higher margin calls for wheat farmers, grain elevators, and other sellers of wheat that had hedged in the futures markets, requiring them to make much larger cash outlays than normal. The National Grain and Feed Association estimated, for example, that a typical grain elevator faced a 300% increase in hedging costs in 2008, compared to 2006. It stated that “recent commodity price increases have led to unprecedented borrowing

by elevators – and unprecedented lending by their bankers – to finance inventory and maintain hedge margins.” According to the Federal Reserve Bank of Kansas City, in the first quarter of 2008, the Farm Credit System “raised \$10 billion in funds through the sale of debt securities to meet increasing demand from elevators and other processing and marketing entities.” In April 2008, the Federal Reserve Bank of Kansas City reported that nearly one-quarter of all grain elevators it surveyed were struggling to acquire the cash needed to manage margin calls; about 40% stated they had “enough cash to just manage current margin calls.”

The cash flow problems confronting many grain elevators directly affected farmers, as those elevators began to reduce their cash purchases, pull back on forward contracts offered to farmers, and lower the cash prices offered for crops. Some began to require farmers to pre-pay for seed and fertilizer, causing cash flow problems for farming operations. Farmers participating directly in the futures market also were subject to rising margin calls. One wheat farmer explained, “If you’ve got 50,000 bushels hedged and the market moves up 20 cents, that would be a \$10,000 day. If you only had \$10,000 in your margin account, you’d have to sit down and write a check. You can see \$10,000 disappear overnight. . . . Everybody has a story about a guy they know getting blown out of his hedge.”

Other problems arose from the unusually large and persistent gap between the futures and cash prices for wheat and the failure of the two prices to converge as futures contracts expired. This persistent pricing difference and lack of convergence meant that farmers, grain elevators, grain merchants, and others who had used the futures market to hedge their future sales found that when they went to sell their wheat, the cash prices were much lower than they had anticipated based upon the futures market. This persistent price gap significantly impaired the ability of farmers and others to protect themselves from declining prices during the dramatic price decreases experienced during the second half of 2008. It also meant that wheat industry participants could no longer rely on the futures markets to reliably price their crops and effectively manage their price risks over time.

In a properly functioning futures market, futures and cash prices converge as futures contracts near expiration. Otherwise, if one price were higher, a trader could buy the commodity in the lesser-priced market and immediately sell it in the higher-priced market for a quick profit. Those types of transactions would soon equalize the two prices. But on many occasions during the last few years in the Chicago wheat market, the two prices have not converged.

One key reason is that the large price disparity between the cash and futures price makes it much more profitable for grain merchants to

buy grain in the cash market, hold onto it, and then sell it later – at the price of the higher-priced futures contracts – than engage in the type of transactions described above between the cash and futures market that would make the two prices converge. In addition, the large price disparity means that merchants who already have grain in storage and have hedged that grain by selling futures contracts could suffer a loss if they decided to actually sell their grain in the cash market, because they also would have to buy back the futures contract at a higher price than they could get for selling their grain in the cash market.

Virtually all of the traders interviewed by the Subcommittee, from all perspectives within the grain business, identified the large presence of index traders in the Chicago market as a major cause of the price convergence problem. This ongoing problem indicates that at a fundamental level the Chicago wheat futures market no longer effectively serves the needs of many wheat growers or commercial wheat users.

Still another set of problems caused by excessive speculation in the wheat market and the disconnect between wheat futures and cash prices affects the federal crop insurance program. Federal crop insurance, which is supported with taxpayer dollars, is available to farmers who want to cover potential financial losses due to bad weather or crop disease. Several types of federal crop insurance use futures prices to determine how much money should be paid to a farmer who has purchased coverage and suffered a loss in crop income. Futures prices are used in the formulas that calculate both the insurance premiums to be paid by farmers and the indemnity payments made to farmers after an insurance claim. Because they are included in the calculations, futures market prices that are significantly higher than actual cash prices impair the accuracy of the insurance formulas and can inflate the final figures. Futures prices that are much higher than the prices in the cash market and that do not closely follow the prices in the cash market can increase both the crop insurance premiums paid in part by farmers and can either increase or decrease the ultimate insurance payout to the farmer – thereby either resulting in too large a payout from a taxpayer-funded program or too small a payout to the farmer who has paid for the insurance. Either scenario undermines the effectiveness of the crop insurance program.

The ongoing large gap between wheat futures prices and cash prices is a problem of intense concern to the wheat industry, the exchanges, and the CFTC. The CFTC has conducted several public hearings and recently formed a special advisory subcommittee to make recommendations on how best to address the problem. The Chicago exchange has amended its wheat contract in several respects – to provide for additional delivery locations, to increase the storage rate for wheat, and to change certain specifications for deliverable wheat – in an effort

to improve trading and create a more active cash market that will force cash and futures prices to converge.

These actions to date, however, do not address one of the fundamental causes of the problem – the large presence of index traders in the Chicago wheat market. These index traders, who buy wheat futures contracts and hold them without regard to the fundamentals of supply and demand in the cash market for wheat, have created a significant additional demand for wheat futures contracts that has as much as doubled the overall demand for wheat futures contracts. Because this significant increase in demand in the futures market is unrelated to any corresponding supply or demand in the cash market, the price of wheat futures contracts has risen relative to the price of wheat in the cash market. The very large number of index traders on the Chicago exchange has, thus, contributed to “unwarranted changes” in the prices of wheat futures relative to the price of wheat in the cash market. These “unwarranted changes” have, in turn, significantly impaired the ability of farmers and other grain businesses to price crops and manage price risks over time, thus creating an undue burden on interstate commerce. The activities of these index traders constitute the type of excessive speculation that the CFTC should diminish or prevent through the imposition and enforcement of position limits as intended by the Commodity Exchange Act.

F. Trading Limits on Index Traders

The Commodity Exchange Act (CEA) directs the CFTC to prevent excessive speculation in the futures markets. Specifically, Section 4a(a) of the CEA requires the CFTC to establish and maintain “position limits” on commodity traders to prevent the undue burden on interstate commerce that results from “sudden or unreasonable fluctuations or unwarranted changes” in the price of a commodity caused by excessive speculation. Pursuant to this statutory mandate, the CFTC has established position limits for the agricultural commodities traded on futures markets such as wheat, corn, oats, and soybeans. These position limits specify the maximum number of outstanding futures contracts that any single trader can hold at any particular time. For example, the CFTC has generally prohibited any single trader from holding more than 6,500 wheat futures contracts at any one time. Prior to 2005, the maximum number of contracts that could be held at any one time was 5,000 contracts.

Over the course of many years, the CFTC has made a number of decisions that have enabled certain index traders to hold more than the current limit of 6,500 wheat futures contracts. The first set of decisions resulted in the CFTC’s granting position limit exemptions to swap dealers selling commodity index swaps. Although the CEA directs the

CFTC to impose trading limits to prevent excessive speculation, section 4a(c) of the Act also states that these limits are not to be applied to "transactions or positions which are shown to be bona fide hedging transactions or positions." The CEA provides the CFTC with the discretion to define the term "bona fide hedging transaction" in order to "permit producers, purchasers, sellers, middlemen, and users of a commodity or a product derived therefrom to hedge their legitimate anticipated business needs for that period of time into the future for which an appropriate futures contract is open and available on an exchange."

Initially, the CFTC limited the concept of a bona fide hedging transaction to transactions directly linked to the business needs of the producers, marketers, and users of a physical commodity in the cash market. But after Congress directed the CFTC, in 1986, to consider expanding its definition to include persons using the futures markets to manage risks associated with financial investment portfolios, the CFTC issued a series of clarifications and interpretations which, in effect, expanded the definition to include trading strategies to reduce financial risks, regardless of whether a matching transaction ever took place in a cash market for a physical commodity.

In 1991, using this expanded definition, the CFTC granted the first exemption from speculative trading limits to a swap dealer seeking to buy futures contracts to hedge its financial exposure to commodity index swaps it had sold to third parties. According to CFTC data provided to the Subcommittee, the CFTC has currently issued four hedge exemptions to swap dealers seeking to buy wheat futures. Those exemptions permit the swap dealers to exceed the 6,500 position limit and hold up to 10,000, 17,500, 26,000, and 53,000 wheat futures contracts to hedge their exposures to commodity index swaps that reference wheat futures prices. In addition, in 2006, the CFTC staff took another step by issuing two "no-action" letters permitting the manager of one index-related exchange traded fund (ETF) to hold up to 11,000 wheat futures contracts and another fund manager to hold up to 13,000 wheat futures contracts.

Together, these hedge exemptions and no-action letters permit six index traders to hold a total of up to almost 130,000 wheat futures contracts at any one time. Absent these waivers from the position limits, these six index traders would have been limited to a total of about 39,000 wheat futures contracts at a time, or less than one-third of the contracts that they are now permitted to hold.

CFTC data indicates that, from 2006 to mid-2008, the total number of outstanding contracts (long open interest) attributable to commodity index traders in the wheat market was about 200,000 contracts. That means that the six index traders granted waivers

from the trading limits may have held up to about 60% of all the outstanding wheat contracts held by index traders.

In directing the CFTC to consider granting position limit exemptions to firms using the futures markets to manage price risks associated with financial portfolios, Congress emphasized that the Commission's actions should remain consistent with its mandate to prevent excessive speculation from causing unreasonable or unwarranted changes in the prices of commodities traded on the futures exchanges. Because the large amount of index investments in the Chicago wheat futures market have been one of the major causes of "unreasonable or unwarranted" changes in wheat futures prices relative to cash prices, the granting of exemptions and waivers to index traders is inconsistent with the CFTC's statutory mandate to prevent excessive speculation on futures exchanges. Accordingly, the Report recommends that the CFTC no longer waive position limits for index traders and, in addition, begin an orderly phase-out of the existing waivers.

If the CFTC were to phase out the exemptions and waivers granted to index traders in the wheat market, those traders would become subject to the position limits for wheat futures contracts that generally apply and would be unable to hold more than 6,500 wheat contracts at any one time. The strict enforcement of the 6,500 contract limit should reduce the presence of index traders in the Chicago wheat futures market and help bring the futures market into better alignment with the cash market.

Restoring the 6,500 position limit to index traders may not, however, fully solve the pricing problems in the Chicago wheat futures market and eliminate the problems in the market exacerbated by excessive speculation. CFTC data indicates that at most 60% of the total outstanding wheat contracts (long open interest) which can be attributed to index investors would be affected by restoring the 6,500 limit. If pricing problems persist in the wheat market after the phase-out of these waivers, and after implementation of other actions being taken by the Chicago exchange, the CFTC should consider imposing additional restrictions on index traders to reduce their presence, such as by restoring the pre-2005 position limit of 5,000 wheat contracts per index trader to reduce their aggregate impact on wheat futures prices.

G. Other Commodities

The wheat market illustrates how a large amount of index trading on a futures exchange can significantly impair the ability of the futures market to perform its primary purposes – to enable commercial market participants, including farmers, grain elevators, grain merchants, and consumers, to efficiently price their commodities and manage their price risks over time. The Subcommittee investigation was made possible in

large part by the availability of data compiled by the CFTC on index trading in the wheat market. Comparable data on index trading in non-agricultural markets, including for crude oil, natural gas, and other energy commodities, is not presently available. The data problem is due in part to the complexity of the over-the-counter (OTC) energy market, the associated difficulty in tracing index trading in that market, and the difficulty in assessing the impact of OTC energy trades on regulated energy futures exchanges. To understand the role of index trading in energy and other non-agricultural commodity markets, the CFTC will need to improve its data collection and analysis efforts for both the OTC markets and index trading. Given the importance of this issue, despite the difficulties, the CFTC should undertake this effort to bring additional transparency to the impact of index trading on energy futures markets.

H. Findings and Recommendations

Based upon the Subcommittee's investigation, the Report makes the following findings of fact and recommendations to diminish or prevent excessive speculation in the wheat market.

Findings of Fact.

- (1) **Excessive Speculation in Wheat.** The large number of wheat futures contracts purchased and held by commodity index traders on the Chicago futures exchange over the last five years constituted excessive speculation.
 - (a) **Index Traders Increased Futures Prices Relative to Cash Prices.** The large number of wheat futures contracts purchased by index traders on the Chicago exchange created additional demand for those contracts and was a major contributing factor in the increasing difference between wheat futures prices and cash prices from 2006 to 2008.
 - (b) **Index Traders Impeded Price Convergence.** Over the past few years, the large number of Chicago wheat futures contracts purchased by index traders has been a major cause of the frequent failure of wheat futures and cash prices to converge upon contract expiration.
 - (c) **Unwarranted Price Changes.** The additional demand for Chicago wheat futures contracts attributable to commodity index traders contributed to "unreasonable fluctuations or unwarranted changes" in wheat futures prices, resulting in an abnormally large and persistent gap between wheat futures and cash prices (the basis). Largely as a result of index trading, the average

difference between the cash and futures price at contract expiration rose from 13 cents per bushel in 2005, to 34 cents in 2006, to 60 cents in 2007, to \$1.53 in 2008, a tenfold increase in four years.

- (d) **Undue Burden on Commerce.** The unwarranted changes in wheat prices resulting from the large amount of index trading in the Chicago wheat futures market created an undue burden on interstate commerce. This undue burden was imposed on farmers, grain elevators, grain merchants, grain processors, and others by impeding useful hedging strategies, imposing significant unanticipated costs, and providing inaccurate indications of expected prices in the wheat markets.
- (2) **CFTC Waivers Facilitated Excessive Speculation.** CFTC actions to waive position limits for commodity index traders facilitated excessive speculation in the Chicago wheat futures market. Waiving position limits for these index traders is inconsistent with the CFTC's statutory mandate to maintain position limits to prevent excessive speculation.
- (3) **Inflated Futures Prices Affect Crop Insurance.** Because federal crop insurance, which is backed with taxpayer dollars, uses futures prices in its calculations, inflated futures prices can inflate insurance premiums, whose cost is shared by farmers and taxpayers, and impair the accuracy of the formulas used to determine the payouts to farmers, resulting in either overpayments or underpayments.
- (4) **Poor Data Impedes Analysis.** There is a lack of adequate data on the number of futures contracts purchased by commodity index traders for non-agricultural commodities like crude oil. Improved data is essential to analyze the extent to which index traders may be contributing to higher futures prices and excessive speculation in crude oil and other markets.

Recommendations.

- (1) **Phase Out Existing Wheat Waivers for Index Traders.** The CFTC should phase out existing waivers, granted through exemptions or no-action letters, which permit commodity index traders to exceed the standard limit of 6,500 wheat contracts per trader at any one time, and re-apply the standard position limit designed to prevent excessive speculation in the wheat market.

- (2) **Take Further Action If Necessary.** If pricing problems in the Chicago exchange persist after the phase-out of index trader waivers and after implementation of other actions being taken by the Chicago exchange, the CFTC should consider imposing additional restrictions on commodity index traders to reduce excessive speculation, such as by imposing a position limit of 5,000 wheat contracts per index trader.
- (3) **Analyze Other Agricultural Commodities.** The CFTC should undertake an analysis of other agricultural commodities to determine whether commodity index traders have increased futures prices compared to cash prices or caused price convergence problems, and whether position limit waivers for index traders should be phased out to eliminate excessive speculation.
- (4) **Strengthen Data Collection for Non-Agricultural Commodities.** The CFTC should develop reliable data on the extent to which commodity index traders purchase non-agricultural commodity futures contracts, especially crude oil and other energy commodities. Once this data is collected, the CFTC should evaluate the impact of index trading in these markets, and whether position limits for index traders should be phased in to eliminate excessive speculation.

The following sections of this Report present detailed information on how, in recent years, the high level of commodity index trading in the wheat market constituted excessive speculation. Section II describes the wheat futures and cash markets, and recent pricing trends that have caused turmoil among wheat producers, merchants, and consumers. Section III provides general information about hedging and speculation in the commodity markets, and why price convergence is important to commercial users of the wheat market. Section IV explains how commodity index trading works, its impact on the futures markets, and how the CFTC has facilitated index trading by waiving position limits for wheat and other agricultural commodities. Section V details the evidence indicating how commodity index trading has been one of the major causes of unwarranted price fluctuations and an undue burden on interstate commerce, and thereby constituted excessive speculation in the wheat market. Section VI describes how inflated futures prices affect the federal crop insurance program.

Selected Commodity Related Exchange Traded Products

Name	2011 Net Assets
SPDR Gold Shares	\$64,137,833,385
iShares Silver Trust	\$9,780,604,138
iShares Gold Trust	\$8,526,095,164
PowerShares DB Commodity Index Tracking	\$5,432,832,000
PowerShares DB Agriculture	\$2,556,022,000
iPath DJ-UBS Commodity Index Total Return ETN	\$2,463,009,415
ETFS Physical Swiss Gold Shares	\$1,631,115,252
United States Natural Gas	\$1,336,881,650
iShares S&P GSCI Commodity-Indexed Trust	\$1,263,970,653
United States Oil	\$1,146,682,883
ELEMENTS Rogers International Commodity ETN	\$690,719,700
ETFS Physical Platinum Shares	\$657,958,972
GreenHaven Continuous Commodity Index	\$627,498,744
ETFS Physical Silver Shares	\$586,857,566
PowerShares DB Oil	\$537,776,000
PowerShares DB Precious Metals	\$509,220,000
ELEMENTS Rogers International Commodity Agriculture ETN	\$506,652,650
ETFS Physical Palladium Shares	\$470,925,030
iPath S&P GSCI Crude Oil Total Return Index ETN	\$434,229,060
PowerShares DB Base Metals	\$421,344,000
PowerShares DB Gold	\$407,952,000
United States Commodity Index	\$397,330,971
ETFS Physical PM Basket Shares	\$237,389,542
iPath DJ-UBS Grains Subindex Total Return ETN	\$230,882,228
United States 12 Month Oil	\$173,186,989
iPath DJ-UBS Agriculture Subindex Total Return ETN	\$158,710,918
PowerShares DB Silver	\$157,200,000
PowerShares DB Energy	\$139,536,000
UBS E-TRACS CMC Total Return ETN	\$136,858,939
iPath DJ-UBS Copper Subindex Total Return ETN	\$123,675,336
iPath DJ-UBS Precious Metals Subindex Total Return ETN	\$112,444,959
Teucrium Corn	\$104,281,614
United States Gasoline	\$96,462,255
iPath S&P GSCI Total Return Index ETN	\$92,824,248
iPath DJ-UBS Natural Gas Subindex Total Return ETN	\$84,274,960
iPath DJ-UBS Cotton Subindex Total Return ETN	\$78,255,370
iPath DJ-UBS Livestock Subindex Total Return ETN	\$77,170,843
ETFS Physical Asian Gold Shares	\$72,697,365

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EXHIBIT #6a

ELEMENTS Rogers International Commodity Energy ETN	\$71,874,000
iPath DJ-UBS Sugar Subindex Total Return ETN	\$68,369,372
GS Connect S&P GSCI Enhanced Commodity Total Return ETN	\$64,225,600
ELEMENTS Rogers International Commodity Metal ETN	\$62,263,600
ETFS Physical White Metals Basket Shares	\$47,710,244
iPath DJ-UBS Platinum Subindex Total Return ETN	\$44,674,420
UBS E-TRACS CMCI Food Total Return ETN	\$43,979,148
UBS E-TRACS Long Platinum Total Return ETN	\$36,264,500
iPath DJ-UBS Softs Subindex Total Return ETN	\$35,604,044
iPath DJ-UBS Industrial Metals Subindex Total Return ETN	\$34,448,027
iPath DJ-UBS Coffee Subindex Total Return ETN	\$31,242,272
United States 12 Month Natural Gas	\$30,736,381
UBS E-TRACS DJ-UBS Commodity Index TR ETN	\$21,956,352
RBS Gold Trendpilot ETN	\$21,161,735
ELEMENTS MLCX Grains Index Total Return ETN	\$20,052,620
PowerShares DB Crude Oil Long ETN	\$19,447,090
iPath DJ-UBS Energy Subindex Total Return ETN	\$17,683,281
iPath DJ-UBS Cocoa Subindex Total Return ETN	\$14,412,444
United States Brent Oil	\$13,850,618
UBS E-TRACS CMCI Agriculture Total Return ETN	\$13,654,240
iPath Pure Beta Sugar ETN	\$12,817,725
iPath DJ-UBS Tin Subindex Total Return ETN	\$11,536,857
PowerShares DB Agriculture Long ETN	\$10,557,540
iPath Pure Beta Broad Commodity ETN	\$9,152,826
iPath DJ-UBS Nickel Subindex Total Return ETN	\$8,415,229
UBS E-TRACS CMCI Gold Total Return ETN	\$8,307,195
ELEMENTS MLCX Biofuels Index TR ETN	\$7,497,600
iPath Pure Beta Grains ETN	\$6,673,920
iPath DJ-UBS Lead Subindex Total Return ETN	\$6,629,610
iPath Pure Beta Coffee ETN	\$6,616,260
PowerShares DB Commodity Long ETN	\$6,468,000
iPath Pure Beta Softs ETN	\$6,354,600
United States Heating Oil	\$6,297,351
iPath Pure Beta Precious Metals ETN	\$6,208,020
UBS E-TRACS CMCI Silver Total Return ETN	\$6,163,950
iPath Pure Beta Cotton ETN	\$6,009,840
iPath Pure Beta Agriculture ETN	\$5,929,740
iPath Pure Beta Lead ETN	\$5,189,560
iPath Seasonal Natural Gas ETN	\$5,185,821
UBS E-TRACS CMCI Livestock Total Return ETN	\$5,119,627
UBS E-TRACS CMCI Industrial Metals Total Return ETN	\$5,116,120

iPath Pure Beta Livestock ETN	\$5,094,600
iPath DJ-UBS Aluminum Subindex Total Return ETN	\$4,823,732
Teucrium WTI Crude Oil	\$4,796,213
iPath Pure Beta S&P GSCI-Weighted ETN	\$4,623,240
iPath Pure Beta Crude Oil ETN	\$4,490,200
iPath Pure Beta Energy ETN	\$4,334,350
iPath Pure Beta Industrial Metals ETN	\$4,041,683
iPath Pure Beta Copper ETN	\$4,009,500
RBS Oil Trendpilot ETN	\$3,999,088
iPath Pure Beta Cocoa ETN	\$3,932,050
iPath Pure Beta Aluminum ETN	\$3,568,680
iPath Pure Beta Nickel ETN	\$3,554,540
UBS E-TRACS CMC Energy Total Return ETN	\$2,866,006
Teucrium Sugar	\$2,417,310
Teucrium Wheat	\$2,244,868
Teucrium Soybean	\$2,191,359
iPath Global Carbon ETN	\$1,976,812
Teucrium Natural Gas	\$1,820,645
PowerShares DB Base Metals Long ETN	\$1,277,696
Total	\$107,531,282,750

Data source: Morningstar, Inc.

List prepared by Permanent Subcommittee on Investigations, Nov. 2011

June 30, 2011



ETFS Physical Palladium Shares – PALL

Investment Objective

ETFS Physical Palladium Shares ("the Shares") are issued by ETFS Palladium Trust ("the Trust"). The investment objective of the Trust, Symbol: PALL, is for the Shares to reflect the performance of the price of palladium, less Trust's expenses. The Shares are designed for investors who want a cost-effective and convenient way to invest in physical palladium.

Key Features

Palladium bullion in plate and ingot form held in London, U.K. and Zurich, Switzerland - The Shares represent beneficial interest in the Trust, which in turn holds allocated physical platinum bullion bars stored in secure vaults in London and Zurich on behalf of the Custodian, JPMorgan Chase Bank, N.A. Each physical plate and ingot is properly segregated, individually identified, and allocated towards the property of the Trust. All physical palladium conforms to the London Platinum and Palladium Market (LPPM) rules for Good Delivery¹.

Cost effective - The Shares are designed for investors who want a cost-effective and convenient way to invest in palladium. For many investors, it is expected that the transaction costs for buying and selling the Shares will be lower than purchasing, storing and insuring physical palladium.

Liquid - The Shares trade on an exchange like any other exchange-listed security. The Trust structure allows for shares to be created and redeemed according to supply and demand in the market.

Transparent - The palladium held by the trust is inspected biannually by the independent metal assayer, Inspectorate International. The pricing information, net asset value of the Trust, and palladium bar numbers held by the Trust are published daily on our website at www.etfsecurities.com.

Flexible - The Shares are listed on the New York Stock Exchange (NYSE Arca: PALL). The shares are available to be bought or sold, like ordinary listed securities, throughout the trading day. Additionally, the shares are eligible for margin² accounts.

About the Pricing

The price of PALL is based on the spot price of palladium less the Trust's expenses.

All palladium is priced off the LPPM's specifications for Good Delivery¹, which is an internationally recognized and transparent benchmark for pricing physical palladium. Details regarding the pricing calculations are available on our website at www.etfsecurities.com.

Risks & Important Considerations:

The ETFS Palladium Trust is not an investment company registered under the Investment Company Act of 1940 or a commodity pool for purposes of the Commodity Exchange Act. Shares of the Palladium Trust are not subject to the same regulatory requirements as mutual funds. These investments are not suitable for all investors. Trusts focusing on a single commodity generally experience greater volatility.

¹ London/Zurich Good Delivery¹ or "Good Delivery" Palladium in plate or ingot form with a minimum fineness and purity of 99.95% weighing between 32.151 and 192.904 troy ounces. One troy ounce equals 31.103 grams meeting the London/Zurich Good Delivery Standards.

² There are special risks associated with short selling and margin investing. Please ask your financial advisor for more information about these risks.

Trading and Listing Data

Primary Listing	New York Stock Exchange - Arca
Ticker	PALL
IOPV*	PALL.IV
Trading	Normal Exchange hours
NAV	Daily NAV at www.etfsecurities.com
Base Currency	USD
Margin Eligible²	Yes
Short Sale Eligible²	Yes

Security & Trading Codes

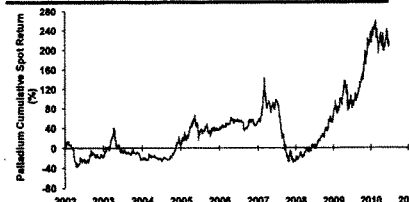
Inception Date	January 08, 2010
Listing	NYSE Arca
Ticker	PALL
CUSIP	26923A 106
Bloomberg	PALL US
Reuters	PALL.P

*Indicative Optimized Portfolio Value

Trust Features

Sponsor	ETF Securities USA LLC
Underlying Metal	Physical, allocated palladium plates and ingots, to LPPM specifications
Vault Inspector	Inspectorate International
Palladium Bar Count	List of allocated plates and ingots and copies of the plate and ingot counts available daily at www.etfsecurities.com
Custodian	JPMorgan Chase Bank, N.A.
Zurich Sub-Custodian (January 2010)	UBS A.G.
Vault Location	London, UK, and Zurich, Switzerland
Trustee	The Bank of New York Mellon
Gross Expense Ratio	0.60% per annum; Ordinary brokerage commissions do apply

Palladium Spot Historical Performance (USD)



Date from 12/31/2002 to 06/30/2011. Data source Bloomberg.

The performance quoted represents past performance of the Palladium spot price (as measured by the London PM Fix) and is not indicative of future performance. The Palladium spot prices are for illustrative purposes only and do not represent actual Trust performance.

Tel: (212) 918-4954

Permanent Subcommittee on Investigations

EXHIBIT #6b

www.etfsecurities.com



Additional Information

To access the list of allocated plates and Ingots held by the Custodian and a copy of the bar counts conducted by Inspectorate International Limited, please visit our website at: www.etfsecurities.com

For More Information

About ETF Securities

Web: www.etfsecurities.com

Email: info@etfsecurities.com

Telephone: (212) 918-4954

Other Sources of Information

www.nyse.com

About ETF Securities USA LLC

ETF Securities USA LLC is a member of the ETF Securities Group and is a provider of Exchange-Traded Products (ETPs). ETF Securities is independently owned and is a European market leader in ETPs. The management of ETF Securities created the world's first physically-backed precious metal product and also constructed the first full ETP platform in 2006, which has listings on various global exchanges.

Important Risks The value of the Shares relates directly to the value of the palladium held by the Trust and fluctuations in the price of palladium could materially adversely affect an investment in the Shares. Several factors may affect the price of palladium including:

- A change in economic conditions, such as a recession, can adversely affect the price of palladium. Palladium is used in a wide range of industrial applications, and an economic downturn could have a negative impact on its demand and, consequently, its price and the price of the Shares;
- Investors' expectations with respect to the rate of inflation;
- Currency exchange rates;
- Interest rates;
- Investment and trading activities of hedge funds and commodity funds; and
- Global or regional political, economic or financial events and situations. Should there be an increase in the level of hedge activity of palladium producing companies, it could cause a decline in world palladium price, adversely affecting the price of the Shares.

Also, should the speculative community take a negative view towards palladium, it could cause a decline in world palladium price, negatively impacting the price of the Shares.

There is a risk that part or all of the Trusts' physical palladium could be lost, damaged or stolen. Failure by the Custodian or Sub-Custodian to exercise due care in the safekeeping of the precious metal held by the Trusts could result in a loss to the Trusts. The Trust will not insure its palladium and shareholders cannot be assured that the custodian will maintain adequate insurance or any insurance with respect to the palladium held by the custodian on behalf of the Trust. Consequently, a loss may be suffered with respect to the Trust's palladium that is not covered by insurance.

Commodities and futures generally are volatile and are not suitable for all investors.

Please refer to the prospectus for complete information regarding all risks associated with the Trust.

Investors buy and sell shares on a secondary market (i.e., not directly from trust). Only market makers or "authorized participants" may trade directly with the fund, typically in blocks of 50k to 100k shares.

Shares in the Trusts are not FDIC insured and may lose value and have no bank guarantee.

Carefully consider each fund's investment objectives, risk factors, and fees and expenses before investing.

For further discussion of the risks associated with an investment in the funds please [click here](#) to read the prospectus. Or visit the ETF Securities website: www.etfsecurities.com

Investment in the Trust does not constitute a direct investment in the underlying metal.

ALPS Distributors, Inc. is unaffiliated with JPMorgan Chase Bank, N.A., UBS A.G. or The Bank of New York Mellon.

ETFS Palladium Trust shares are not guaranteed by JPMorgan Chase Bank, N.A. or anyone else. ETFS Palladium Trust shares are direct, limited recourse obligations of the Trust alone and not obligations of any other person including JPMorgan Chase Bank, N.A., any member of the JPMorgan Chase Group, or its affiliates.

ALPS Distributors, Inc. is the marketing agent for ETFS Palladium Trust.

ETF000390 01/31/2012

Tel: (212) 918-4954

www.etfsecurities.com



Fact Sheet

All data as of 6/30/11

ProShares Ultra DJ-UBS Commodity



FUND OBJECTIVE

ProShares Ultra DJ-UBS Commodity seeks daily investment results, before fees and expenses, that correspond to twice (200%) the daily performance of the Dow Jones-UBS Commodity Index.¹

FUND DETAILS

Inception Date	11/24/08
Trading Symbol	UCD
Intraday Symbol	UCD IV
Bloomberg Index Symbol	DJUBS
CUSIP	74242W106
Net Assets	\$16.69 million
Expense Ratio ²	.95%

ProShares Ultra ETFs seek to return twice the index performance on a daily basis (before fees and expenses)

- Magnify exposure to an index for a certain dollar amount
- Provide a certain exposure to an index for less cash
- Track your investment throughout the day
- No margin account

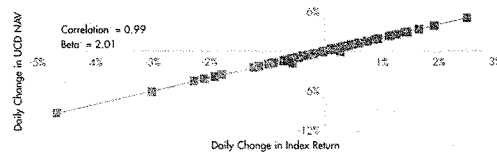
FUND PERFORMANCE AND BENCHMARK HISTORY

ProShares Ultra DJ-UBS Commodity seeks a return of 200% of the return of a benchmark target¹ for a single day, as measured from one NAV calculation to the next. Due to the compounding of daily returns, returns over periods other than one day will likely differ in amount and possibly direction from the target return for the same period. Investors should monitor holdings consistent with their strategies, as frequently as daily. For more on correlation, leverage and other risks, please read the prospectus.

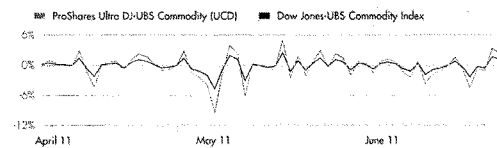
	2Q 2011	Year to Date	1-Year	3-Year	5-Year	Since Inception
ProShares Ultra DJ-UBS Commodity	-15.38%	-8.20%	49.26%	—	—	11.78%
NAV Total Return	-15.38%	-8.20%	49.26%	—	—	11.78%
ProShares Ultra DJ-UBS Commodity	-15.86%	-7.97%	50.63%	—	—	11.77%
Market Price Total Return	-15.86%	-7.97%	50.63%	—	—	11.77%
Dow Jones-UBS Commodity Index	-6.73%	-2.58%	25.91%	—	—	10.05%

DAILY PERFORMANCE OF UCD vs. INDEX DURING 2Q 2011

The following scatter graph charts the daily NAV-to-NAV results of the fund against its underlying index return on a daily basis.



DAILY RETURN DURING 2Q 2011



PAST PERFORMANCE IS NOT INDICATIVE OF FUTURE RESULTS. Investment return and principal value of an investment will fluctuate so that on investor's shares, when sold or redeemed, may be worth more or less than they originally cost. Current performance may be lower or higher than the performance quoted. Performance data current to the most recent month-end may be obtained by calling toll-free, 866-PRO-5125 or visiting proshares.com. Index performance does not reflect any management fees, transaction costs or expenses. Indexes are unmanaged and one cannot invest directly in any index.

ProShares are not suitable for all investors. Futures trading involves a substantial risk of loss.

Since inception returns are annualized. Market returns are based on the composite closing price and do not represent the returns you would receive if you traded shares at other times. The first trading date is typically several days after the fund inception date. Therefore, NAV is used to calculate market returns prior to the first trade date. Expense ratio does not include brokerage commissions and related fees paid by the fund. Correlation is a measure of the strength and direction of a linear relationship between two variables. Beta is a measure of the slope, which is the steepness of the line drawn through the fund return vs. the benchmark return on a daily basis.





Fact Sheet

All data as of 6/30/11

ProShares Ultra DJ-UBS Commodity



INDEX DESCRIPTION

The Dow Jones-UBS Commodity Index (DJUBSCI) is a highly liquid and diversified benchmark that allows investors to track the commodity futures market. It is composed of futures contracts on 19 physical commodities. Unlike equities, which enable the holder to a continuing stake in a corporation, commodity futures contracts specify a delivery date for an underlying physical commodity. The DJUBSCI purchases futures contracts of a commodity, and, as the date for a futures contract comes due, the index sells that contract and purchases a new short-term contract with delivery dates a few months out. The DJUBSCI thus rolls its futures positions, and continually avoids delivery of the physical commodity. It rolls its contracts over the course of five consecutive business days, starting on the sixth business day of the month. Each day, approximately 20% of each futures position that is included in the month's roll is rolled. If for all contracts are rolled every month. The DJUBSCI is valued using the settlement prices for the underlying futures contracts. Visit dowjones.com for a list of futures and their roll months.

INDEX CHARACTERISTICS

Total Index Constituents 19
Quarterly Index Volatility¹ 18.80%

TOP 10 INDEX CONSTITUENTS

	Weight
Crude Oil Futures, 09/11	15.38%
Gold Futures, 08/11	11.16%
Natural Gas Futures, 09/11	10.94%
Copper Futures, 09/11	7.29%
Soybeans Futures, 11/11	7.21%
Corn Futures, 09/11	7.00%
Aluminum Futures, 09/11	5.11%
Heating Oil Futures, 09/11	4.11%
Unleaded Gas (RBOB) Futures, 09/11	4.09%
Silver Futures, 09/11	3.83%

INDEX SECTOR WEIGHTINGS



Energy	34.53%
Grains	20.41%
Industrial Metals	17.19%
Precious Metals	15.04%
Softs	7.10%
Livestock	5.65%

¹The quarterly volatility refers to annualized standard deviation, a statistical measure that captures the variation of an index's returns from their mean and that is often used to quantify the risk of the index over a specific time period. The higher the volatility, the more an index's return fluctuates over time. This ETF invests substantially in financial instruments linked to the performance of commodities and currencies, such as swap agreements, forward contracts, and futures and options contracts, which may be subject to greater volatility than investments in traditional securities. Certain of these financial instruments will also subject the fund to counterparty risk and credit risk, which could result in significant losses for the fund. There are additional risks due to large institutional purchases or sales, one natural and technological factors such as severe weather, unusual climate change, and development and depletions of alternative resources.

Investing in this ETF involves substantial risk, including loss of principal. ProShares are non-diversified and entail certain risks, including risk associated with the use of derivatives (swap agreements, futures contracts and similar instruments), imperfect benchmark correlation, leverage and market price variance. These risks may pose risks different from, or greater than, those associated with a direct investment in the securities underlying the fund's benchmarks, can increase volatility, and may dramatically decrease performance. Narrowly focused investments typically exhibit higher volatility. For more on correlation, leverage and other risks, please read the prospectus. There is no guarantee any ProShares ETF will achieve its investment objective.

ProShares are distributed by SEI Investments Distribution Co., which is not affiliated with the fund's sponsor.

ProShares Trust II is a commodity pool as defined in the Commodity Exchange Act and the applicable regulations of the CFTC. ProShare Capital Management LLC is the Trust Sponsor, commodity pool operator (CPO) and commodity trading advisor. The Sponsor is registered as a CPO and commodity trading advisor with the CFTC, and is a member of the NFA. Neither this ETF nor ProShares Trust II is an investment company regulated under the Investment Company Act of 1940 and neither is afforded its protections.

This material must be accompanied or preceded by a ProShares Trust II prospectus. Investing in these ETFs involves significant risks. Investors could lose all or substantially all of their investment. ProShares Trust II (the issuer) has filed a registration statement (including a prospectus) with the SEC for the offering to which this communication relates. Before you invest, you should read the prospectus in that registration statement and other documents the issuer has filed with the SEC for more complete information about the issuer and this offering. You may get these documents for free by visiting ESEDAR on the SEC website at sec.gov. Alternatively, the issuer will arrange to send you the prospectus if you request it by calling toll-free 866.PRO.5125, or visit proshares.com. These funds may have different tax implications and generate a K-1 tax form. This ETF does not invest directly in commodities.

The "Dow Jones-UBS Commodity Index" is a joint product of Dow Jones Indexes, the marketing name and a licensed trademark of CME Group Index Services LLC ("CME Indexes"), and UBS Securities LLC ("UBS Securities"). "Dow Jones", "DJ", "Dow Jones Indexes", "UBS" and "Dow Jones-UBS Commodity Indexes" are service marks of Dow Jones Indexes Holdings, LLC ("Dow Jones") and UBS AG ("UBS AG"), as the case may be, and have been licensed to CME Indexes and sub-licensed to ProShares. ProShares have not been passed on by these entities as to their legality or suitability. ProShares are not sponsored, endorsed, sold or promoted by Dow Jones, UBS AG, UBS Securities, CME Indexes or any of their affiliates. Dow Jones, UBS AG, UBS Securities, CME Indexes and their affiliates make no representation regarding the advisability of investing in ProShares. THESE ENTITIES AND THEIR AFFILIATES MAKE NO WARRANTIES AND BEAR NO LIABILITY WITH RESPECT TO PROSHARES.

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For more information, visit
proshares.com and seek advice
from your financial adviser or broker.
Financial professionals should call
ProShares at 866.PRO.5125.



home prospectus disclosure related products

Fund Information

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- [account statements >>](#)
- [filings and reports >>](#)
- [roll dates >>](#)
- [schedule K-1 >>](#)
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Fund Objective & Key Features

The United States Oil Fund LP is a domestic exchange traded security designed to track the movements of light, sweet crude oil ("West Texas Intermediate").

USO is a commodity pool organized as a Delaware limited partnership that issues units that may be purchased and sold on the NYSE Arca.

USO's Objective

The investment objective of USO is for the changes in percentage terms of its units' net asset value ("NAV") to reflect the changes in percentage terms of the spot price of light, sweet crude oil delivered to Cushing, Oklahoma, as measured by the changes in the price of the futures contract for light, sweet crude oil traded on the New York Mercantile Exchange (the "NYMEX"), less USO's expenses.

USO's Target

Crude oil is one of the most important physical commodities in the global economy. WTI light, sweet crude oil futures contracts are also the most actively traded, and WTI light, sweet crude oil is the primary US benchmark for crude oil.

USO's Portfolio

The portfolio will consist of listed crude oil futures contracts and other oil related futures, forwards, and swap contracts. USO will also invest in obligations of the United States government with remaining maturities of two years or less and hold cash and cash equivalents to be used to meet its current or potential margin or collateral requirements with respect to its investments in crude oil futures contracts and other oil interests.

USO's Key Features

United States Oil Fund, LP is an exchange traded security listed on NYSE Arca under the symbol USO. The symbol for USO's Indicative Intraday Fund ("IIF") Value is UOI. The symbol for USO's net asset value ("NAV") is UOINV. The symbol for USO's shares outstanding is UOISO.

USO's units will trade throughout the market day.

Units will be created and redeemed by "authorized purchasers."

An "authorized purchaser" purchases or redeems creation baskets or redemption baskets, respectively, from or to USO.

USO does NOT seek to use leverage and targets a 1:1 relationship between assets and crude oil exposure.

The management fee is 45bp.

United States Commodity Funds, LLC, USO's manager and General Partner, seeks to minimize tracking error, NOT outperform the market.

Transparent portfolio market price, NAV, and portfolio holdings.

Annual tax reporting done by PricewaterhouseCoopers.

USO's Creation & Redemption Process

Creation/Redemption Basket Size 100,000 Units

Order Cut-off for Authorized Purchasers ("AP") is 12:00 p.m. EST

USO's NAV calculated as of 4:00 pm

Settlement is T+3

Transaction charge for Each AP Order is \$1,000 (per order, not per basket)

Creation Payment is in Cash and/or Acceptable Treasuries

Custodian is Brown Brothers Harriman

Marketing Agent is ALPS Distributors, Inc.

U.S. Federal Income Tax Considerations

A summary of the material U.S. federal income tax consequences of the purchase, ownership and disposition of units in USO, and the U.S. federal income tax treatment of USO, is set forth in the Prospectus.

Each prospective investor is advised to consult its own tax advisor as to the U.S. federal income tax consequences of an investment in USO and as to applicable state, local or foreign taxes.

Tax Status of USO

USO is organized and will be operated as a limited partnership in accordance with the provisions of the LP Agreement and applicable state law. Under the Internal Revenue Code of 1986, as amended (the "Code"), an entity classified as a partnership that is deemed to be a "publicly traded partnership" is generally taxable as a corporation for federal income tax purposes. The Code provides an exception to this general rule for a publicly traded partnership whose gross income for each taxable year of its existence consists of at least 90% "qualifying income" ("qualifying income exception"). For this purpose, section 7704 defines "qualifying income" as including, in pertinent part, interest (other than from a financial business), dividends and gains from the sale or disposition of capital assets held for the production of interest or dividends. In addition, in the case of a partnership a principal activity of which is the buying and selling of commodities (other than as inventory) or of futures, forwards and options with respect to commodities, "qualifying income" includes income and gains from such commodities and futures, forwards and options with respect to commodities. USO and the General Partner have represented the following to Sutherland Asbill & Brennan LLP:

At least 90% of USO's gross income for each taxable year will constitute "qualifying income" within the meaning of Code section 7704 (as described above);

USO will be organized and operated in accordance with its governing agreements and applicable law;

USO has not elected, and will not elect, to be classified as a corporation for U.S. federal income tax purposes.

Fund Details

USO Data as of 10/18/2011

Ticker	USO
IIV	USO.IV
CUSIP	91232N108
ISIN	US91232N1081
Minimum Trade Size	1 share
Marginal*	Yes
Options Traded	Yes
Administrator	Brown Brothers Harriman & Co
Distributor	ALPS Distributors, Inc.
General Partner	United States Commodity Funds, LLC
Management Expense Ratio	0.45%
Trading Increment	\$0.01

*There are special risks associated with margin investing. Please ask your financial advisor for more information about these risks.

United States Oil Fund - Details

Page 2 of 2

For a copy of the Prospectus contact:
ALPS Distributors, Inc., 1290 Broadway,
Suite 1100, Denver, Colorado 80203 or
call 800.820.0289 or click here.

USO is not a mutual fund or any other
type of investment company within the
meaning of the Investment Company Act
of 1940, as amended, and is not subject
to regulation thereunder.

Commodities and futures generally are
volatile and are not suitable for all
investors. USO is speculative and
involves a high degree of risk. An
investor may lose all or substantially all
of an investment in USO. Funds that
focus on a single sector generally
experience greater volatility.

For further discussion of these and additional
risks associated with an investment in USO units,
click here.

Investing in USO subjects you to the risks of the
oil industry. These risks could result in large
fluctuations in the price of USO's units. An
investor could lose all or substantially all of
his/her investment.

The price of units may not accurately track the
spot price of oil and you may not be able to
effectively use USO as a way to hedge the risk of
losses in your oil-related transactions or as a way to indirectly invest in oil.

Investors buy and sell units in the secondary market (i.e., not directly from USO). Only "authorized purchasers" may trade directly with USO, in minimum blocks of 100,000 units.

The United States Oil Fund is distributed by ALPS Distributors, Inc.

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Based in part on these representations, Sutherland Asbill & Brennan LLP is of the opinion that
USO will be classified as a partnership for federal income tax purposes and that it will not be
taxable as a corporation for such purposes.

If USO failed to satisfy the qualifying income exception in any year, other than a failure that is
determined by the IRS to be inadvertent and that is cured within a reasonable time after
discovery, USO would be taxable as a corporation for federal income tax purposes and would
pay federal income tax on its income at regular corporate rates. In that event, unitholders
would not report their share of USO's income or loss on their returns. In addition, distributions
to unitholders would be treated as dividends to the extent of USO's current and accumulated
earnings and profits. To the extent a distribution exceeded USO's earnings and profits, the
distribution would be treated as a return of capital to the extent of a unitholder's basis in its
units, and thereafter as gain from the sale of units. Accordingly, if USO were to be taxable as a
corporation, it would likely have a material adverse effect on the economic return from an
investment in USO and on the value of the units.

Under recently enacted legislation, interests in and income from "qualified publicly traded
partnerships" satisfying certain gross income tests are treated as qualifying assets and
income, respectively, for purposes of determining eligibility for regulated investment company
("RIC") status. A RIC may invest up to 25% of its assets in interests in a qualified publicly
traded partnership. The determination of whether a publicly traded partnership such as USO is
a qualified publicly traded partnership is made on an annual basis. USO expects to be a
qualified publicly traded partnership in each of its taxable years. However, such qualification is
not assured.

The foregoing is only a partial summary of the federal income tax consequences of an
investment in USO. The full summary can be found in the Prospectus.

[back to the top >>](#)

<http://www.unitedstatesoilfund.com/uso-details.php>

10/19/2011

Selected Commodity Related Mutual Funds

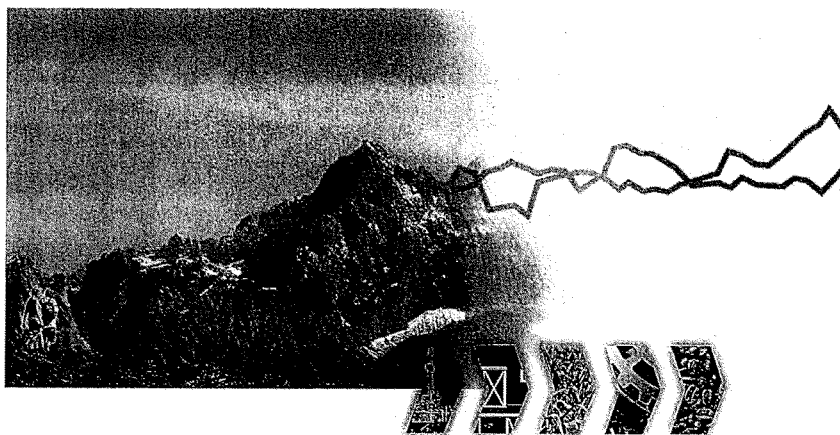
Name	2011 Net Assets
PIMCO Commodity Real Return Strategy Fund	\$22,785,400,000
Fidelity Series Commodity Strategy Fund	\$7,150,700,000
Credit Suisse Commodity Return Strategy	\$5,407,400,000
Highbridge Dynamic Commodities Strategy Fund	\$2,413,200,000
PIMCO CommoditiesPLUS Strategy Fund	\$1,976,900,000
Oppenheimer Commodity Strategy Total Return Fund	\$1,212,400,000
Russell Commodity Strategies Fund	\$1,146,200,000
DWS Enhanced Commodity Strategy Fund	\$1,130,000,000
Rydex/SGI Managed Futures Strategy Fund	\$1,130,000,000
Altegris Managed Futures Strategy Fund	\$1,015,000,000
Grant Park Managed Futures Strategy Fund	\$1,000,000,000
Goldman Sachs Commodity Strategy Fund	\$898,600,000
Equinox MutualHedge Frontier Legends Fund	\$556,600,000
Natixis ASG Managed Futures Strategy Fund	\$530,400,000
Eaton Vance Commodity Strategy Fund	\$508,700,000
Princeton Futures Strategy Fund	\$385,100,000
Rydex SGI Long/Short Commodities Strategy Fund	\$380,400,000
Harbor Commodity Real Return Strategy Fund	\$276,700,000
MFS Commodity Strategy Fund	\$249,800,000
Ramius Trading Strategies Managed Futures Fund	\$225,500,000
DFA Commodity Strategy Fund	\$210,200,000
Transamerica Goldman Sachs Commodity Strategy Fund	\$169,100,000
Altegris Macro Strategy Fund	\$147,400,000
Invesco Balanced-Risk Commodity Strategy Fund	\$145,400,000
Direxion Commodity Trends Strategy Fund	\$131,700,000
Jefferies Asset Management Commodity Strategy Allocation Fund	\$119,200,000
Credit Suisse Trust Commodity Return Strategy Fund	\$114,200,000
Fidelity Commodity Strategy Fund	\$112,000,000
ING Goldman Sachs Commodity Strategy Portfolio	\$102,200,000
Invesco Commodities Strategy Fund	\$87,000,000
LoCorr Managed Futures Strategy Fund	\$77,300,000
Blackrock Commodities Strategy Fund	\$48,200,000
Van Eck CM Commodity Index Fund	\$41,200,000
Rydex Commodities Strategy Fund	\$24,600,000
SCA Absolute Return Fund	\$22,200,000
Eaton Vance Parametric Structured Commodity Strategy Fund	\$18,200,000
Arrow Commodity Strategy Fund	\$16,800,000
Columbia Commodity Strategy Fund	\$8,700,000
TCW Enhanced Commodity Strategy I	\$4,100,000
Mosaic Managed Futures Strategy Fund	\$1,700,000
Total	\$51,980,400,000

Data source: Morningstar, Inc. and various mutual fund materials
 List prepared by Permanent Subcommittee on Investigations, Nov. 2011

Permanent Subcommittee on Investigations
EXHIBIT #7a

a managed tactical fund

the Commodity Trends Strategy Fund



A Diversified Long/Short Commodity Fund.

direxionfunds.

Think direction. Invest.

Permanent Subcommittee on Investigations
EXHIBIT #7b

Why commodities?

Financial professionals and their clients have found that commodities can:

- potentially provide additional risk-adjusted returns over time to a diversified portfolio;
- be an attractive investment option when global demand for commodities surge;
- offer low correlation to stocks and bonds;
- be an effective hedge against inflation; and
- be a diversification tool with the potential to enhance all asset allocation models.

Why consider long/short commodities?

Most traditional commodity funds only provide long exposure to commodities. However, these long-only commodity strategies have not proven to provide sustainable gains over time because:

- commodity returns are typically cyclical and sporadic;
- individual commodity sub-sectors tend to perform dissimilarly in different market environments; and
- significant drawdowns can be damaging to portfolios over time.

What does that mean for investors? Long-only exposure can tend to limit commodities' potential to contribute to a portfolio's long-term performance. For example, \$1 invested in commodities in 1956 is worth 71 cents (inflation-adjusted) today¹.

The following chart illustrates the Commodity Trends Indicator's (a long/short index) performance results from 2004 through 2010, as compared to the performance of two long only commodity indices, the S&P GSCI™ (Goldman Sachs Commodity Index) and the DJUBS CI (Dow Jones UBS Commodity Index).²

Commodity Trends Indicator (CTI) vs. the S&P GSCI and DJUBS CI: 2004-2010 ³			
	CTI	S&P GSCI	DJUBS CI
Compound Annual Return ⁴	10.26%	1.38%	1.38%
Annualized Standard Deviation ⁵	12.04%	27.49%	16.67%
Sharpe Ratio ⁶	0.70	0.35	0.46
Maximum Drawdown ⁷	-38.97%	-51.49%	-36.38%

As demonstrated in the table, while the long-only indexes had periods of strong positive returns, the long/short index was able to maintain more favorable returns with a lower volatility measure for the seven year period.²

¹ The chart is meant to demonstrate the differences between long only and long/short indices and is not indicative of the funds performance.

² Based on data provided by the Chart Store for the Reuters/CRB Continuous Futures Index for the period 11/30/56 - 01/31/11.

³ Past performance, especially statistical information, is not necessarily indicative of future results.

⁴ Standard Deviation is a measure of the dispersion of a set of data from its mean.

⁵ The expected return of that asset, less the rate of return on a risk-free asset. This rate is denominated by the risk of that asset, which is expressed as the standard deviation of returns.

⁶ The greatest percent decline from a previous high.

The Commodity Trends Strategy Fund

Investment objective

The Commodity Trends Strategy Fund seeks to match the performance of the Commodity Trends Indicator (CTI®), which offers pure commodity exposure that seeks to benefit in all market conditions, through its unique long/short exposure.

Principal investment strategy

Like the Commodity Trends Indicator, the Fund invests primarily in commodity futures, positions its investments in each sector and component either long or short depending upon price trends within that component, and rebalances each sector monthly.

How does the Commodity Trends Indicator work?

The CTI® is a managed futures index that tracks both rising and falling trends in the commodity markets. It offers exposure to 16 commodity markets (in six sectors) and will hold them long or short, based on price trends. The long/short decision involves monitoring the price of the sectors in relation to their respective seven-month moving average price, which allows investors to benefit from rising and falling commodity prices. The exception within the model is the Energy sector which, due to geopolitical issues, economic changes and other factors uniquely related to the sector, is positioned either long or neutral (flat).

Share Class	Index*	Investor Class	C Shares	Institutional Class
Fees Gross/Net	n/a	1.75/1.75	2.26/2.26	1.25/1.25
Symbol	CTITR	DXCTX	DXSCX	DXCIX
CUSIP	n/a	254939457	254939341	254939382

Principal Risks

The principal risks of investing in the Commodity Trends Strategy Fund are risks of investing in commodity-linked derivatives, risks of investing in wholly owned subsidiary, high portfolio turnover, tax risk, risk of tracking error, risks of aggressive investment techniques, leverage risk, derivatives risks, counterparty risks, risk of non-diversification, risks of investing in other investment companies and ETFs, adverse market conditions, risks of investing in equity securities, credit risk, derivatives risk, risks of shorting instruments, risks of volatile markets, risks of investing in Wholly Owned Subsidiary and concentration risk.

*One cannot invest directly in an index. This information is for illustrative purposes only.

Concentration risks result from focusing the Commodity Trends Strategy Fund investments in a specific industry or sector.

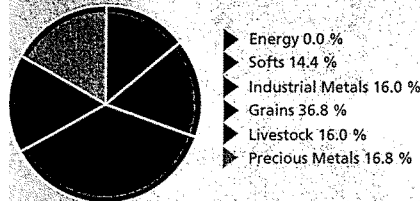
The performance of the fund may be more volatile than a fund that does not concentrate its investments.

The performance of the Fund is designed to correlate to the performance of its index. As a consequence, the fund's performance will suffer during conditions which are adverse to the investment goals.

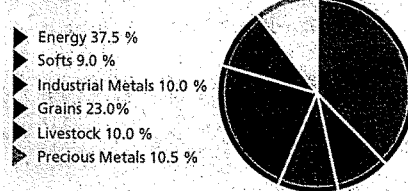
Diversification does not guarantee protection against market losses or ensure a gain.

CTI Index Compositions

When the Energy Sector is Flat



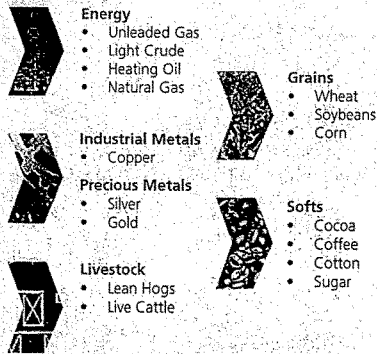
When the Energy Sector is Long



Leveraging the advantages of the CTI

By investing in the Commodity Trends Strategy Fund, offered by Direxion Funds, investors can take advantage of the benefits of a diversified, open-ended commodity mutual fund—without the inconvenience and high expenses ordinarily associated with other commodity options.

The six major sectors and components that the CTI track are:

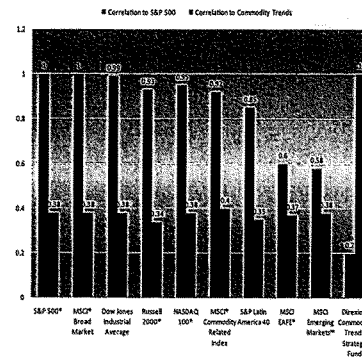


The importance of non-correlation

Non-correlating assets help reduce volatility, while providing diversification and risk-adjusted returns for your investors' portfolios. Whether market volatility is high or low, investors should consider incorporating alternative assets that have low correlation to traditional investment vehicles into their portfolios.

The graph (below) compares the correlation of traditional asset classes to that of both the S&P 500® Index and the Direxion Commodity Trends Strategy Fund.

6 Month Correlation through 12/31/10



As you can see, the Commodity Trends Strategy Fund has historically performed independently of traditional asset classes, such as stocks and bonds. This non-correlation could allow portfolio volatility to be reduced when the fund is included as part of a well balanced portfolio.

It is important to note that different time frames will result in different correlations.

The Russell Indexes noted herein are trademarks of Russell Investments and have been licensed for use by Direxion Shares. The fund is not sponsored, endorsed, sold or promoted by Russell Investments and Russell Investments makes no representation regarding the advisability of investing in the fund. The S&P indexes are trademarks of Standard and Poor's, a division of the McGraw Hill Companies, Inc. MSCI indexes are the exclusive property of MSCI and its affiliates. All rights reserved. Indexes are unmanaged and cannot be invested in directly.

Advantages of including the Commodity Trends Strategy Fund in your investment strategies

The Commodity Trends Strategy Fund, with its long and short exposure:

- may provide potentially solid returns over time;
- typically exhibits a low correlation to stocks and bonds;
- can potentially serve as an effective hedge against both inflation and deflation;
- potentially provides additional risk-adjusted returns over time to a well-balanced and diversified portfolio;
- provides investors with a means to capitalize on surges and declines in commodity demand and prices;
- allows for a buy and hold strategy while simultaneously acting upon short term market trends; and
- may be an effective complement to other alternative investments.

Diversification does not guarantee protection against market losses or ensure a gain.

To learn more about the Commodity Trends Strategy Fund and the role it can play in your clients' investment strategies, please contact Direxion Funds at 877-437-9363 or visit us at www.direxionfunds.com.

direxionfunds.

Think direction. Invest.

877.437.9363
info@direxionfunds.com
www.direxionfunds.com

An investor should consider the investment objectives, risks, charges, and expenses of the Direxion funds carefully before investing. The prospectus contains this and other information about Direxion funds. To obtain a prospectus, please contact Direxion Funds at 800.851.0511. The prospectus should be read carefully before investing. Investing in funds that invest in specific industries or geographic regions may be more volatile than investing in broadly diversified funds.

Date of First Use: April 30, 2010.
Distributed by: Rafferty Capital Markets, LLC

NOT FDIC INSURED | NO BANK GUARANTEE | MAY LOSE VALUE

Highbridge Dynamic Commodities Strategy Fund

Data as of September 30, 2011

A Shares (HDSAX)
C Shares (HDCSX)
Select Shares (HDCSX)

(Offered on a 47-net basis.)

Fund overview

Objective

The Fund seeks long-term total return.

Strategy/Investment process

- Invests in commodity-linked derivative instruments.
- Long-biased investment strategy combines a fundamental and systematic approach to commodities investing.
- Risk control process may reduce exposure to commodities in certain market environments.

Portfolio managers/industry experience

Sassan Alizadeh, 17 years
Mark Nodelman, 12 years
Christopher Tufts, 14 years

The Fund invests in commodity-linked derivative instruments backed by a portfolio of high quality fixed income securities, such as commercial paper or other instruments that generally have a weighted average maturity of 90-days or less.

The fund's exposure to commodities may vary as a percentage of total fund net assets. The fund has flexibility to invest in long positions ranging from 0% to 200% of the value of the fund's net assets and short positions ranging from 0% to 100% of the value of the fund's net assets.

In the net commodity exposure table, the fund's net exposure as of 8/31/11 is equal to 86.8% of the fund's net assets and its gross exposure as of 8/31/11 is equal to 150.5% of the fund's net assets. The fund's net exposure equals the value of the fund's long positions minus the short positions. The fund's gross exposure equals the sum of the fund's long positions and short positions. Exposures are calculated as the notional value of the fund's derivative positions as a percentage of total net assets.

Portfolio characteristics	
Fund assets (in billions)	\$2.41
Commodity maturity (%) ^{3,4}	
0 - 3 Months	65.0
3 - 6 Months	35.0
6+ Months	0.0
Fixed income maturity (%) ^{3,4}	
Less than one month	54.3
1 - 3 Months	33.6
3 - 6 Months	11.0
6+ Months	1.1
Net commodity exposure (%) ^{3,4}	
Precious Metals and Financial Commodities	77.1
Agriculture	14.9
Energy	-1.5
Industrial Metals	-3.8
Cash investments (%) ^{3,4}	
U.S. Government Agency Securities	63.9
Short-Term Investments	26.5
Repurchase Agreements	5.7
U.S. Treasury Securities	1.9
Certificates of Deposit	0.2

³Data as of 8/31/11

⁴Due to rounding, values may not total 100%

⁵Percent of total net assets

Fund performance*

Performance at NAV (%)

	Latest QTR	YTD
A Shares	-6.27	-4.87
C Shares	-6.42	-5.20
Select Shares	-6.24	-4.65
Dow Jones UBS Commodity Index Total Return	-11.33	-13.62
Upper Commodities General Funds Average	-10.87	-9.70

With sales charges (%)

A Shares with 5.25% max. sales charge	-11.21	-9.86
C Shares with 1.00% max. COC	-7.42	-6.20

The Fund launched on 1/13/10 and was seeded with proprietary assets. Please note the performance shown does not take into consideration the inflow and outflows of cash which would have had an effect on performance. Also note, the limited performance track record is not a true indication of how this fund will perform in the long term.

*The performance quoted is past performance and is not a guarantee of future results. Mutual funds are subject to certain market risks. Investment returns and principal value of an investment will fluctuate so that an investor's shares, when redeemed, may be worth more or less than original cost. Current performance may be higher or lower than the performance data shown. For performance current to the most recent month-end please call 1-800-460-4111.

Annual operating expenses

	A Shares	C Shares	Select
Expense cap expiration date	2/29/2012	2/29/2012	2/29/2012
Expense cap (%)	1.65	2.15	1.40
Total annual fund operating expenses (%)	2.33	2.78	2.22
Fee waivers and/or expense reimbursements (%) ¹	(0.61)	(0.56)	(0.75)
Net expenses (%) ²	1.72	2.22	1.47

¹The Investment Advisor, Administrator and Distributor have contractually agreed to waive fees and/or reimburse expenses to the extent that Total Annual Operating Expenses (excluding Acquired Fund Fees and Expenses, dividend expenses relating to short sales, interest, taxes and extraordinary expenses and expenses related to the Board of Trustees' deferred compensation plan) exceed the expense cap of the average daily net assets through the expense cap expiration date. In addition, the Fund's service providers may voluntarily waive or reimburse certain of their fees, as they may determine, from time to time.

Portfolio statistics

	A Shares	C Shares	Select
Inception date	1/13/2010	1/13/2010	1/13/2010
Investment minimum	\$1,000	\$1,000	\$1M
Fund number	2013	2014	2015
CUSIP	48121A696	48121A688	48121A670

Please refer to the back of the page for important disclosure information including risks associated with investing in the Fund.

Insight + Process = Results™

J.P.Morgan
Asset Management

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Highbridge Dynamic Commodities Strategy Fund

A Shares (HDSAX)
C Shares (HDCSX)
Select Shares (HDCSX)

(Offered on a written basis.)

Contact JPMorgan Distribution Services, Inc. at 1-800-480-4111 for a fund prospectus. You can also visit us at www.jpmorganfunds.com. Investors should carefully consider the investment objectives and risks as well as charges and expenses of the mutual fund before investing. The prospectus contains this and other information about the mutual fund. Read the prospectus carefully before investing.

RISKS ASSOCIATED WITH INVESTING IN THE FUND:

The fund will gain exposure to commodity markets primarily by investing up to 25% of its total assets in the HCM Commodities Strategy Fund Ltd., a wholly owned subsidiary of the Fund organized under the laws of the Cayman Islands. By investing in the Subsidiary, the Fund is indirectly exposed to the risks associated with the Subsidiary's investments. The derivatives and other investments held by the Subsidiary are generally similar to those that are permitted to be held by the Fund and are subject to the same risks that apply to similar investments if held directly by the Fund. The Fund may use derivatives in connection with its investment strategies. Derivatives may be riskier than other types of investments because they may be more sensitive to changes in economic or market conditions than other types of investments and could result in losses that significantly exceed the Fund's original investment. The techniques and strategies contemplated by the Fund are expected to result in a high degree of portfolio turnover. Portfolio turnover may vary greatly from year to year as well as within a particular year. High portfolio turnover (e.g. over 100%) may involve correspondingly greater expenses to the Fund, including brokerage commissions or dealer mark-ups and other transaction costs on the sale of securities and reinvestments in other securities. Assets not invested in commodity-linked derivatives, currency-linked derivatives or the Subsidiary will be invested in fixed income securities. The fixed income portion of the Fund is intended to provide liquidity and preserve capital. The Fund generally will only buy securities that have remaining maturities of 397 days or less. The dollar-weighted average maturity of the Fund's fixed income investments will generally be 90 days or less.

The Fund's investment in income securities is subject to interest rate risks. Bond prices generally fall when interest rates rise. The Fund will have a significant portion of its assets concentrated in commodity-linked securities. Developments affecting commodities will have a disproportionate impact on the Fund. The Fund's investment in commodity-linked derivative instruments may subject the Fund to greater volatility than investments in traditional securities, particularly if the instruments involve leverage. The value of commodity-linked derivative instruments may be affected by changes in overall market movements, commodity index volatility, changes in interest rates, or factors affecting a particular industry or commodity, such as drought, floods, weather, livestock disease, embargoes, tariffs and international economic, political and regulatory developments. Use of leveraged commodity-linked derivatives creates an opportunity for increased return but, at the same time, creates the possibility for greater loss (including the likelihood of greater volatility of the Fund's net asset value), and there can be no assurance that the Fund's use of leverage will be successful.

INDEXES DEFINED:

The Dow Jones-UBS Commodity Index Total Return is composed of futures contracts on 19 physical commodities. The performance of the index does not reflect the deduction of expenses associated with a fund, such as investment management fees. By contrast, the performance of the Fund reflects the deduction of the fund expenses, including sales charges if applicable. An individual cannot invest directly in an index.

The performance of the Lipper Commodities General Funds Average includes expenses associated with a mutual fund, such as investment management fees. These expenses are not identical to the expenses charged by the Fund.

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Total return assumes reinvestment of dividends and capital gains distributions and reflects the deduction of any sales charges, where applicable. Performance may reflect the waiver of a portion of the Fund's advisory or administrative fees for certain periods since the inception date. If fees had not been waived, performance would have been less favorable.

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J.P.Morgan
Asset Management



MutualHedge Frontier Legends Fund

CLASS A AND CLASS C SHARES

Annual Report September 30, 2010

1-888-643-3431
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MutualHedge Frontier Legends Fund.

Annual Letter to Shareholders for the period ended September 30, 2010

MutualHedge Frontier Legends Fund began trading on December 31, 2009 with an Initial NAV of \$10.00. For the period ending on September 30, 2010, Class A Shares returned 1.00% and Class C Shares returned 0.50%. For the same nine-month period, the CASAM CISDM CTA Asset Weighted Index® (the "Managed Futures Index") returned 4.93% and the S&P 500 Total Return Index™ returned 3.89%.

Most of the Fund's underperformance versus the Managed Futures Index came in the first quarter of 2010, the Fund's very first quarter of operations, when the Fund was down about 1%. As discussed in our last letter, this was the period during which CTA Programs (defined below) were brought "on line" one at a time and were scaled into gradually. The Fund was down 1.3% during the second quarter, but there was a strong rebound in performance during the third quarter, when the Fund was up a healthy 3.3%. We discuss performance attribution at greater length later in this letter.

The Fund's investment objective and strategy is to achieve capital appreciation in both rising and falling equity markets with an annualized level of volatility similar to the historic level of volatility experienced by the S&P 500 Index. By analyzing the interrelationships among selected programs, the Fund seeks to combine them in a portfolio that offers more consistent performance potential with lower volatility than individual programs. The Fund gains exposure to managed futures programs of selected commodity trading advisors ("CTA Programs") through its investments in trading companies.¹ The Fund's allocation as of September 30, 2010 to the five currently selected CTA Programs is displayed below. These allocations will vary over time as a function of ongoing portfolio management and as new programs are identified and added to the mix.

MutualHedge Managed Futures Exposure as of September 30, 2010

	Allocation % (based on)	Allocation changes from
--	-------------------------	-------------------------

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EDGAR Filing Documents for 0000910472-10-001293

Trading Company Name	notional exposure levels ¹	3/31/2010 to 9/30/2010
Beach Horizon Trading - Horizon Program, LLC	22.3%	-2.7%
Cantab Trading Company - Aristarchus Program, LLC	21.4%	4.4%
QIM Trading Company - Global Program, LLC	20.7%	-3.9%
Tiverton Trading Company - Discretionary Program, LLC	17.6%	1.1%
WNTN Trading Company - Diversified Program, LLC	18.0%	1.1%

¹ The Fund invests in the CTA Programs through its wholly-owned subsidiary.

The five programs differ in terms of primary trading characteristics. This is reflected in their long-term historical correlations, which are generally fairly low.

Correlation Coefficient of CTA Programs January 2005 to September 2010	Beach	Cantab	QIM	Tiverton	Winton
Beach Horizon, LLP	1.00	0.61	-0.04	0.63	0.73
Cantab Capital Partners, LLP	0.61	1.00	0.05	0.47	0.58
Quantitative Investment Management, LLC	-0.04	0.05	1.00	0.07	-0.10
Tiverton Trading, Inc.	0.63	0.47	0.07	1.00	0.42
Winton Capital Management	0.73	0.58	-0.10	0.42	1.00

Note that the Fund gains exposure to these CTA Programs through trading companies managed by the CTAs listed above. The correlation coefficients in the chart above are based upon each CTA's track record. Not all CTAs have track records for the full period of this analysis. Inception dates for these are: Beach Horizon: May 2005; Tiverton: April 2006; Cantab: March 2007. The track records, with the exception of Beach Horizon and Cantab which use a model account, are the composite track records of the respective CTAs, and do not include fees and expenses associated with an investment in the Fund including the indirect expenses of the Fund's subsidiary and the CTA Programs.

Correlation Coefficient: The correlation coefficient, r , indicates both the strength and direction of the relationship between the independent and dependent variables. Values of r range from -1.0, a strong negative relationship, to +1.0, a strong positive relationship. When $r=0$, there is no relationship between the S&P 500[®] and the other funds it is being compared to.

In reviewing the Fund's performance, it is important to recognize that CTA Programs can hold long, short or neutral positions, with the potential to earn profits in rising or falling markets across the six different sectors: metals, energy, agricultural, currencies, interest rates and stock indexes.

For the period from inception through September 30, 2010, three of our five CTA Programs posted positive returns of 9.6%, 2.9% and 1.5%, respectively, while the two negatively performing programs returned -4.1% and -5.7%. The underlying CTA Programs' month-by-month results also attest to the fact that the five programs have widely varying sources of returns: there was not a single month in which all five programs traded down, and two months in which they all earned positive returns. Further, their best and worst months of performance generally did not coincide. This pattern of monthly returns reflects the low correlations among the programs and illustrates the potential benefits of a diversified portfolio.

1678-NLD-11/12/2010

The drivers of performance also tend to differ across the programs. The best performing program, Winton, earned the bulk of its positive performance from trading interest rates, currencies and metals, while experiencing smaller losses in stock indexes, energy, and agricultural. The worst performing program, QIM, incurred losses mainly in trading stock indexes, as well as in all other market sectors except interest rates, which were slightly profitable. The remaining three programs were all profitable in interest rates and metals; Beach Horizon and Cantab had meaningful losses in the other four sectors, while Tiverton's losses were smaller. On the whole, then, interest rates were the most significant positive contributor to Fund performance, followed by metals, while the losing sectors were led by stock indexes.

Other contributors to the Fund's underperformance versus the Managed Futures Index include: the fact that (i) the Fund's investments in the CTA Programs do not correspond with the components and weightings of the Managed Futures Index and some managed futures strategies may not be represented in the Fund, and (ii) the timing effects of the Fund's new investments into the trading companies may cause outperformance or underperformance against the Managed Futures Index.

A material portion of the Fund is invested in securities known as exchange traded funds (ETFs), which are designed to mimic the performance of specific fixed-income indices. These investments may have material effects on the Fund's overall performance. For the period from inception through September 30, 2010, the CTA Programs out-performed the ETFs.

[http://globaldocuments.morningstar.com/documentlibrary/document/5f8cc96c443448750862ea2730ef0e7c.msdoc/original\[10/27/2011 10:52:47 AM\]](http://globaldocuments.morningstar.com/documentlibrary/document/5f8cc96c443448750862ea2730ef0e7c.msdoc/original[10/27/2011 10:52:47 AM])

DGAR Filing Documents for 0000910472-10-001293

Returns on the Fund's investment in the Subsidiary are net of the management fees and incentive fees of the trading companies. The aggregate weighted average management fee and weighted average incentive fee of the trading companies, in which the Subsidiary invested, were 0.64% of assets under management and 24.55% of trading profits, as of September 30, 2010.

Market Commentary

In May this year, the "flash crash" in U.S. stock markets raised some serious concerns in the minds of investors. It is worth noting that circuit breakers in the S&P index futures market were triggered and succeeded in slowing down trading, demonstrating the efficacy of some of the safety nets that have the potential to protect futures markets. The trading systems of our CTA Programs also appear to have been robust enough to withstand the shock. While four of our five programs did have negative performance during May, the Fund lost only about 1.5%. For comparison, the worst month during this year for the Managed Futures Index was January, when it fell as much as 3.0%.

1678-NLD-11/12/2010

The global economy continued to grow during the second and third quarters, although the outlook remains weak and policymakers face several tricky imbalances. The headline story during recent months has been the rally in bonds, catalyzed by the weak economy and expectations of further quantitative easing by the U.S. Federal Reserve. Interest rates are unusually low, especially in developed economies, reflecting both aggressive monetary policy as well as weak demand for credit. As money flows out of these countries and into emerging economies, where interest rates are higher, upward pressure develops on their currencies, potentially hurting exports. The higher rates of economic growth in these countries are also creating inflationary pressures, which may result in tighter monetary policies and further interventions in currency markets.

Meanwhile, the effects of the financial meltdown are still being felt mainly in developed economies as businesses and banks hoard cash and deleverage. In the U.S., manufacturing continues to increase at a very slow pace. Personal income and spending have increased modestly, while consumer confidence remains low. The housing market has not shown significant signs of recovery. The good news is that inflation appears to be under control, at least for the foreseeable future. Additionally, the outlook for emerging economies like China and India remains positive, albeit tempered by longer-term challenges and the need for structural changes.

The price of gold continues to climb, possibly a reflection of its status as a perceived safe haven. Energy markets have been fairly quiet, while agricultural prices have displayed an upward trend. Other significant market developments have included the sovereign debt crisis in Europe, the weakness of the U.S. dollar, the strength of the Japanese yen. The high probability of gridlock in Washington after the U.S. elections appears to have energized Wall Street and the equity markets. The prospect of lower taxes, lower deficits and a lower level of effort directed towards regulatory reform of the markets is appealing to many market participants.

Although we are pleased with the Fund's recent performance, because of the unpredictable nature in the short-term of financial markets and most asset classes, we encourage investors to focus on holding a portfolio that contains a mix of stocks, bonds, cash and alternative asset classes appropriate for their long-term goals. Such a well-balanced portfolio can provide protection from volatility while also affording opportunities for potential long-term growth. We believe that the Fund can play an important part in such a portfolio.

Thank you for investing in the MutualHedge Frontier Legends Fund.

1678-NLD-11/12/2010

* The **CASAM CISDM CTA Asset Weighted Index** reflects the dollar-weighted performance of Commodity Trading Advisors (CTAs) reporting to the CASAM CISDM Database. CTAs trade a wide variety of OTC and exchange-traded forward, futures and options markets (e.g., physicals, currency, financial), based on a wide variety of trading models. In order to be included in the Asset Weighted Index universe, a CTA must have at least \$500,000 under management and at least a 12-month track record. The index goes back historically to January 1980. Source: casamhedge.com.

** The **S&P 500® Total Return Index** is widely regarded as the best single gauge of the U.S. equities market. This world-renowned index includes 500 leading companies in leading industries of the U.S. economy. Although the S&P 500 focuses on the large cap segment of the market, with approximately 75% coverage of U.S. equities, it is also an ideal proxy for the total market. Total return provides investors with a price-plus-gross cash dividend return. Gross cash dividends are applied on the ex-date of the dividend. Source: standardandpoors.com.

1678-NLD-11/12/2010

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MutualHedge Frontier Legends Fund
PORTFOLIO REVIEW
September 30, 2010 (Unaudited)

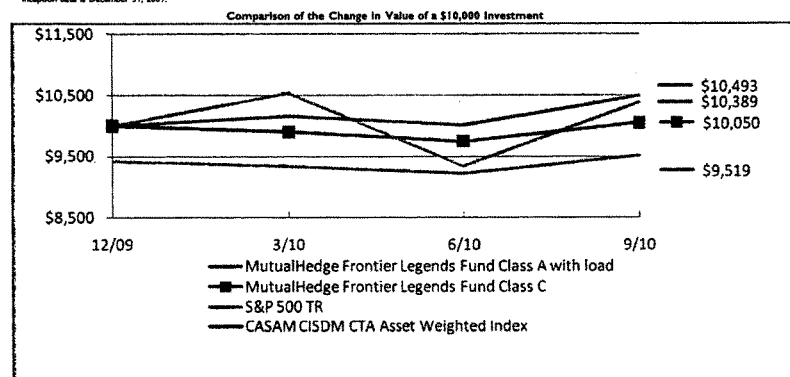
The Fund's performance figures* for the period ending September 30, 2010, compared to its benchmarks:

	Inception** – September 30, 2010
MutualHedge Frontier Legends Fund – Class A	1.00%
MutualHedge Frontier Legends Fund – Class A with load	-4.81%
MutualHedge Frontier Legends Fund – Class C	0.50%
CASAM CISDM CTA Asset Weighted Index	4.93%
S&P 500 Total Return Index	3.89%

* The performance data quoted here represents past performance. The performance comparison includes reinvestment of all dividends and capital gains and has been adjusted for the Class A maximum applicable sales charge of 5.75%. Current performance may be lower or higher than the performance data quoted above. Past performance is no guarantee of future results. The investment return and principal value of an investment will fluctuate so that investor's shares, when redeemed, may be worth more or less than their original cost. The returns shown do not reflect the deduction of taxes that a shareholder would pay on fund distributions or on the redemption of fund shares. Performance figures for periods greater than 1 year are annualized. The Fund's total annual operating expenses are 2.20% for Class A shares, 2.95% for Class C shares per the January 1, 2010, prospectus. For performance information current to the most recent month-end, please call toll-free 1-888-643-3431.

The CASAM CISDM CTA Asset Weighted Index reflects the dollar-weighted performance of Commodity Trading Advisors (CTAs) reporting to the CASAM CISDM Database. CTAs trade a wide variety of OTC and exchange-traded forward, futures and options markets (e.g., physicals, currency, financial), based on a wide variety of trading models. In order to be included in the Asset Weighted Index universe, a CTA must have at least \$500,000 under management and at least a 12-month track record. The index goes back historically to January 1980.

** Inception date is December 31, 2009.



The Fund's Top Asset Classes are as follows:

Sectors	% of Net Assets
Exchange Traded Funds – Bonds	56.3%
Systematic Trading Companies	19.2%
Other, Cash & Cash Equivalents	24.5%
	100.00%

MutualHedge Frontier Legends Fund
CONSOLIDATED PORTFOLIO OF INVESTMENTS
September 30, 2010

Shares

Value

<http://globaldocuments.morningstar.com/documentlibrary/documents/5f8cc96c443448750862ea2730ef0a7c.mxdoc/original>[10/27/2011 10:52:47 AM]

DGAR Filing Documents for 0000910472-10-001293

EXCHANGE TRADED FUNDS - 56.3%		
210,375	iShares Barclays 1-3 Year Credit Bond Fund	\$ 22,097,790
203,630	iShares Barclays Aggregate Bond Fund	22,124,399
22,490	iShares S&P/Citigroup 1-3 Year International Treasury Bond Fund	2,365,948
882,513	PowerShares VRDO Tax-Free Weekly Portfolio	22,058,412
TOTAL EXCHANGE TRADED FUNDS		68,646,549
(Cost \$68,160,093)		
SYSTEMATIC TRADING COMPANIES - 19.2%		
8,581,423	Beach Horizon Trading Co. - Horizon Program, LLC * +	6,943,487
6,652,569	Cantab Trading Co. - Aristarchus Program, LLC * +	7,289,020
4,578,664	QIM Trading Co. - Global Program, LLC * +	3,860,776
1,782,534	Tiverton Trading Co. - Discretionary Program, LLC * +	2,201,537
1,727,763	WNTN Trading Co. - Diversified Program, LLC * +	3,109,507
TOTAL SYSTEMATIC TRADING COMPANIES		23,404,327
(Cost \$19,986,110)		
TOTAL INVESTMENTS - 75.5% (Cost \$88,146,203) (a)		\$ 92,050,876
OTHER ASSETS AND LIABILITIES - 24.5%		29,962,446
TOTAL NET ASSETS - 100.0%		\$ 122,013,322

(a) Represents cost for financial reporting purposes. Aggregate cost for federal tax purposes is \$88,146,203 and differs from market value by net unrealized appreciation (depreciation) of securities as follows:

Unrealized Appreciation:	\$ 3,921,918
Unrealized Depreciation:	(17,245)
Net Unrealized Appreciation:	\$ 3,904,673

*Non-income producing investment.

+This investment is a holding of MutualHedge Fund Limited SPC.

See accompanying notes to financial statements.

MutualHedge Frontier Legends Fund
CONSOLIDATED STATEMENT OF ASSETS AND LIABILITIES
September 30, 2010

ASSETS

Investment securities:	
At cost	\$ 88,146,203
At value	\$ 92,050,876
Cash	29,177,552
Receivable for Fund shares sold	1,019,195
Dividends and interest receivable	6,030
Prepaid expenses and other assets	269
TOTAL ASSETS	122,253,922

LIABILITIES

Investment advisory fees payable	113,309
Distribution (12b-1) fees payable	26,788
Fees payable to other affiliates	18,716
Payable for Fund shares repurchased	1,850
Accrued expenses and other liabilities	79,937
TOTAL LIABILITIES	240,600

NET ASSETS

\$ 122,013,322

Composition of Net Assets:

Paid in capital [\$0 par value, unlimited shares authorized]	\$ 118,108,649
Net unrealized appreciation of investments	3,904,673

NET ASSETS

\$ 122,013,322

Net Asset Value Per Share:

Class A Shares:	
Net Assets	\$ 113,177,204

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Shares of beneficial interest outstanding	11,203,024
Net asset value (Net Assets + Shares Outstanding), offering price and redemption price per share (a)(b)	\$ 10.10
Maximum offering price per share (net asset value plus maximum sales charge of 5.75%) (c)	\$ 10.72
Class C Shares:	
Net Assets	\$ 8,836,118
Shares of beneficial interest outstanding	879,246
Net asset value (Net Assets + Shares Outstanding), offering price and redemption price per share (b)	\$ 10.05

- (a) For certain purchases of \$1 million or more, a 1% contingent deferred sales charge may apply to redemptions made within twelve months of purchase.
 (b) Redemptions made within 30 days of purchase may be assessed a redemption fee of 1.00%.
 (c) On investments of \$25,000 or more, the offering price is reduced.

See accompanying notes to financial statements.

MutualHedge Frontier Legends Fund
CONSOLIDATED STATEMENT OF OPERATIONS
 For the Period Ended September 30, 2010(a)

INVESTMENT INCOME	
Dividends	\$ 207,150
Interest	20,587
TOTAL INVESTMENT INCOME	227,737
EXPENSES	
Investment advisory fees	388,406
Professional fees	102,903
Distribution (12b-1) fees:	
Class A	53,861
Class C	13,030
Transfer agent fees	44,112
Administrative services fees	40,517
Accounting services fees	22,171
Registration fees	12,488
Compliance officer fees	9,853
Printing and postage expenses	9,853
Custodian fees	8,129
Trustees fees and expenses	5,941
Insurance expense	464
Other expenses	3,972
TOTAL EXPENSES	715,700
Less: Fees waived by the Advisor	(206,650)
NET EXPENSES	509,050
NET INVESTMENT LOSS	(281,313)
REALIZED AND UNREALIZED GAIN ON INVESTMENTS	
Net realized gain from security transactions	1,442
Net change in unrealized appreciation (depreciation) of investments	3,904,673
NET REALIZED AND UNREALIZED GAIN ON INVESTMENTS	3,906,115
NET INCREASE IN NET ASSETS RESULTING FROM OPERATIONS	\$ 3,624,802

(a) The MutualHedge Frontier Legends Fund commenced operations on December 31, 2009.

See accompanying notes to financial statements.

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MutualHedge Frontier Legends Fund
CONSOLIDATED STATEMENT OF CHANGES IN NET ASSETS

	For the Period Ended September 30, 2010 (a)
FROM OPERATIONS	
Net investment loss	\$ (281,313)
Net realized gain from security transactions	1,442
Net change in unrealized appreciation (depreciation) of investments	3,904,673
Net increase in net assets resulting from operations	<u>3,624,802</u>
FROM SHARES OF BENEFICIAL INTEREST	
Proceeds from shares sold:	
Class A	114,100,529
Class C	8,588,156
Redemption fee proceeds:	
Class A	1,434
Class C	91
Payments for shares redeemed:	
Class A	(4,287,819)
Class C	(13,871)
Net increase in net assets from shares of beneficial interest	<u>118,388,520</u>
TOTAL INCREASE IN NET ASSETS	<u>122,013,322</u>
NET ASSETS	
Beginning of Period	
End of Period	<u>\$ 122,013,322</u>
SHARE ACTIVITY	
Class A:	
Shares Sold	11,638,891
Shares Redeemed	(435,867)
Net increase in shares of beneficial interest outstanding	<u>11,203,024</u>
Class C:	
Shares Sold	880,644
Shares Redeemed	(1,398)
Net increase in shares of beneficial interest outstanding	<u>879,246</u>

(a) The MutualHedge Frontier Legends Fund commenced operations on December 31, 2009.

See accompanying notes to financial statements.

MutualHedge Frontier Legends Fund
CONSOLIDATED FINANCIAL HIGHLIGHTS
Per Share Data and Ratios for a Share of Beneficial Interest Outstanding Throughout the Period

	Class A	Class C
	Period Ended September 30, 2010 (1)	Period Ended September 30, 2010 (1)
Net asset value, beginning of period	\$ 10.00	\$ 10.00
Activity from investment operations:		

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Net investment loss (2)	(0.09)	(0.14)
Net realized and unrealized gain on investments	0.19	0.19
Total from investment operations	0.10	0.05
Net asset value, end of period	\$ 10.10	\$ 10.05
Total return (3)(8)	1.00%	0.50%
Net assets, at end of period (000s)	\$ 113,177	\$ 8,836
Ratio of gross expenses to average net assets (4)(5)(6)	2.98%	5.97%
Ratio of net expenses to average net assets (5)(6)	2.20%	2.95%
Ratio of net investment loss to average net assets (5)(7)	(1.19)%	(1.99)%
Portfolio Turnover Rate (8)	0%	0%

- (1) The MutualHedge Frontier Legends Fund's Class A and Class C shares commenced operations December 31, 2009.
(2) Per share amounts calculated using the average shares method, which more appropriately presents the per share data for the period.
(3) Total returns shown exclude the effect of applicable sales charges and redemption fees.
(4) Represents the ratio of expenses to average net assets absent fee waivers and/or expense reimbursements by the Advisor.
(5) Annualized for periods less than one full year.
(6) Does not include the expenses of other investment companies in which the Fund invests.
(7) Recognition of net investment income by the Fund is affected by the timing of the declaration of dividends by the underlying investment companies in which the Fund invests.
(8) Not annualized.

See accompanying notes to financial statements.

MutualHedge Frontier Legends Fund
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
September 30, 2010

1. ORGANIZATION

The MutualHedge Frontier Legends Fund (the "Fund") is a non-diversified series of shares of beneficial interest of Northern Lights Fund Trust (the "Trust"), a statutory trust organized under the laws of the State of Delaware on January 19, 2005, and is registered under the Investment Company Act of 1940, as amended (the "1940 Act"), as an open-end management investment company. The Fund currently offers two distinct share classes: Class A and Class C shares. The Fund seeks to achieve capital appreciation in both rising and falling (bull and bear) equity markets with an annual volatility that is generally lower than the volatility experienced by the S&P 500 Index. The investment objective of the Fund is non-fundamental and may be changed without shareholder approval.

The Fund currently offers Class A and Class C shares. Class C shares are offered at net asset value. Class A shares are offered at net asset value plus a maximum sales charge of 5.75%. Each class represents an interest in the same assets of the Fund and classes are identical except for differences in their sales charge structures and ongoing service and distribution charges. All classes of shares have equal voting privileges except that each class has exclusive voting rights with respect to its service and/or distribution plans. The Fund's income, expenses (other than class specific distribution fees) and realized and unrealized gains and losses are allocated proportionately each day based upon the relative net assets of each class.

2. SIGNIFICANT ACCOUNTING POLICIES

The following is a summary of significant accounting policies followed by the Fund in preparation of its consolidated financial statements. The policies are in conformity with accounting principles generally accepted in the United States of America ("GAAP"). The preparation of the consolidated financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of income and expenses for the period. Actual results could differ from those estimates.

Security Valuation – Securities, including exchange traded funds, listed on an exchange are valued at the last reported sale price at the close of the regular trading session of the exchange on the business day the value is being determined, or in the case of securities listed on NASDAQ at the NASDAQ Official Closing Price ("NOCP"). In the absence of a sale such securities shall be valued at the last bid price on the day of valuation. If market quotations are not readily available or if the Advisor believes the market quotations

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are not reflective of market value, securities will be valued at their fair market value as determined in good faith by the Trust's Fair Value Committee and in accordance with the Trust's Portfolio Securities Valuation Procedures (the "Procedures"). The Board of Trustees (the "Board") will review the fair value method in use for securities requiring a fair market value determination at least quarterly. The Procedures consider, among others, the following factors to determine a security's fair value: the nature and pricing history (if any) of the security; whether any dealer quotations for the security are available; and possible valuation methodologies that could be used to determine the fair value of the security. Investments in Systematic Trading Companies are valued at a fair value based on the net asset value as reported by underlying trading companies. Short-term debt obligations having 60 days or less remaining until maturity, at time of purchase, are valued at amortized cost. Investments in open-end investment companies are valued at net asset value.

MutualHedge Frontier Legends Fund
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
September 30, 2010

The Fund utilizes various methods to measure the fair value of most of its investments on a recurring basis. GAAP establishes a hierarchy that prioritizes inputs to valuation methods. The three levels of input are:

Level 1 – Unadjusted quoted prices in active markets for identical assets and liabilities that the Fund has the ability to access.

Level 2 – Observable inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly or indirectly. These inputs may include quoted prices for the identical instrument in an inactive market, prices for similar instruments, interest rates, prepayment speeds, credit risk, yield curves, default rates and similar data.

Level 3 – Unobservable inputs for the asset or liability, to the extent relevant observable inputs are not available, representing the Fund's own assumptions about the assumptions a market participant would use in valuing the asset or liability, and would be based on the best information available.

The availability of observable inputs can vary from security to security and is affected by a wide variety of factors, including, for example, the type of security, whether the security is new and not yet established in the marketplace, the liquidity of markets, and other characteristics particular to the security. To the extent that valuation is based on models or inputs that are less observable or unobservable in the market, the determination of fair value requires more judgment. Accordingly, the degree of judgment exercised in determining fair value is greatest for instruments categorized in Level 3.

The inputs used to measure fair value may fall into different levels of the fair value hierarchy. In such cases, for disclosure purposes, the level in the fair value hierarchy within which the fair value measurement falls in its entirety, is determined based on the lowest level input that is significant to the fair value measurement in its entirety.

The inputs or methodology used for valuing securities are not necessarily an indication of the risk associated with investing in those securities. The following tables summarize the inputs used as of September 30, 2010 for the Fund's assets and liabilities measured at fair value:

MutualHedge Frontier Legends Fund
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
September 30, 2010

Assets	Level 1	Level 2	Level 3	Total
Exchange Traded Funds	\$ 68,646,549	\$ -	\$ -	\$ 68,646,549
Systematic Trading Companies	-	23,404,327	-	\$ 23,404,327
Total	\$ 68,646,549	\$ 23,404,327	\$ -	\$ 92,050,876

The Fund did not hold any Level 3 securities during the period.

MutualHedge Fund Limited SPC (MFL-SPC) – The consolidated financial statements of the Fund include MFL-SPC, a wholly-owned and controlled subsidiary. All inter-company accounts and transactions have been eliminated in consolidation.

The Fund may invest up to 25% of its total assets in a segregated portfolio company ("SPC"), which acts as an investment vehicle in order to effect certain investments consistent with the Fund's investment objectives and policies.

MFL-SPC invests in the global derivatives markets through the use of one or more proprietary global macro trading programs ("global macro programs"), which are often labeled "managed futures" programs. Global macro programs attempt to earn profits in a variety of markets by employing long and short trading algorithms applied to futures, options, forward contracts, and other derivative instruments. It is anticipated that the global macro programs used by MFL-SPC will be tied to a variety of global markets for currencies, interest rates, stock market indices, energy resources, metals and agricultural products. MFL-SPC's investment in a global

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macro program may be through investment in one or more unaffiliated private investment vehicles or unaffiliated commodity pools ("unaffiliated trading companies") advised by one or more commodity trading advisors or "CTAs" registered with the U.S. Commodity Futures Trading Commission. The Fund or MFL-SPC do not consolidate the assets, liabilities, capital or operations of the trading companies into their financial statements. Rather, the unaffiliated trading companies are separately presented as an investment in the Fund's consolidated portfolio of investments. Income, gains and unrealized appreciation or depreciation on the investments in the trading companies are recorded in the Fund's consolidated statement of assets and liabilities and the Fund's consolidated statement of operations.

In accordance with its investment objectives and through its exposure to the aforementioned global macro programs, the Fund may have increased or decreased exposure to one or more of the following risk factors defined below:

Commodity Risk. Commodity risk relates to the change in value of commodities or commodity indexes as they relate to increases or decreases in the commodities market. Commodities are physical assets that have tangible properties. Examples of these types of assets are crude oil, heating oil, metals, livestock, and agricultural products.

Credit Risk. Credit risk relates to the ability of the issuer to meet interest and principal payments, or both, as they come due. In general, lower-grade, higher-yield bonds are subject to credit risk to a greater extent than lower-yield, higher-quality bonds.

Equity Risk. Equity risk relates to the change in value of equity securities as they relate to increases or decreases in the general market.

MutualHedge Frontier Legends Fund
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
September 30, 2010

Foreign Exchange Rate Risk. Foreign exchange rate risk relates to the change in the U.S. dollar value of a security held that is denominated in a foreign currency. The U.S. dollar value of a foreign currency denominated security will decrease as the dollar appreciates against the currency, while the U.S. dollar value will increase as the dollar depreciates against the currency.

Interest Rate Risk. Interest rate risk refers to the fluctuations in value of fixed-income securities resulting from the inverse relationship between price and yield. For example, an increase in general interest rates will tend to reduce the market value of already issued fixed-income investments, and a decline in general interest rates will tend to increase their value. In addition, debt securities with longer maturities, which tend to have higher yields, are subject to potentially greater fluctuations in value from changes in interest rates than obligations with shorter maturities.

Volatility Risk. Volatility risk refers to the magnitude of the movement, but not the direction of the movement, in a financial instrument's price over a defined time period. Large increases or decreases in a financial instrument's price over a relative time period typically indicate greater volatility risk, while small increases or decreases in its price typically indicate lower volatility risk.

Please refer to the Fund's prospectus for a full listing of risks associated with these investments.

A summary of the Fund's investments in the MFL-SPC is as follows:

MutualHedge Fund Limited SPC (MFL-SPC) *	
September 30, 2010	
Fair Value of Systematic Trading Companies	\$ 23,404,327
Other Assets	\$ 49,955
Total Net Assets	\$ 23,454,282
Percentage of the Fund's Total Net Assets	
	19.22%
* MFL-SPC commenced operations on January 12, 2010	

For tax purposes, MFL-SPC is an exempted Cayman investment company. MFL-SPC has received an undertaking from the Government of the Cayman Islands exempting it from all local income, profits and capital gains taxes. No such taxes are levied in the Cayman Islands at the present time. For U.S. income tax purposes, MFL-SPC is a Controlled Foreign Corporation and as such is not subject to U.S. income tax. However, as a wholly-owned Controlled Foreign Corporation, MFL-SPC's net income and capital gain, to the extent of its earnings and profits, will be included each year in the Fund's investment company taxable income.

Security Transactions and Related Income – Security transactions are accounted for on trade date basis. Interest income is recognized on an accrual basis. Discounts are accreted and premiums are amortized on securities purchased over the lives of the respective securities. Dividend income is recorded on the ex-dividend date. Realized gains or losses from sales of securities are determined by comparing the identified cost of the security lot sold with the net sales proceeds.

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MutualHedge Frontier Legends Fund
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
September 30, 2010

Dividends and Distributions to Shareholders – Dividends from net investment income, if any, are declared and paid at least annually. Distributable net realized capital gains, if any, are declared and distributed annually. Dividends from net investment income and distributions from net realized gains are determined in accordance with federal income tax regulations, which may differ from GAAP. These "book/tax" differences are considered either temporary (i.e., deferred losses, capital loss carry forwards) or permanent in nature. To the extent these differences are permanent in nature, such amounts are reclassified within the composition of net assets based on their federal tax-basis treatment; temporary differences do not require reclassification. Dividends and distributions to shareholders are recorded on ex-dividend date.

Cash and Cash Equivalents – Cash and cash equivalents include cash and overnight investments in interest-bearing demand deposits with a financial institution with maturities of three months or less. The Fund maintains deposits with a high quality financial institution in an amount that is in excess of federally insured limits.

Federal Income Taxes – The Fund intends to continue to comply with the requirements of the Internal Revenue Code applicable to regulated investment companies and to distribute all of its taxable income to its shareholders. Therefore, no provision for Federal income tax is required. The Fund recognizes the tax benefits of uncertain tax positions only where the position is "more likely than not" to be sustained assuming examination by tax authorities. The Fund identifies its major tax jurisdictions as U.S. Federal, Nebraska and foreign jurisdictions where the Fund makes significant investments; however the Fund is not aware of any tax positions for which it is reasonably possible that the total amounts of unrecognized tax benefits will change materially in the next twelve months.

Indemnification – The Trust indemnifies its officers and trustees for certain liabilities that may arise from the performance of their duties to the Trust. Additionally, in the normal course of business, the Fund enters into contracts that contain a variety of representations and warranties and which provide general indemnities. The Fund's maximum exposure under these arrangements is unknown, as this would involve future claims that may be made against the Fund that have not yet occurred. However, based on experience, the risk of loss due to these warranties and indemnities appears to be remote.

3. INVESTMENT TRANSACTIONS

For the period ended September 30, 2010, cost of purchases and proceeds from sales of portfolio securities, other than short-term investments and U.S. Government securities, amounted to \$88,146,203 and \$0, respectively.

4. INVESTMENT ADVISORY AGREEMENT AND TRANSACTIONS WITH AFFILIATES

The business activities of the Fund are overseen by the Board, which is responsible for the overall management of the Fund. Equinox Fund Management, LLC serves as the Fund's Investment Advisor (the "Advisor"). The Fund has employed Gemini Fund Services, LLC ("GFS") to provide administration, fund accounting, and transfer agent services. A Trustee and certain officers of the Fund are also officers of GFS, and are not paid any fees directly by the Fund for serving in such capacities.

MutualHedge Frontier Legends Fund
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
September 30, 2010

Pursuant to an Advisory Agreement with the Fund, the Advisor, under the oversight of the Board, directs the daily operations of the Fund and supervises the performance of administrative and professional services provided by others. As compensation for its services and the related expenses borne by the Advisor, the Fund pays the Advisor a management fee, computed and accrued daily and paid monthly, at an annual rate of 1.70% of the Fund's average daily net assets.

Pursuant to a written contract (the "Waiver Agreement"), the Advisor has agreed, at least until January 31, 2012, to waive a portion of its advisory fee and has agreed to reimburse the Fund for other expenses to the extent necessary so that the total expenses incurred by the Fund (excluding front-end or contingent deferred loads, brokerage fees and commissions, acquired fund fees and expenses, borrowing costs such as interest and dividend expenses on securities sold short, or extraordinary expenses, such as litigation, not incurred in the ordinary course of the Fund's business) do not exceed 2.20% and 2.95% per annum of the Fund's average daily net assets for Class A and Class C shares, respectively. For the period ended September 30, 2010, the Advisor waived fees in the amount of \$206,650.

If the Advisor waives any fee or reimburses any expense pursuant to the Waiver Agreement, and the Fund's Operating Expenses are subsequently less than 2.20% and 2.95% of average daily net assets attributable to Class A and Class C shares, respectively, the Advisor shall be entitled to reimbursement by the Fund for such waived fees or reimbursed expenses provided that such reimbursement does not cause the Fund's expenses to exceed 2.20% and 2.95% of average daily net assets for each share class. If

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Fund Operating Expenses attributable to Class A and Class C shares subsequently exceed 2.20% and 2.95%, respectively per annum of the average daily net assets, the reimbursements shall be suspended.

The Advisor may seek reimbursement only for expenses waived or paid by it during the three fiscal years prior to such reimbursement; provided, however, that such expenses may only be reimbursed to the extent they were waived or paid after the date of the Waiver Agreement (or any similar agreement). The Board may terminate this expense reimbursement arrangement at any time.

As of September 30, 2010, the Advisor has \$206,650 of waived expenses that may be recovered no later than September 30, 2013.

The Board has adopted a Distribution Plan and Agreement (the "Plan") pursuant to Rule 12b-1 under the 1940 Act. The Plan provides that a monthly service and/or distribution fee is calculated by the Fund at an annual rate of 0.25% of the average daily net assets attributable to the Class A shares and 1.00% of the average daily net assets attributable to Class C shares and is paid to Northern Lights Distributors, LLC (the "Distributor"), to provide compensation for ongoing distribution-related activities or services and/or maintenance of the Fund's shareholder accounts, not otherwise required to be provided by the Advisor. The Plan is a compensation plan, which means that compensation is provided regardless of 12b-1 expenses incurred.

MutualHedge Frontier Legends Fund
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
September 30, 2010

The Distributor acts as the Fund's principal underwriter in a continuous public offering of the Fund's Class A and Class C shares. The Distributor is an affiliate of GFS. For the period ended September 30, 2010, the Distributor received \$433,975 in underwriting commissions for sales of Class A shares, of which \$61,789 was retained by the principal underwriter or other affiliated broker-dealers.

The Fund pays its pro rata share of a total fee of \$12,500 per quarter for the Northern Lights Fund Trust to each Trustee who is not affiliated with the Trust or Advisor. The Fund pays the chairperson of the audit committee its pro rata share of an additional \$2,500 per quarter. The "interested persons" who serve as Trustees of the Trust receive no compensation for their services as Trustees. None of the executive officers receive compensation from the Trust.

Pursuant to separate servicing agreements, GFS is compensated for providing administration, fund accounting and transfer agency services to the Fund as follows:

Administration. The Fund pays GFS an asset-based fee in decreasing amounts as Fund assets reach certain breakpoints. The Fund is subject to a minimum annual fee. The Fund also pays GFS for any out-of-pocket expenses. Fees are billed monthly as follows:

The greater of:

- A minimum annual fee of \$40,000 per annum or
- 10 basis points or 0.10% per annum on the first \$100 million in net assets
- 6 basis points or 0.06% per annum on the next \$150 million in net assets
- 5 basis points or 0.05% per annum on net assets greater than \$250 million

Fund Accounting. Total charges for Fund Accounting services include asset-based fees and out-of-pocket expenses. Fees are calculated based upon the average net assets of the Fund for the previous month. The Fund pays GFS a base annual fee of \$24,000 plus \$6,000 for each additional share class above one plus a basis point fee in decreasing amounts as Fund assets reach certain breakpoints, as follows:

- 2 basis points or 0.02% on net assets of \$25 million to \$100 million
- 1 basis point or 0.01% on net assets greater than \$100 million

Transfer Agency. For the services rendered by GFS in its capacity as transfer agent, the Fund pays GFS transfer agent fees, out-of-pocket expenses, activity charges, and special report charges. The fees are billed monthly as follows:

- The greater of the annual minimum or per account charges. The annual minimum is \$15,000 per class and the per account charge is \$14.00 for open accounts and \$2.00 for closed accounts.

In addition, certain affiliates of GFS provide ancillary services to the Fund(s) as follows:

MutualHedge Frontier Legends Fund
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
September 30, 2010

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Northern Lights Compliance Services, LLC ("NLCS")

NLCS, an affiliate of GFS, provides a Chief Compliance Officer ("CCO") to the Trust, as well as related compliance services, pursuant to a consulting agreement between NLCS and the Trust. Under the terms of such agreement, NLCS receives from the Fund an annual fee, payable quarterly, and is reimbursed for out-of-pocket expenses. For the period ended September 30, 2010, the Fund incurred expenses of \$9,853 for compliance services pursuant to the Trust's Agreement with NLCS. Such fees are included in the line item marked "Compliance Officer Fees" on the Statement of Operations in this shareholder report.

GemCom, LLC ("GemCom")

GemCom, an affiliate of GFS, provides EDGAR conversion and filing services as well as print management services for the Fund on an ad-hoc basis. For EDGAR services, GemCom charges a per-page conversion fee and a flat filing fee. For the period ended September 30, 2010, GemCom collected amounts totaling \$2,914 for EDGAR and printing services performed. Such fees are included in the line item marked "Printing and Postage Expenses" on the Statement of Operations in this shareholder report.

5. TAX COMPONENTS OF CAPITAL

As of September 30, 2010, the components of accumulated earnings/(deficit) on a tax basis were as follows:

Undistributed	Undistributed	Capital	Post	Unrealized	Total
Ordinary	Long-Term	Loss	October	Appreciation/	Accumulated
Income	Gains	Carry Forwards	Losses	(Depreciation)	Earnings/(Deficit)
\$	\$	\$	\$	\$ 3,904,679	\$ 3,904,679

Permanent book and tax differences primarily attributable to net operating losses, tax treatment of short-term capital gains and adjustments resulting from the Fund's investment in a controlled foreign corporation, resulted in reclassification for the Fund for the period ended September 30, 2010 was follows: a decrease in paid in capital of \$279,871; a decrease in accumulated net investment loss of \$281,313; and a decrease in accumulated net realized gain from security transactions of \$1,442.

6. NEW ACCOUNTING PRONOUNCEMENT

In January 2010, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2010-06 "Improving Disclosures about Fair Value Measurements." ASU No. 2010-06 amends FASB Accounting Standards Codification Topic 820, Fair Value Measurements and Disclosures, to require additional disclosures regarding fair value measurements. Certain disclosures required by ASU No. 2010-06 are effective for interim and annual periods beginning after December 15, 2009, and other required disclosures are effective for fiscal years beginning after December 15, 2010, and for interim periods within those fiscal years. Management is currently evaluating the impact ASU No. 2010-06 will have on the Fund's financial statement disclosures.

MutualHedge Frontier Legends Fund
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
September 30, 2010

7. SUBSEQUENT EVENTS

The Fund is required to recognize in the financial statements the effects of all subsequent events that provide additional evidence about conditions that existed at the date of the Statement of Assets and Liabilities. For non-recognized subsequent events that must be disclosed to keep the financial statements from being misleading, the Fund is required to disclose the nature of the event as well as an estimate of its financial effect, or a statement that such an estimate cannot be made. In addition, the Fund is required to disclose the date through which subsequent events have been evaluated. Management has evaluated subsequent events through the issuance of these financial statements and has noted no such events.

Report of Independent Registered Public Accounting Firm

**To the Board of Trustees of Northern Lights Fund Trust
and the Shareholders of MutualHedge Frontier Legends Fund**

We have audited the accompanying consolidated statement of assets and liabilities of MutualHedge Frontier Legends Fund (Fund), including the consolidated portfolio of investments, as of September 30, 2010, and the related consolidated statements of operations, changes in net assets and financial highlights for the period from December 31, 2009 (commencement of operations) through September 30, 2010. These consolidated financial statements and consolidated financial highlights are the responsibility of the Fund's management. Our responsibility is to express an opinion on these consolidated financial statements and consolidated financial highlights based on our audit.

[http://globaldocuments.morningstar.com/documentlibrary/document/5f8cc96c443448750862ea2730ef0a7c.mxdoo/original\[10/27/2011 10:52:47 AM\]](http://globaldocuments.morningstar.com/documentlibrary/document/5f8cc96c443448750862ea2730ef0a7c.mxdoo/original[10/27/2011 10:52:47 AM])

DGAR Filing Documents for 0000910472-10-001293

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements and consolidated financial highlights are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements. Our procedures included confirmation of securities owned as of September 30, 2010, by correspondence with the custodian. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the consolidated financial statements and consolidated financial highlights referred to above present fairly, in all material respects, the financial position of the Fund as of September 30, 2010, the results of its operations, changes in its net assets and the financial highlights for the period from December 31, 2009 (commencement of operations) through September 30, 2010, in conformity with accounting principles generally accepted in the United States of America.

/s/ McGladrey & Pullen, LLP

Denver, Colorado
November 30, 2010

MutualHedge Frontier Legends Fund
EXPENSE EXAMPLES
September 30, 2010 (Unaudited)

As a shareholder of the MutualHedge Frontier Legends Fund, you incur two types of costs: (1) transaction costs, including sales charges (loads) on purchases of Class A shares; (2) ongoing costs, including management fees; distribution and/or service (12b-1) fees; and other Fund expenses. This example is intended to help you understand your ongoing costs (in dollars) of investing in the MutualHedge Frontier Legends Fund and to compare these costs with the ongoing costs of investing in other mutual funds.

The example is based on an investment of \$1,000 invested at the beginning of the period and held for the entire period from April 1, 2010 through September 30, 2010.

Actual Expenses

The "Actual Expenses" line in the table below provides information about actual account values and actual expenses. You may use the information below, together with the amount you invested, to estimate the expenses that you paid over the period. Simply divide your account value by \$1,000 (for example, an \$8,600 account value divided by \$1,000 = 8.6), then multiply the result by the number in the table under the heading entitled "Expenses Paid During Period" to estimate the expenses you paid on your account during this period.

Hypothetical Example for Comparison Purposes

The "Hypothetical" line in the table below provides information about hypothetical account values and hypothetical expenses based on the MutualHedge Frontier Legends Fund's actual expense ratio and an assumed rate of return of 5% per year before expenses, which is not the Fund's actual return. The hypothetical account values and expenses may not be used to estimate the actual ending account balances or expenses you paid for the period. You may use this information to compare this 5% hypothetical example with the 5% hypothetical examples that appear in the shareholder reports of other funds.

Please note that the expenses shown in the table are meant to highlight your ongoing costs only and do not reflect any transactional costs, such as sales charges (loads), or redemption fees. Therefore, the table is useful in comparing ongoing costs only, and will not help you determine the relative total costs of owning different funds. In addition, if these transactional costs were included, your costs would have been higher.

	Beginning Account Value 4/1/10	Ending Account Value 9/30/10	Expenses Paid During Period 4/1/10 - 9/30/10	Expense Ratio During Period** 4/1/10 - 9/30/10
Actual				
Class A	\$1,000.00	\$1,019.20	\$11.14*	2.20%
Class C	1,000.00	1,015.20	14.90*	2.95
Hypothetical				
(5% return before expenses)				
Class A	\$1,000.00	\$1,014.04	\$ 11.11*	2.20%
Class C	1,000.00	1,010.28	14.87*	2.95

*Expenses are equal to the average account value over the period, multiplied by the Fund's annualized expense ratio, multiplied by the number of days in the period (183) divided by the number of days in the fiscal year (365).

**Annualized.

MutualHedge Frontier Legends Fund
SUPPLEMENTAL INFORMATION (Continued)

[http://globaldocuments.morningstar.com/documentlibrary/document/2f8cc96a43448750862a2730e0da7c.msdoc/original\[10/27/2011 10:52:47 AM\]](http://globaldocuments.morningstar.com/documentlibrary/document/2f8cc96a43448750862a2730e0da7c.msdoc/original[10/27/2011 10:52:47 AM])

OPPENHEIMER

Commodity Strategy Total Return Fund

Summary Prospectus March 30, 2011

NYSE Ticker Symbols

Class A QRAAX
 Class B QRABX
 Class C QRACX
 Class N QRANX
 Class Y QRAYX

Before you invest, you may want to review the Fund's prospectus, which contains more information about the Fund and its risks. You can find the Fund's prospectus, Statement of Additional Information, Annual Report and other information about the Fund online at <https://www.oppenheimerfunds.com/fund/investors/overview/CommodityStrategyTotalReturnFund>. You can also get this information at no cost by calling 1.800.225.5677 or by sending an email request to: info@oppenheimerfunds.com.

The Fund's prospectus and Statement of Additional Information ("SAI"), both dated March 30, 2011, and pages 7 through 78 of its most recent Annual Report, dated December 31, 2010, are incorporated by reference into this Summary Prospectus. You can access the Fund's prospectus and SAI at <https://www.oppenheimerfunds.com/fund/investors/overview/CommodityStrategyTotalReturnFund>. The Fund's prospectus is also available from financial intermediaries who are authorized to sell Fund shares.

Investment Objective. The Fund seeks total return.

Fees and Expenses of the Fund. This table describes the fees and expenses that you may pay if you buy and hold or redeem shares of the Fund. You may qualify for sales charge discounts if you (or you and your spouse) invest, or agree to invest in the future, at least \$25,000 in certain funds in the Oppenheimer family of funds. More information about these and other discounts is available from your financial professional and in the section "About Your Account" beginning on page 14 of the prospectus and in the sections "How to Buy Shares" beginning on page 64 and "Appendix A" in the Fund's Statement of Additional Information.

Shareholder Fees (fees paid directly from your investment)

	Class A	Class B	Class C	Class N	Class Y
Maximum Sales Charge (Load) imposed on purchases (as % of offering price)	5.75%	None	None	None	None
Maximum Deferred Sales Charge (Load) (as % of the lower of original offering price or redemption proceeds)	None	5%	1%	1%	None

Annual Fund Operating Expenses (expenses that you pay each year as a percentage of the value of your investment)

	Class A	Class B	Class C	Class N	Class Y
Management Fees of the Fund and Subsidiary ¹	1.04%	1.04%	1.04%	1.04%	1.04%
Distribution and/or Service (12b-1) Fees	0.25%	1.00%	1.00%	0.50%	None
Other Expenses					
Other Expenses of the Fund	0.50%	1.13%	0.63%	0.74%	0.26%
Other Expenses of the Subsidiary	0.00%	0.00%	0.00%	0.00%	0.00%
Total Other Expenses	0.50%	1.13%	0.63%	0.74%	0.26%
Acquired Fund Fees and Expenses	0.05%	0.05%	0.05%	0.05%	0.05%
Total Annual Fund Operating Expenses	1.84%	3.22%	2.72%	2.33%	1.35%
Fee Waiver and Expense Reimbursement ²	(0.38%)	(0.95%)	(0.49%)	(0.61%)	(0.27%)
Total Annual Fund Operating Expenses After Fee Waiver and Expense Reimbursement	1.46%	2.27%	2.23%	1.72%	1.08%

1. "Management Fees of the Fund and Subsidiary" reflects the gross management fees paid to the Manager by the Fund and the Subsidiary during the Fund's most recent fiscal year.

2. The Manager has contractually agreed to waive the management fee it receives from the Fund in an amount equal to the management fee paid to the Manager by the Subsidiary. This waiver will continue in effect for so long as the Fund invests in the Subsidiary, and may not be terminated by the Manager unless termination is approved by the Fund's Board of Trustees. The Fund's investment adviser has voluntarily agreed to waive fees and/or reimburse Fund expenses in an amount equal to the indirect management fees incurred through the Fund's investment in Oppenheimer Institutional Money Market Fund. The Fund's transfer agent has voluntarily agreed to limit its fees for all classes to 0.35% of average annual net assets per class. These expense limitations may be amended or withdrawn no earlier than one year from the date of this prospectus.

Example. The following Example is intended to help you compare the cost of investing in the Fund with the cost of investing in other mutual funds. The Example assumes that you invest \$10,000 in a class of shares of the Fund for the time periods indicated. The Example also assumes that your investment has a 5% return each year and that the Fund's operating expenses remain the same. Although your actual costs may be higher or lower, based on these assumptions your expenses would be as follows:



	If shares are redeemed				If shares are not redeemed			
	1 Year	3 Years	5 Years	10 Years	1 Year	3 Years	5 Years	10 Years
Class A	\$ 716	\$ 1,090	\$ 1,488	\$ 2,598	\$ 716	\$ 1,090	\$ 1,488	\$ 2,598
Class B	\$ 733	\$ 1,217	\$ 1,626	\$ 2,877	\$ 733	\$ 917	\$ 1,626	\$ 2,877
Class C	\$ 729	\$ 808	\$ 1,414	\$ 3,055	\$ 729	\$ 808	\$ 1,414	\$ 3,055
Class D	\$ 276	\$ 676	\$ 1,203	\$ 2,849	\$ 276	\$ 676	\$ 1,203	\$ 2,849
Class Y	\$ 111	\$ 404	\$ 718	\$ 1,611	\$ 111	\$ 404	\$ 718	\$ 1,611

Portfolio Turnover. The Fund pays transaction costs, such as commissions, when it buys and sells securities (or "turns over" its portfolio). A higher portfolio turnover rate may indicate higher transaction costs and may result in higher taxes when Fund shares are held in a taxable account. These costs, which are not reflected in the annual fund operating expenses or in the example, affect the Fund's performance. During the most recent fiscal year, the Fund's portfolio turnover rate was 38% of the average value of its portfolio.

Principal Investment Strategies. The Fund mainly invests in a combination of commodity-linked derivatives, corporate and governmental fixed-income securities and certain other types of derivative investments.

■ **Commodity-Linked Derivatives.** A derivative is an investment whose value depends on (or is derived from) the value of an underlying security, asset, interest rate, index or currency. A commodity-linked derivative is a derivative instrument whose value is linked to the price movement of a commodity, commodity index, or commodity option or futures contract. Commodity-linked derivatives may include commodity-linked notes, swaps, futures and options. The value of some commodity-linked derivatives may be based on a multiple of those price movements.

Physical commodities are assets that have tangible properties. The Fund's commodity-linked investments provide exposure to the investment returns of commodities markets without investing directly in physical commodities. The commodity-linked instruments that the Fund invests in may be linked to the price movements of: a physical commodity such as heating oil, livestock, or agricultural products; a commodity option or futures contract; a commodity index such as the S&P GSCI ("S&P GSCI," formerly the "Goldman Sachs Commodity Index"); or some other readily measurable variable that reflects changes in the value of particular commodities or commodities markets. The Fund does not intend to invest more than 10% of its total assets, determined at the time of investment, in commodity-linked notes that mature in more than 19 months.

■ **Fixed-Income Securities.** The fixed-income securities the Fund may invest in may be of any maturity and include U.S. Government securities, repurchase agreements, money market securities and affiliated money market funds. The Fund may buy debt securities for liquidity purposes, for collateral management or to seek income.

■ **Other Derivative Investments.** The Fund may also invest in other derivative instruments such as forwards, options, futures and swaps relating to debt securities, interest rates or currencies. It may do so to seek to increase its investment returns or to hedge against declines in the value of the Fund's other investments.

The Fund can purchase investment-grade and below investment-grade securities (also referred to as "junk bonds"). The Fund can invest up to 10% of its assets in lower-grade securities. The Fund may invest in U.S. or foreign securities, including derivative instruments that trade on U.S. or foreign exchanges or in the "over-the-counter" ("OTC") market.

The Fund can also invest up to 25% of its total assets in its wholly-owned and controlled subsidiary (the "Subsidiary"). The Subsidiary primarily invests in commodity-linked derivatives (including commodity futures, options and swap contracts) and fixed income securities and other investments that serve as collateral for its derivatives positions. Investments in the Subsidiary are intended to provide the Fund with exposure to commodities market returns within the limitations of the federal tax requirements that apply to the Fund. The Subsidiary will be subject to the same investment restrictions and limitations, and follow the same compliance policies and procedures as the Fund.

In selecting investments for the Fund's portfolio, the portfolio managers generally allocate the Fund's commodity-linked investments among a variety of different commodity sectors, based on the weightings of the components of the Fund's benchmark index, the S&P GSCI. The Fund is not an "index" fund, however, and its investment allocations and performance will usually differ from the weightings and performance of the S&P GSCI. The portfolio managers currently focus on the following inter-related components, which may vary in particular cases and may change over time:

■ **Commodities Selection.** The portfolio managers use a model-driven approach and their own analysis and judgment to try to identify differences in quality between two commodities or contracts with the intent of exploiting temporary market inefficiencies. The Fund's proprietary models also incorporate fundamental and technical factors intended to identify extreme market pricing imbalances for individual commodities or sectors and catalysts that may potentially eliminate the particular imbalances.

■ **Form of Investment.** The portfolio managers also consider which instrument or form of investment is best suited to provide the desired commodities exposure. If the portfolio managers determine that a commodity-linked note is appropriate, the Fund would generally invest directly in the commodity-linked note. If the portfolio managers decide that a commodity futures contract, swap, or option on a futures contract is appropriate, the Fund might enter into the futures or swap contract or purchase the option directly or it might invest in that instrument indirectly through its Subsidiary.

■ **Collateral Management.** The portfolio managers use a team approach to construct a portfolio of fixed-income securities that includes U.S. Government securities, repurchase agreements, money market securities and affiliated money market funds to provide collateral, liquidity and income.

■ **Performance and Portfolio Risk Monitoring.** The portfolio managers monitor the performance and risks of the Fund's investments on an ongoing basis.

The Fund's investment in the Subsidiary will vary based on the portfolio managers' use of different types of commodity-linked derivatives. If the Fund increases its use of commodity linked notes, that would typically result in a lower level of investment in the Subsidiary. If the Fund increases its use of commodity futures, swaps, or options on futures, that would typically result in a higher level of investment in the Subsidiary.

Industry Concentration. The Fund will maintain exposure of 25% or more of its total assets in securities and derivatives linked to the energy and natural resources, agriculture, livestock, industrial metals, and precious metals sectors as a group. However, the Fund will not concentrate more than 25% of its total assets in issuers in any one industry. At times the Fund may emphasize investments in some industries more than others. The individual components of an index will be considered as separate industries for this purpose.

Principal Risks. The price of the Fund's shares can go up and down substantially. The value of the Fund's investments may change because of broad changes in the markets in which the Fund invests or from poor security selection, which could cause the Fund to underperform other funds with similar investment objectives. There is no assurance that the Fund will achieve its investment objective. When you redeem your shares, they may be worth more or less than what you paid for them. *These risks mean that you can lose money by investing in the Fund.*

Risks of Commodity-Linked Investments. Investments linked to the prices of commodities are considered speculative. The values of commodities and commodity-linked investments are affected by events that might have less impact on the values of stocks and bonds. Prices of commodities and related contracts may fluctuate significantly over short periods due to a variety of factors, including changes in supply and demand relationships, weather, agriculture, fiscal, and exchange control programs, disease, pestilence, and international economic, political, military and regulatory developments. These risks may make commodity-linked investments more volatile than other types of investments. The commodity-linked instruments in which the Fund invests have substantial risks, including risk of loss of a significant portion of their principal value.

The commodity markets are subject to temporary distortions and other disruptions due to, among other factors, lack of liquidity, the participation of speculators, and government regulation and other actions. U.S. futures exchanges and some foreign exchanges limit the amount of fluctuation in futures contract prices which may occur in a single business day (generally referred to as "daily price fluctuation limits"). The maximum or minimum price of a contract as a result of these limits is referred to as a "limit price." If the limit price has been reached in a particular contract, no trades may be made beyond the limit price. Limit prices have the effect of precluding trading in a particular contract or forcing the liquidation of contracts at disadvantageous times or prices. These circumstances could adversely affect the value of the commodity-linked investments.

Risks of Derivative Investments. Derivatives may be volatile and may involve significant risks. The underlying security or other instrument on which a derivative is based, or the derivative itself, may not perform as expected. Some derivatives have the potential for unlimited loss, regardless of the size of the Fund's initial investment. The Fund may also lose money on a derivative investment if the issuer fails to pay the amount due. Certain derivative investments held by the Fund may be illiquid, making it difficult to close out an unfavorable position. Derivative transactions may require the payment of premiums and can increase portfolio turnover. As a result of these risks, the Fund could realize little or no income or lose money from its investment, or a hedge might be unsuccessful.

■ **Special Risks of Options.** If the Fund sells a put option, there is a risk that the Fund may be required to buy the underlying investment at a disadvantageous price. If the Fund sells a call option, there is a risk that the Fund may be required to sell the underlying investment at a disadvantageous price. If the Fund sells a call option on an investment that the Fund owns (a "covered call") and the investment has increased in value when the call option is exercised, the Fund will be required to sell the investment at the call price and will not be able to realize any of the investment's value above the call price. Options may involve economic leverage, which could result in greater price volatility than other investments.

■ **Special Risks of Futures Contracts.** The volatility of futures contracts prices has been historically greater than the volatility of stocks and bonds. The liquidity of the futures market depends on participants entering into offsetting transactions rather than making or taking delivery. To the extent participants decide to make or take delivery, liquidity in the futures market could be reduced. In addition, futures exchanges often impose a maximum permissible price movement on each futures contract for each trading session. The Fund may be disadvantaged if it is prohibited from executing a trade outside the daily permissible price movement.

■ **Special Risks of Swap Transactions.** There is no central exchange or market for swap transactions and therefore they are less liquid than exchange-traded instruments. If the Fund were to sell a swap it owned to a third party, the Fund would still remain primarily liable for the obligations under the swap contract.

■ **Total Return Swaps.** In a total return swap transaction, one party agrees to pay the other party an amount equal to the total return on a defined underlying asset or a non-asset reference during a specified period of time. The underlying asset might be a security, commodity contract or basket of securities or commodity contracts or a non-asset reference might be a securities or commodities index. In return, the other party would make periodic payments based on a fixed or variable interest rate or on the total return from a different underlying asset or non-asset reference.

Total return swaps could result in losses if the underlying asset or reference does not perform as anticipated. Total return swaps can have the potential for unlimited losses. They are also subject to counterparty risk. If the counterparty fails to meet its obligations, the Fund may lose money.

Special Risks Of Commodity-Linked Notes. The Fund may invest in commodity-linked notes to gain exposure to commodities markets. Commodity-linked notes may be subject to special risks that do not affect traditional equity and debt securities:

■ **Risk of loss of interest.** If the interest rate on a commodity-linked note is based on the value of a particular commodity, commodity index or other economic variable, the Fund might receive lower interest payments (or not receive any interest) if the value of the underlying investment falls.

■ **Risk of loss of principal.** To the extent that the amount of the principal to be repaid upon maturity is linked to the value of a particular commodity, commodity index or other economic variable, the value of the commodity, commodity index or other economic variable may not increase sufficiently so that the Fund might not receive a portion (or any) of the principal when the investment matures or upon earlier exchange.

■ **Credit Risk.** Commodity-linked notes are subject to credit risks on the underlying investment and to counterparty credit risk. If the counterparty fails to meet its obligations, the Fund may lose money.

■ **Valuation risk.** The value of commodity-linked notes may be influenced by several factors, including: value of the commodity, commodity index or other economic variable, volatility, interest and yield rates in the market, the time remaining to maturity and the credit worthiness of the issuer of the commodity-linked note.

■ **Liquidity risk.** A liquid secondary market may not exist for certain commodity-linked notes the Fund buys, which may make it difficult for the Fund to sell them at an acceptable price or to accurately value them.

■ **Volatility risk.** The value of the commodity-linked derivatives the Fund buys may fluctuate significantly because the values of the underlying investments to which they are linked are extremely volatile. Additionally, the particular terms of a commodity-linked note may create economic leverage by requiring payment by the issuer of an amount that is a multiple of the price increase or decrease of the underlying commodity, commodity index, or other economic variable. Economic leverage increases the volatility of the value of commodity-linked notes and their value may increase or decrease more quickly than the underlying commodity, commodity index or other economic variable.

Risks of Investments in Leverage. Certain derivatives and other investments of the Fund may involve leverage. Leverage may be created when an investment exposes the Fund to a risk of loss that exceeds the amount invested. Certain derivatives and other investments provide the potential for investment gain or loss that may be several times greater than the change in the value of an underlying security, asset, interest rate, index or currency, resulting in the potential for a loss that may be substantially greater than the amount invested.

Some derivatives and other leveraged investments have the potential for unlimited loss, regardless of the size of the initial investment. Because leverage can magnify the effects of changes in the value of the Fund and make the Fund's share price more volatile, a shareholder's investment in the Fund will tend to be more volatile, resulting in larger gains or losses in response to the fluctuating prices of the Fund's investments.

The Fund has limits on the leverage ratio of each commodity-linked note it buys and on its overall portfolio. The Fund is also subject to legal requirements designed to reduce the effects of any leverage created by the use of certain investments. Under these requirements, the Fund must earmark or segregate liquid assets or engage in other asset coverage measures with regard to the Fund's potential obligations with respect to those investments. The Fund, including the Subsidiary, will comply with these requirements.

Risks Of Investments In The Fund's Wholly-Owned Subsidiary. The Subsidiary is not registered under the Investment Company Act and is not subject to its investor protections (except as otherwise noted in this prospectus). As an investor in the Subsidiary, the Fund does not have all of the protections offered to investors by the Investment Company Act, however the Fund wholly owns and controls the Subsidiary, and the Fund and the Subsidiary are both managed by the Manager and the Sub-Adviser. The Fund's ownership and control make it unlikely that the Subsidiary will take actions contrary to the interests of the Fund or its shareholders. The Fund's Board has oversight responsibility for the Fund's investment activities, including its investments in the Subsidiary and its role as the Subsidiary's sole shareholder. The Manager and Sub-Adviser also apply the same investment restrictions and operational guidelines in managing the Subsidiary's portfolio that are applied to managing the Fund.

Changes in the laws of the Cayman Islands, under which the Subsidiary is incorporated, could prevent the Subsidiary from operating as described in this prospectus and could negatively affect the Fund and its shareholders. For example, the Cayman Islands currently does not impose any income, corporate or capital gains tax, estate duty, inheritance tax, gift tax or withholding tax on the Subsidiary. If Cayman Islands law were changed and the Subsidiary was required to pay Cayman Islands taxes, the investment returns of the Fund would likely decrease.

Main Risks of Debt Securities. Debt securities may be subject to credit risk, interest rate risk, prepayment risk and extension risk. Credit risk is the risk that the issuer of a security might not make interest and principal payments on the security as they become due. If an issuer fails to pay interest or repay principal, the Fund's income or share value might be reduced. Adverse news about an issuer or a downgrade in an issuer's credit rating, for any reason, can also reduce the market value of the issuer's securities. Interest rate risk is the risk that when prevailing interest rates fall, the values of already-issued debt securities generally rise, and when prevailing interest rates rise, the values of already-issued debt securities generally fall, and they may be worth less than the amount the Fund paid for them. When interest rates change, the values of longer-term debt securities usually change more than the values of shorter-term debt securities. When interest rates fall, debt securities may be repaid more quickly than expected and the Fund may be required to reinvest the proceeds at a lower interest rate. This is referred to as "prepayment risk." When interest rates rise, debt securities may be repaid more slowly than expected and the value of the Fund's holdings may fall sharply. This is referred to as "extension risk." Interest rate changes normally have different effects on variable or floating rate securities than they do on securities with fixed interest rates.

Because the Fund can invest up to 10% of its assets in lower-grade securities, the Fund's credit risks are greater than those of funds that buy only investment-grade securities.

Fixed-Income Market Risks. Economic and other market developments can adversely affect fixed-income securities markets in the United States, Europe and elsewhere. At times, participants in debt securities markets may develop concerns about the ability of certain issuers of debt securities to make timely principal and interest payments, or they may develop concerns about the ability of financial institutions that make markets in certain debt securities to facilitate an orderly market. Those concerns can cause increased volatility in those debt securities or debt securities markets. Under some circumstances, as was the case during the latter half of 2008 and early 2009, those concerns could cause reduced liquidity in certain debt securities markets. A lack of liquidity or other adverse credit market conditions may hamper the Fund's ability to sell the debt securities in which it invests or to find and purchase suitable debt instruments.

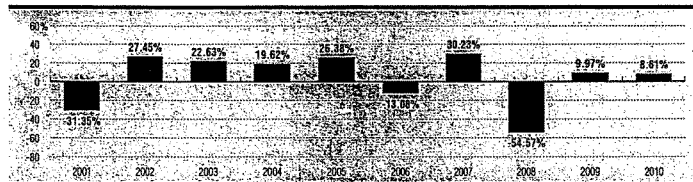
Main Risks of Foreign Investing. Foreign securities are subject to special risks. Foreign issuers are usually not subject to the same accounting and disclosure requirements that U.S. companies are subject to, which may make it difficult for the Fund to evaluate a foreign company's operations or financial condition. A change in the value of a foreign currency against the U.S. dollar will result in a change in the U.S. dollar value of securities denominated in that foreign currency and in the value of any income or distributions the Fund may receive on those securities. The value of foreign investments may be affected by exchange control regulations, foreign taxes, higher transaction and other costs, delays in the settlement of transactions, changes in economic or monetary policy in the United States or abroad, expropriation or nationalization of a company's assets, or other political and economic factors. These risks may be greater for investments in developing or emerging market countries.

Time-Zone Arbitrage. The Fund may invest in securities of foreign issuers that are traded in U.S. or foreign markets. If the Fund invests a significant amount of its assets in foreign markets, it may be exposed to "time-zone arbitrage" attempts by investors seeking to take advantage of differences in the values of foreign securities that might result from events that occur after the close of the foreign securities market on which a security is traded and before the Fund's net asset value is calculated. If such time-zone arbitrage were successful, it might dilute the interests of other shareholders. The Fund's use of "fair value pricing" to adjust certain market prices of foreign securities may help deter those activities.

Who Is the Fund Designed For? The Fund is designed for aggressive investors seeking total return over the long term, mainly from commodity-linked derivatives. Those investors should be willing to assume the risks of potentially significant short-term share price fluctuations and losses because of the Fund's investments in commodity-linked instruments. The Fund is not designed for investors seeking current income or preservation of capital. Investors should consider buying shares of the Fund as part of an overall portfolio strategy that includes other asset classes, such as fixed-income and equity investments. The Fund is not a complete investment program and may not be appropriate for all investors. You should carefully consider your own investment goals and risk tolerance before investing in the Fund.

An investment in the Fund is not a deposit of any bank and is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency.

The Fund's Past Performance. The bar chart and table below provide some indication of the risks of investing in the Fund by showing changes in the Fund's performance from year to year and by showing how the Fund's average annual returns for 1, 5 and 10 years compare with those of a broad measure of market performance. The Fund's past investment performance (before and after taxes) is not necessarily an indication of how the Fund will perform in the future. More recent performance information is available by calling the toll-free number on the back of this prospectus and on the Fund's website:
<https://www.oppenheimerfunds.com/fund/investors/overview/CommodityStrategyTotalReturnFund>



Sales charges and taxes are not included and the returns would be lower if they were. During the period shown, the highest return for a calendar quarter was 30.80% (2nd Qtr 08) and the lowest return was -52.35% (4th Qtr 08).

The following table shows the average annual total returns for each class of the Fund's shares. After-tax returns are calculated using the highest individual federal marginal income tax rates and do not reflect the impact of state or local taxes. Your actual after-tax returns, depending on your individual tax situation, may differ from those shown and after-tax returns shown are not relevant to investors who hold their Fund shares through tax-deferred arrangements, such as 401(k) plans or individual retirement accounts. After-tax returns are shown for only one class and after-tax returns for other classes will vary.

Average Annual Total Returns for the periods ended December 31, 2010:

	1 Year	5 Years	10 Years (or life of class, if less)
Class A Shares (inception 03-31-1997)			
Return Before Taxes	23.6%	(10.36%)	(0.63%)
Return After Taxes on Distributions	1.84%	(11.98%)	(2.85%)
Return After Taxes on Distributions and Sale of Fund Shares	1.54%	(9.16%)	(1.34%)
Class B Shares (inception 03-31-1997)	2.48%	(10.35%)	(0.54%)
Class C Shares (inception 03-31-1997)	8.74%	(10.03%)	(0.86%)
Class N Shares (inception 03-01-2001)	7.21%	(9.58%)	0.46%
Class Y Shares (inception 03-31-1997)	8.99%	(8.84%)	0.40%
S&P GSCI	9.03%	(5.70%)	1.77%
(reflects no deduction for fees, expenses or taxes)			2.51%

1. From 02/28/01

Investment Adviser. OppenheimerFunds, Inc. is the Fund's investment adviser (the "Manager") and Oppenheimer Real Asset Management, Inc. (the "Sub-Adviser"), a wholly-owned subsidiary of the Manager, is its sub-adviser.

Portfolio Managers. Kevin Baum, CFA, CAIA, has been a Vice President of the Fund since October 2000, and a portfolio manager of the Fund since May 1999. Robert Baker, CFA, has been a Vice President and portfolio manager of the Fund since May 2007. Carol Wolf has been a Vice President and portfolio manager of the Fund since December 2008.

Purchase and Sale of Fund Shares. In most cases, you can buy Fund shares with a minimum initial investment of \$1,000 and make additional investments with as little as \$50. For certain investment plans and retirement accounts, the minimum initial investment is \$500 and, for some, the minimum additional investment is \$25. For certain fee based programs the minimum initial investment is \$250.

Shares may be purchased through a financial intermediary or the Distributor and redeemed through a financial intermediary or the Transfer Agent on days the New York Stock Exchange is open for trading. Shareholders may purchase or redeem shares by mail, through the website at www.oppenheimerfunds.com or by calling 1.800.225.5677. Share transactions may be paid by check, by Federal Funds wire or directly from or into your bank account.

Taxes. If your shares are not held in a tax-deferred account, Fund distributions are subject to Federal income tax as ordinary income or as capital gains and they may also be subject to state or local taxes.

Payments to Broker-Dealers and Other Financial Intermediaries. If you purchase Fund shares through a broker-dealer or other financial intermediary (such as a bank), the Fund, the Manager, or their related companies may pay the intermediary for the sale of Fund shares and related services. These payments may create a conflict of interest by influencing the broker-dealer or other intermediary and your salesperson to recommend the Fund over another investment. Ask your salesperson or visit your financial intermediary's website for more information.

For More Information About Oppenheimer Commodity Strategy Total Return Fund

You can access the Fund's [prospectus](https://www.oppenheimerfunds.com/fund/investors/overview/CommodityStrategyTotalReturnFund) and [SAI](https://www.oppenheimerfunds.com/fund/investors/overview/CommodityStrategyTotalReturnFund) at <https://www.oppenheimerfunds.com/fund/investors/overview/CommodityStrategyTotalReturnFund>. You can also request additional information about the Fund or your account:

By Telephone:	Call Oppenheimer Funds Services toll-free 1-800-CALL-OPP (225-5677).	
By Mail:	For requests by mail:	For courier or express mail requests:
	Oppenheimer Funds Services	Oppenheimer Funds Services
	P.O. Box 5270	12100 East Iliff Avenue, Suite 300
	Denver, Colorado 80217-5270	Aurora, Colorado 80014
On the Internet:	You can read or download information on the Oppenheimer Funds website at www.oppenheimerfunds.com .	

PR0735.001.0311



The Fund's shares are distributed by:
OppenheimerFunds®
 Distributor, Inc.

PIMCO

Your Global Investment Authority



CommodityRealReturn Strategy Fund*
CommoditiesPLUS™ Strategy Fund

Accessing the Diversification and Inflation-Hedging Potential of Commodities

Fund Overview

Portfolio managers


Mihir Worah, Ph.D.
 Managing Director,
 Head of Real Return
 Portfolio Management Team,
 Portfolio Manager

Nicholas Johnson
 Senior Vice President,
 Portfolio Manager

Protecting against inflation by preserving the purchasing power of one's assets is a key element in achieving long-term financial security. However, long-term inflation rates will always be highly uncertain, and as a result it is difficult to preserve the real value of one's assets by using traditional stock and bond investments alone. PIMCO, a global commodity manager, has long believed that the selective use of commodities within one's investment strategy can prove highly effective as a portfolio diversifier and a hedge against inflation, albeit with additional risk. Our actively managed commodity index mandates include two PIMCO funds—PIMCO CommodityRealReturn Strategy Fund and the PIMCO CommoditiesPLUS Strategy Fund. Both Funds employ our enhanced-index approach to commodity investing. This involves combining positions in commodity index-linked derivatives that capture the price return of the commodities futures market with a fixed income collateral portfolio that is actively managed with the objective of adding incremental return above those markets.

Why invest in commodities?

Commodities are assets that have tangible properties, such as oil, metals and agricultural products. Historically, commodity investments have had a positive correlation (tendency to move in tandem) with changes in inflation and a low correlation to stock and bond returns. That is why commodities can be used to hedge against inflation as well as to enhance portfolio diversification. Further,

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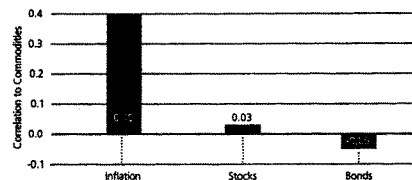
underlying economic fundamentals suggest that commodities will almost certainly trend upward over the long term. This is largely due to growing demand from emerging markets and underinvestment in infrastructure. Investors should be aware, however, that commodities are volatile investments, should only form a small part of a diversified portfolio and may not be suitable for all investors.

How do these funds gain exposure?

The funds do not invest in physical commodities. Instead, they use an "enhanced index" strategy. This exposes the funds to commodities through investments in commodity-index-linked derivative instruments. PIMCO CommodityRealReturn Strategy Fund is linked to the Dow Jones UBS Commodity Total Return Index. PIMCO CommoditiesPLUS Strategy Fund is linked to the Credit Suisse Commodity Benchmark. Also, the funds may invest in derivatives linked to the value of a particular commodity or commodity futures contracts (or in subsets). PIMCO CommodityRealReturn Strategy Fund then "collateralizes" these derivative instruments by investing the remaining portfolio assets in an actively managed portfolio of inflation-indexed bonds and other fixed income securities. In this way, the fund seeks to capitalize on the inflation-hedging properties of both commodities and inflation-indexed bonds.

Inflation hedging and diversification

Commodities have historically had a positive correlation with inflation and a noncorrelation with stock and bond returns, making them an attractive vehicle to enhance portfolio diversification and guard against inflation. Of course, diversification does not guarantee a profit or protect against a loss.



Past performance is no guarantee of future results. Above data reflects quarterly returns for the period 12/31/91–12/31/09. Commodities, stocks, bonds and inflation represented by the Dow Jones UBS Commodity Total Return Index, S&P 500 Index, Barclays Capital U.S. Aggregate Index and Consumer Price Index–All Urban Consumers, respectively.

PIMCO CommoditiesPLUS Strategy Fund "collateralizes" these derivative instruments by investing the assets in an actively managed portfolio of high-quality short-term bonds. PIMCO has extensive experience managing both index-linked securities and the collateral backing this exposure.

What are some of the advantages of this enhanced-index approach?

Our approach to the commodity index markets relies on our core strengths as a derivatives manager and creates the potential for the portfolios to outperform the benchmarks. Rather than purchase individual commodities, we use derivatives to obtain exposure to changes in a broad index of commodity futures prices without committing a substantial amount of capital, leaving the remaining portfolio assets to serve as collateral. We seek to invest the portfolio assets that serve as collateral in a portfolio of fixed income securities. If these fixed income investments provide a higher return than the T-bill rate embedded in the returns of the commodity index, then the total return of the overall portfolio should be enhanced by the difference between these two rates.

What are the active commodities strategies the funds employ?

Structural alpha strategies seek to add value by taking advantage of identifiable economic factors that create patterns of risk upon which the funds can capitalize and other factors that might generate returns. These are distinguished from traditional active commodities strategies, which are based on outright technical and fundamental views that directly over- and underweight individual commodities or commodity sectors.

Why did PIMCO choose the Dow Jones UBS Commodity Total Return Index and the Credit Suisse Commodity Benchmark as our benchmarks?

Commodity indices calculate the returns to a hypothetical portfolio that contains only long positions in commodity futures contracts, passively managed, on a fully collateralized basis. Only long positions are considered, so that the portfolio will consistently benefit if commodity futures prices rise. Only commodity (and not financial) futures are considered, so that

Real Return Portfolio Management Team. He joined PIMCO in 2001 as a member of the analytics team and worked on term structure modeling and options pricing. He has a Ph.D. in theoretical physics from the University of Chicago and is the author of numerous scientific papers. PIMCO CommoditiesPLUS Strategy Fund is managed by Nicholas Johnson, a senior vice president and portfolio manager. He joined PIMCO in 2004 and previously managed the portfolio analyst group. Prior to joining PIMCO, he worked at NASA's Jet Propulsion Laboratory, developing Mars missions and new methods of autonomous navigation. He holds a master's degree in financial mathematics from the University of Chicago and an undergraduate degree from California Polytechnic State University.

How can I learn more?

Ask your financial advisor for more information, including a copy of the prospectus. You can also visit our website at pimco.com/investments or call us at 1.888.87.PIMCO.

Investors should consider the investment objectives, risks, charges and expenses of the funds carefully before investing. This and other information is contained in the funds' prospectuses and summary prospectuses, if available, which may be obtained by contacting your financial advisor or by visiting pimco.com/investments or by calling 1-888-87-PIMCO. Please read them carefully before you invest or send money.

A word about risk: The funds invest in commodity-linked derivative instruments, including commodity index-linked notes, swap agreements, commodity options, futures and options on futures. These instruments and commodities in general may subject the funds to greater volatility than investments in traditional securities. The value of a commodity-linked derivative is generally based on: price movements of a commodity, a commodity futures contract, a commodity index or other economic variables based on changes in the commodities markets. Use of derivative instruments may involve certain costs and risks such as liquidity risk, interest rate risk, market risk, credit risk, management risk and the risk that a fund could not close out a position when it would be most advantageous to do so. The funds' commodity exposures are backed by a portfolio of inflation-indexed securities and other fixed income instruments. Inflation-indexed bonds issued by the U.S. Government, known as TIPS, are fixed income securities whose principal value is periodically adjusted according to the rate of inflation, which will affect the interest payable on them. Repayment upon maturity of the adjusted principal value is guaranteed by the U.S. Government. Neither the current market value of inflation-indexed bonds nor the share value of a fund that invests in them is guaranteed, and either or both may fluctuate. These funds may invest in non-U.S. securities, non-U.S. currency-denominated securities, which may entail greater risk due to foreign economic and political developments, a small percentage in high yield securities and may invest in mortgage-related securities. High yield bonds typically have a lower credit rating than other bonds. Lower-rated bonds generally involve a greater risk to principal than higher-rated bonds. The funds are non-diversified, which means they may incur greater risk by concentrating assets in a smaller number of issuers than a diversified fund. The funds may also invest in common and preferred stocks as well as convertible securities of issuers in commodity-related industries.

Past performance is no guarantee of future results. This material contains the current opinions of PIMCO, which are subject to change without notice. Statements concerning financial market trends are based on current market conditions, which will fluctuate. There is no guarantee that these investment strategies will work under all market conditions, and each investor should evaluate their ability to invest for the long term, especially during periods of downturn in the market.

Alpha measures a portfolio's risk-adjusted performance, which is the difference between a portfolio's actual and expected returns, given the level of market risk as measured by beta. The Consumer Price Index (CPI) is an unmanaged index representing the rate of inflation in U.S. consumer prices as determined by the U.S. Department of Labor Statistics.

The Dow Jones UBS Commodity Total Return Index is composed of futures contracts on 19 physical commodities. The Standard & Poor's 500 Composite Index (S&P 500) is an unmanaged index generally representative of the U.S. stock market. The Barclays Capital U.S. Aggregate Index is composed of securities from the Barclays Capital Government/Credit Bond Index, Mortgage-Backed Securities Index and Asset-Backed Securities Index. It is generally considered to be representative of the domestic, investment-grade, fixed-rate, taxable bond market. The Credit Suisse Commodity Benchmark is an unmanaged index composed of futures contracts on 30 physical commodities. The objective of the benchmark is to gain exposure to the broad commodity universe while maintaining sufficient liquidity. Commodities were chosen based on world production levels, sufficient open interest and volume of trading. The index is designed to be a highly liquid and diversified benchmark for commodities as an asset class. It is not possible to invest directly in an index.

PIMCO advised funds are distributed by PIMCO Investments LLC.

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About PIMCO

PIMCO is a leading global investment management firm, with offices in 10 countries throughout North America, Europe and Asia. Founded in 1971, PIMCO offers a wide range of innovative solutions to help millions of investors worldwide meet their needs. Our goal is to provide attractive returns while maintaining a strong culture of risk management and long-term discipline.

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Mutual Funds

All data as of 09/30/11, unless otherwise indicated.

PIMCO CommodityRealReturn Strategy Fund INSTL (PCRIX)

Performance quoted represents past performance. Past performance is no guarantee of future results. Investment return and the principal value of an investment will fluctuate. Shares may be worth more or less than original cost when redeemed. Current performance may be lower or higher than performance shown. Performance quoted does not reflect any sales charges, if applicable, and performance would be lower if it did. Click Performance tab for performance current to the most recent month-end.

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About this Fund Performance Portfolio Documents

Class INSTL

All data as of 10/19/11

Objective

Seeks maximum real return consistent with prudent investment management

Daily Price

NAV	CHG(\$)	1 Day Return	YTD Return
\$7.66	-\$0.11	-1.42%	-6.29%

Primary Portfolio

Commodity Index-linked derivative instruments backed by a portfolio of inflation-indexed bonds and other fixed income securities

Historical Prices

NAV	CHG(\$)	1 Day Return	YTD Return
\$7.79	\$7.76	\$7.77	
10/14/11	10/17/11	10/18/11	

Historical data

At a Glance

Symbol

PCRIX

CUSIP Number

722005667

Total Fund Assets (in millions)

\$22,785.4

Share Class Inception Date

06/28/2002

Dividend Frequency

QUARTERLY

Maximum Sales Charge

-

Net Operating Expenses

0.740 %

Total Annual Operating Expenses

0.896 %

Fund Overview

Summary

Capturing the diversification and inflation-hedging potential of commodities

With its innovative Double Real™ strategy, this unique Fund seeks to capture the performance potential of a commodities index backed with Treasury Inflation-Protected Securities (TIPS). The resulting portfolio potentially offers a double hedge against inflation and a powerful diversification tool.

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Quick Links

Managers



Mihir Worah

Mr. Worah is a managing director in the Newport Beach office, a portfolio manager, and head of the Real Return portfolio management team. He was previously a member of the analytics team and worked on real and nominal term structure modeling and options pricing. Prior to joining PIMCO in 2001, he was a postdoctoral research associate at the University of California, Berkeley, and the Stanford Linear Accelerator Center, where he built models to explain

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10/20/2011

Why Invest in this Fund***A Double Real™ inflation-hedging strategy***

Instead of investing in physical commodities, the Fund purchases derivatives linked to a broad index, helping it diversify without committing substantial capital. The Fund then "collateralizes" these derivatives with an actively managed TIPS portfolio. This dual approach seeks to capitalize on real (after-inflation) returns from commodities and real returns from TIPS. TIPS may decline in value if interest rates rise, and may be particularly sensitive if real interest rates rise rapidly.

A carefully chosen index

The Fund offers exposure to the performance potential of the Dow Jones–UBS Commodity Total Return Index, which provides broad diversification across 19 physical commodities. The index also offers an annual rebalancing feature, which may enhance potential returns, and relies on clearly defined rules to ensure that no single commodity or sector dominates the index, which may help reduce volatility.

The diversification potential of commodities

Commodities are real assets like oil, metal or grain, as opposed to "paper" assets like stocks or bonds. As a result, they are sensitive to different economic factors and tend to perform differently, as evidenced by their low or negative correlation (tendency to move in tandem) with stocks and bonds. Adding commodities to a balanced portfolio may enhance overall diversification, though diversification does not guarantee a profit or protect against loss.

Investment Process

Rather than invest directly in physical commodities, the Fund employs an "enhanced-index" strategy. Specifically, the Fund gains exposure to the commodity markets through investments in commodity-index-linked derivative instruments and through investments in the PIMCO Cayman Commodity Fund I Ltd., a wholly owned subsidiary of the Fund organized under the laws of the Cayman Islands (the "Subsidiary"). The derivative instruments in which the Fund and the Subsidiary primarily intend to invest are instruments linked to certain commodity indices, specifically the Dow Jones–UBS Commodity Total Return Index. Additionally, the Fund or the Subsidiary may invest in derivative instruments linked to the value of a particular commodity or commodity futures contract, or a subset of commodities or commodity futures contracts. The Fund collateralizes the commodity-index-linked derivative instruments by investing its assets in an actively managed portfolio of inflation-indexed bonds and other fixed-income securities. Inflation-indexed bonds offer a return that is linked to changes in the rate of inflation. As a result, the Fund attempts to employ a Double Real™ strategy, seeking to capitalize on the inflation-hedging properties of both commodities and inflation-indexed bonds. PIMCO has extensive experience in managing both index-linked securities and the collateral backing this type of exposure.

About Commodity-Index-Linked Instruments

Commodities are assets that have tangible properties, such as oil, metals and agricultural products. Rather than invest directly in these physical commodities, the Fund may use a range of index-linked instruments to gain exposure to the commodities market. As with any commodity-index-linked instruments, the value of these instruments may be affected by overall market movements and other factors that affect the value of a particular industry or commodity, such as weather, disease, embargoes or political and regulatory developments. The market for these instruments has evolved and become more sophisticated, offering risk management solutions and often acting as a substitute for direct securities ownership.

Investors should consider the investment objectives, risks, charges and expenses of the funds carefully before investing. This and other information are contained in the fund's prospectus and summary prospectus, if available, which may be obtained by contacting your financial advisor or PIMCO representative. Click here for a complete list of the PIMCO Funds prospectuses and summary prospectuses. Please read them carefully before you invest or send money.

A word about risk:

Fixed income investments are subject to interest rate risk; their value will normally decline as interest rates rise. Commodities are assets that have tangible properties, such as oil, metals, and agricultural products. Commodities and commodity-index-linked securities may be affected by overall market movements and other factors that affect the value of a particular industry or commodity, such as weather, disease, embargoes, or political and regulatory developments. The value of a commodity-linked derivative is generally based on price movements of a commodity, a commodity futures contract, a commodity index, or other economic variables based on changes in the commodities markets. Use of derivative instruments may involve certain costs and risks such as liquidity risk, interest rate risk, market risk, credit risk, management risk and the risk that a fund could not close out a position when it would be most advantageous to do so. Portfolios investing in derivatives could lose more than the principal amount invested in those instruments.

Mortgage-backed securities are subject to prepayment risk and may be sensitive to changes in prevailing interest rates. The value of some mortgage-related or asset-backed securities may be particularly sensitive to interest rate changes, and there is no assurance that private insurers of the underlying mortgages or assets will meet their obligations. The Fund's commodity exposure is backed by a portfolio of inflation-indexed securities and other fixed-income instruments. Inflation-indexed bonds issued by the U.S. Government, known as TIPS, are fixed-income securities whose principal value is periodically adjusted according to the rate of inflation, which will affect the interest payable on them. Repayment upon maturity of the adjusted principal value is guaranteed by the U.S. Government. Neither the current market value of inflation-indexed bonds nor the share value of a fund that invests in them is guaranteed, and either or both may fluctuate. This Fund may invest in non-U.S. securities, which may entail greater risk due to foreign economic and political developments; these risks may be enhanced in emerging markets. This Fund is non-diversified, which means it may incur greater risk by concentrating its assets in a smaller number of issuers than a diversified fund.

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10/20/2011

RYDEX|SGI LONG SHORT COMMODITIES STRATEGY FUND**RYDEX | SGI**
THE INTELLIGENT PURSUIT OF WEALTH™**A FUND PROVIDING LONG/SHORT EXPOSURE TO THE COMMODITIES MARKET****SECOND QUARTER 2011****FUND HIGHLIGHTS & APPLICATIONS**

- Offers broad exposure to the commodities markets, which has traditionally served as a way to participate in the growth of the global economy and as an inflation hedge
- Long/short strategies may help mitigate commodities portfolio drawdowns
- Potential low noncorrelation to equity and fixed income markets

INVESTMENT STRATEGY

The fund seeks to achieve positive total returns with less volatility than the broad commodity markets

INCOME DISTRIBUTION FREQUENCY

Annual, if applicable

FUND TYPE

Commodities

PORTFOLIO MANAGERS

Team managed

BENCHMARK COMPARISONS

- JPMorgan Core Commodity-Investable Global Asset Rotator Sigma Long-Short Total Return Index
- S&P GSCI
- DJ UBS Commodity Index

SYMBOL & CUSIP NUMBER

	Symbol	CUSIP #
A-Class	RYLBX	78356A244
C-Class	RYLEX	78356A236
H-Class	RYLFX	78356A251
Institutional Class	RYITX	78356A152

For information,
call 800.820.0888 or visit
www.rydex-sgi.com

RYDEX|SGI LONG SHORT COMMODITIES STRATEGY FUND offers broad exposure to the commodities markets through a systematic trend-identifying strategy that seeks to exploit both rising and falling price trends.

The fund may be up to 100% long and 100% short (200% gross exposure) at times in energy, metals and agricultural commodities. The long short approach may mitigate the volatility and drawdowns often experienced in long-only commodities investing, while attempting to preserve other characteristics often found in commodity investments, such as the potential for a low correlation to equity markets and use as an inflation hedge.

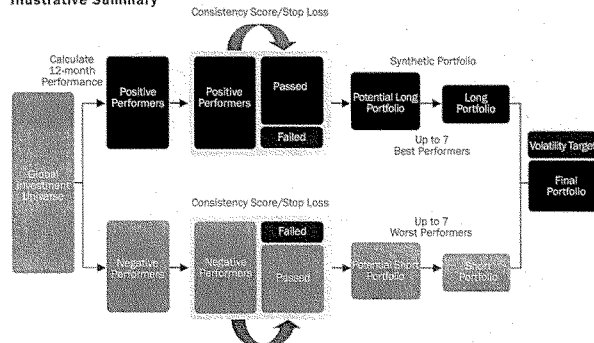
INVESTMENT PROCESS

The fund follows a transparent investment methodology that:

- Seeks to identify longer-term price trends in 14 commodities futures
- Tests recent price movements for consistency relative to the longer-term trend
- Weights positions equally
- Attempts to control for expected portfolio volatility

Investment Universe

Energy	Industrial Metals	Precious Metals	Agriculture
Natural Gas	Nickel	Silver	Wheat
Gasoline	Lead	Gold	Soybeans
Heating Oil	Copper		Corn
Brent Crude	Aluminum		
WTI Crude			

Illustrative Summary

Rydex|SGI Long Short Commodities Strategy Fund is subject to a number of risks and may not be suitable for all investors. • The fund's use of derivatives such as futures, options, structured notes and swap agreements may expose the fund to additional risks that it would not be subject to if it invested directly in the securities underlying those derivatives. • A highly liquid secondary market may not exist for the commodity-linked structured notes the fund invests in, and there can be no assurance that a highly liquid secondary market will develop. The fund's exposure to the commodity markets may subject the fund to greater volatility as commodity-linked investments may be affected by changes in overall market movements, commodity index volatility, changes in interest rates or factors affecting a particular industry or commodity—such as droughts, floods, weather, embargos, tariffs and international economic, political and regulatory developments. • The fund's use of short selling involves increased risk and costs. The fund risks paying more for a security than it received from its sale. Theoretically, securities sold short have the risk of unlimited losses. The more the fund invests in leveraged instruments, the more the leverage will magnify any gains or losses on those investments. • The fund's investment in other investment companies, including ETFs, subjects the fund to those risks affecting the investment company, including the possibility that the value of the underlying securities held by the investment company could decrease. Moreover, the fund will incur its pro rata share of the expenses of the underlying investment companies' expenses. • Securities are not deposits or obligations of any bank, are not guaranteed by any bank, are not insured by the FDIC or any other agency, and involve investment risk, including the possible loss of the principal amount invested. • See the prospectus for more details. • The fund is considered nondiversified and can invest a greater portion of its assets in securities of individual issues than a diversified fund. As a result, changes in the market value of a single security could cause greater fluctuations in the value of fund shares than would occur in a more diversified fund.

RYDEX|SGI ALTERNATIVE MUTUAL FUNDS OFFER:

- Daily liquidity.
- Daily performance in addition to semi-annual and annual reports.
- Convenience of 1099s for tax reporting.
- Availability to all investors*, depending on investment minimums and investor suitability. (Not subject to investor accreditation.)
- SEC-registered and-regulated. Although registration with the SEC is a requirement for a 1940 Act mutual fund, neither the SEC nor any other regulatory organization endorses, indemnifies or guarantees the fund's performance.

*Excluding non-resident aliens.

AVERAGE ANNUAL TOTAL RETURNS (AS OF 6/30/2011)

	YTD ¹	1-Year	3-Year	5-Year	10-Year	SI	Gross/Net Expense Ratio ³	Inception Date
A-Share Class (w/load)	-1.55%	15.98%	n/a	n/a	n/a	4.60%	2.09%/1.93%	6/25/09
A-Share Class (NAV)	3.37%	21.78%	n/a	n/a	n/a	7.17%	2.09%/1.93%	6/25/09
C-Share Class (w/load)	1.99%	19.90%	n/a	n/a	n/a	6.35%	2.83%/2.67%	6/25/09
C-Share Class (NAV)	2.99%	20.90%	n/a	n/a	n/a	6.35%	2.83%/2.67%	6/25/09
H-Share Class	3.38%	21.79%	n/a	n/a	n/a	7.15%	2.07%/1.91%	6/25/09
Institutional Class	3.53%	22.15%	n/a	n/a	n/a	7.88%	1.88%/1.70%	5/03/10
C-IGAR Sigma Index ⁴	3.56%	25.30%	n/a	n/a	n/a	11.59% ²	n/a	—
S&P GSCI ⁴	2.71%	26.11%	-21.66%	-6.16%	3.69%	9.10% ²	n/a	—
DJ UBS Commodity Index ⁴	-2.58%	25.80%	-11.82%	-0.05%	6.59%	13.21% ²	n/a	—

Performance displayed represents past performance, which is no guarantee of future results. Investment return and principal value will fluctuate so that when shares are redeemed, they may be worth more or less than original cost. Returns reflect the reinvestment of all dividends. Current performance may be lower or higher than the performance data quoted. For up-to-date fund performance, including performance current to the most recent month-end, visit our web site at www.rydex-sgi.com. Class A-Share with load performance reflects a maximum sales charge of 4.75%. A-Share investors may be eligible for a reduction in sales charges. Under certain circumstances, there may be a CDSC of 1% for redemptions within 12 months of purchase. Class C-Share with load performance reflects a maximum contingent deferred sales charge (CDSC) of 1% for shares redeemed within 12 months of purchase. For additional information, see the fund's prospectus.

Effective July 11, 2011, the fund's investment objective changed from seeking to track the performance of a benchmark to seeking to achieve positive absolute returns. The fund's principal investment strategy was also revised to reflect the new objective.

¹ Partial-year returns are cumulative, not annualized. Performance results are short-term and may not provide an adequate basis for evaluating the performance potential of the fund over varying market conditions or economic cycles.² Returns are for the period 6/25/09–6/30/2011 (since inception of Rydex|SGI Long Short Commodities Strategy Fund H-Class).³ The net expense ratio reflects the advisor's agreement to waive the management fee it receives from the fund in an amount equal to the management fee paid to the advisor by the subsidiary. This undertaking will continue in effect for so long as the fund invests in the subsidiary, and may be terminated only with the approval of the fund's board of trustees. In any event, this undertaking will continue through April 30, 2012. See the prospectus for more information.⁴ C-IGAR Sigma, S&P GSCI and DJ UBS Commodity indices are shown as performance comparisons. The referenced indices are unmanaged and not available for direct investment. Index performance does not reflect transaction costs, fees or expenses.

Index disclaimer: J.P. Morgan and J.P. Morgan Core Commodity-Investable Global Asset Rotator Sigma Long-Short Index are trademarks of J.P. Morgan Securities Ltd. (together with its affiliates, "J.P. Morgan") and have been licensed for use by Rydex Investments and its affiliates. The information and J.P. Morgan Core Commodity-Investable Global Asset Rotator Sigma Long-Short Index may not be copied, used or distributed without J.P. Morgan's prior written approval. Copyright 2011, J.P. Morgan. All rights reserved. Rydex|SGI Long Short Commodities Strategy Fund is not sponsored, endorsed, sold or promoted by J.P. Morgan and J.P. Morgan makes no representation regarding the advisability of investing in the fund.

For more complete information regarding the fund, call 800.820.0888 or visit www.rydex-sgi.com for a prospectus and a summary prospectus (if available). Investors should carefully consider the investment objectives, risks, charges and expenses of a fund before investing. The fund's prospectus and its summary prospectus (if available) contains this and other information about the fund. Please read the prospectus and summary prospectus (if available) carefully before you invest or send money.

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RYDEX|SGI MANAGED FUTURES STRATEGY FUND**RYDEX SGI**
THE OPTIMAL RESULT OF WEALTH™A FUND OFFERING BROAD EXPOSURE TO THE COMMODITIES AND FINANCIAL MARKETS AND
SEEKING TO CAPTURE PRICE TRENDS IN BOTH RISING AND FALLING MARKETS

SECOND QUARTER 2011

FUND HIGHLIGHTS & APPLICATIONS¹

- A medium-term-trend-following managed futures strategy
- Balanced exposure between commodities and financial markets (but does not take short positions in energy)
- Investment methodology is primarily based on the S&P Diversified Trends Indicator

INVESTMENT PROCESS
Rydex|SGI Managed Futures Strategy Fund seeks to achieve positive absolute returns.

TOTAL ASSETS
\$2,592,373,196
(As of 6/30/2011)

INCOME DISTRIBUTION FREQUENCY
Annual, if applicable

FUND TYPE
Alternative Investment Fund

PORTFOLIO MANAGER
Team managed

BENCHMARK COMPARISONS

- S&P Diversified Trends Indicator
- Bank of America Merrill Lynch 3 Month Treasury Bill

SYMBOL & CUSIP NUMBER

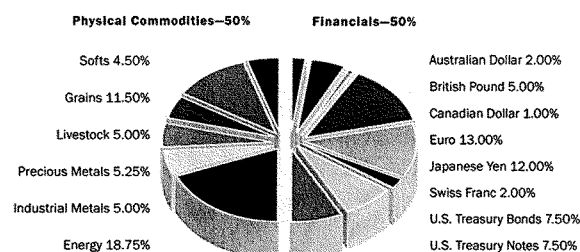
	Symbol	CUSIP #
A-Class	RYMTX	78356A517
H-Class	RYMFX	78356A491
C-Class	RYMZX	78356A525
Institutional Class	RYIFX	78356A145

For information,
call 800.258.4332 or
visit www.rydex-sgi.com

RYDEX|SGI MANAGED FUTURES STRATEGY FUND seeks to achieve positive absolute returns using a rules-based trend-following strategy. It represents a composite of commodity and financial futures designed to provide exposure to both up and down major global market price trends. Positions may be either long or short based on current prices relative to their moving averages.

SECTOR WEIGHTINGS

The fund gains exposure to 14 sectors, with 50% allocated to financial futures and 50% to commodity futures. Each month, the fund's sector exposure is rebalanced to the weightings identified below, and sectors may be positioned either long or short, depending on current prices relative to their medium-term moving averages. The one exception is the energy sector, which cannot be held short because of political issues, economic changes and other risk factors unique to that sector. Should the energy sector take a neutral position, its weighting will be allocated proportionately to the other sectors.



Composition is subject to change.

¹ Rydex|SGI Managed Futures Strategy Fund is subject to a number of risks and may not be suitable for all investors. Investing in mutual funds involves risk and does not assure a profit. • The fund's use of derivatives such as futures, options, structured notes and swap agreements may expose the fund to additional risks that it would not be subject to if it invested directly in the securities underlying those derivatives. A highly liquid secondary market may not exist for the commodity-linked structured notes the fund invests in, and there can be no assurance that a highly liquid secondary market will develop. • The fund's exposure to the commodity and currency markets may subject the fund to greater volatility as commodity- and currency-linked derivative investments may be affected by changes in overall market movements, commodity index volatility, changes in interest rates or factors affecting a particular industry, commodity or currency, such as droughts, floods, weather, livestock disease, embargos, tariffs and international economic, political and regulatory developments. The fund may also incur transaction costs with the conversion between various currencies. • The fund's use of short selling involves increased risk and costs. The fund risks paying more for a security than it received from its sale. Theoretically, securities sold short have the risk of unlimited losses. • The fund's investment in other investment companies, including ETFs, subjects the fund to those risks affecting the investment company, including the possibility that the value of the underlying securities held by the investment company could decrease. Moreover, the fund will incur its pro rata share of the expenses of the underlying investment companies' expenses. • This fund is considered nondiversified and can invest a greater portion of its assets in securities of individual issuers than a diversified fund. As a result, changes in the market value of a single security could cause greater fluctuations in the value of fund shares than would occur in a more diversified fund. • Securities are not deposits or obligations of any bank; are not guaranteed by any bank, are not insured by the FDIC or any other agency, and involve investment risk, including the possible loss of the principal amount invested. • See the prospectus for more details.

• "S&P" and "Standard & Poor's" are trademarks of Standard & Poor's Financial Services, LLC and have been licensed for use by Rydex|SGI. Rydex|SGI Managed Futures Strategy Fund is not sponsored, endorsed, sold or promoted by S&P or Alpha Financial Technologies, Inc. ("AFT"), the owner of the Diversified Trends Indicator methodology, and S&P and AFT make no representation regarding the advisability of investing in the fund.

RYDEX|SGI ALTERNATIVE MUTUAL FUNDS OFFER:

- Daily liquidity.
- Daily performance in addition to semi-annual and annual reports.
- Convenience of 1099s for tax reporting.
- Availability to all investors*, depending on investment minimums and investor suitability (Not subject to investor accreditation).
- SEC registered and regulated. Although registration with the SEC is a requirement for a 1940 Act mutual fund, neither the SEC nor any other regulatory organization endorses, indemnifies or guarantees the fund's performance.

*Excluding non-resident aliens.

PORTFOLIO RISK/RETURN METRICS

Since Fund Inception (3/02/2007-6/30/2011)

	RYMFX	S&P DTT	ML 3M T-Bills
Annualized Standard Deviation ⁴	11.41	11.45	0.37
Beta ⁵	1.38	1.52	1.00
Annualized Alpha ⁶	-0.35	0.51	0.00
Sharpe Ratio ⁷	-0.02	0.05	0.00
Correlation ¹⁰ to S&P 500	-0.13	-0.10	-0.12
Correlation ¹⁰ to ML 3M T-Bills	0.04	0.05	1.00

Source: FactSet. Calculations performed using daily data points.

AVERAGE ANNUAL TOTAL RETURNS (AS OF 6/30/2011)

	YTD ²	1-Year	3-Year	5-Year	10-Year	SI	Gross Expense Ratio ³	Net Expense Ratio ³	Inception Date
A-Class (w/load)	-5.80%	-4.28%	-4.26%	n/a	n/a	0.19%	2.04%	1.97%	03/02/2007
A-Class (NAV)	-1.09%	0.51%	-2.69%	n/a	n/a	1.32%	2.04%	1.97%	03/02/2007
C-Class (w/load)	-2.42%	-1.24%	-3.42%	n/a	n/a	0.57%	2.79%	2.72%	03/02/2007
C-Class (NAV)	-1.44%	-0.24%	-3.42%	n/a	n/a	0.57%	2.79%	2.72%	03/02/2007
H-Class	-1.09%	0.51%	-2.69%	n/a	n/a	1.32%	2.04%	1.97%	03/02/2007
Institutional Class	-0.93%	0.83%	n/a	n/a	n/a	0.03%	1.78%	1.72%	05/03/2010
S&P DTT ⁸	0.69%	2.99%	-2.72%	n/a	n/a	2.18% ⁹	—	—	—
Bank of America Merrill Lynch 3-Month Treasury Bill ⁹	0.08%	0.16%	0.42%	n/a	n/a	1.52% ⁹	—	—	—

Performance displayed represents past performance, which is no guarantee of future results. Investment return and principal value will fluctuate so that when shares are redeemed, they may be worth more or less than original cost. Returns reflect the reinvestment of all dividends. Current performance may be lower or higher than the performance data quoted. For up-to-date fund performance, including performance current to the most recent month-end, visit our web site at www.rydex-sgi.com. Class A-Share with load performance reflects a maximum sales charge of 4.75%. A-Share investors may be eligible for a reduction in sales charges. Under certain circumstances, there may be a CDSC of 1% for redemptions within 12 months of purchase. Class C-Share with load performance reflects a maximum contingent deferred sales charge (CDSC) of 1% for shares redeemed within 12 months of purchase. For additional information, see the fund's prospectus.

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Read the fund's prospectus and summary prospectus (if available) carefully before investing. It contains the fund's investment objectives, risks, charges, expenses and other information, which should be considered carefully before investing. Obtain a prospectus and summary prospectus (if available) at www.rydex-sgi.com or call 800.258.4332.

Rydex|SGI funds are distributed by Rydex Distributors, LLC (RDL). Security Investors, LLC (SI) is a registered investment advisor, and does business as Security Global Investors® and Rydex Investments. SI and RDL are affiliates and are subsidiaries of Security Benefit Corporation, which is wholly owned by Guggenheim SBC Holdings, LLC, a special purpose entity managed by an affiliate of Guggenheim Partners, LLC, a diversified financial services firm with more than \$100 billion in assets under supervision. QTR-FSMF-0611 x0911 #3201.

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Van Eck CM Commodity Index Fund

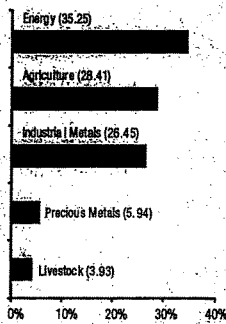
August 2011

vaneck.com/cmc | vaneck.com/commodities

CMCAX | COMIX | CMCYX

The Van Eck CM Commodity Index Fund is a passively-managed mutual fund that seeks to track, before fees and expenses, the performance of the UBS Bloomberg Constant Maturity Commodity Total Return Index ("CMCI"). The CMCI employs a methodology that seeks to minimize exposure to the front end of the futures curve and diversify across maturities. By spreading its exposure across multiple maturities, the index can potentially mitigate the impacts of contango and negative roll yield.

CMCI Target Weightings (%): 2H 2011



Expenses: Class A: Gross 1.52%; Net 0.95%; Class I: Gross 0.86%; Net 0.65% and Class Y: Gross 1.27%; Net 0.70%. Expenses are capped contractually until 05/01/12 at 0.95% for Class A, 0.65% for Class I and 0.70% for Class Y. Caps exclude certain expenses, such as interest.

The tables present past performance which is no guarantee of future results and which may be lower or higher than current performance. Returns reflect applicable fee waivers and/or expense reimbursements. Had the Fund incurred all expenses and fees, investment returns would have been reduced. Investment returns and Fund share values will fluctuate so that investor's shares, when redeemed, may be worth more or less than their original cost. Fund returns assume that dividends and capital gains distributions have been reinvested in the Fund at NAV. Index returns assume that dividends of the index constituents in the index have been reinvested.

This Fund is newly offered and has a limited operating history. The performance shown for the indices does not reflect fees and charges, which are assessed with the purchase and ownership of the Fund. Indices are not securities in which investments can be made.

Investment Approach

- The Fund seeks to track the performance of the CMCI by primarily investing in commodity-linked derivative instruments and more conservative fixed income securities, such as U.S. Treasury Bills
- The Fund may invest in instruments linked to the value of a particular commodity or commodity futures contract through a wholly owned subsidiary of the Fund formed in the Cayman Islands

UBS Bloomberg CMCI Highlights

- Diversified across 27 commodity components and up to five maturities
- Potential for higher risk-adjusted returns than traditional commodity indices
- Constant maturity approach: daily rolling of a small proportion of underlying contracts
- Monthly rebalancing: limited concentration risk to any one underlying commodity

Fund Facts as of 08/31/11

Net Assets (Class A, I, Y)	\$43.8M	Number of Commodity Sectors	5
Average Weighted Contract Maturity	7.7 Months	Number of Commodity Components	27

Average Annual Total Returns (%) as of 08/31/11

	1 Mo ¹	3 Mo ¹	YTD ¹	1 Yr	3 Yr	5 Yr	10 Yr	Life ²
Class A: NAV (Inception 12/31/10)	-0.74	0.00	5.07	--	--	--	--	--
Class A: Maximum 5.75% load	-6.42	-5.76	-0.96	--	--	--	--	--
Class I: NAV (Inception 12/31/10)	-0.64	0.21	5.41	--	--	--	--	--
Class Y: NAV (Inception 12/31/10)	-0.64	0.11	5.29	--	--	--	--	--
UBS Bloomberg CMCI	-0.66	0.27	5.99	31.35	-0.39	--	--	7.06

Average Annual Total Returns (%) as of 06/30/11

	1 Mo ¹	3 Mo ¹	YTD ¹	1 Yr	3 Yr	5 Yr	10 Yr	Life ²
Class A: NAV (Inception 12/31/10)	-2.68	-4.42	2.25	--	--	--	--	--
Class A: Maximum 5.75% load	-6.28	-9.92	-3.61	--	--	--	--	--
Class I: NAV (Inception 12/31/10)	-2.57	-4.31	2.48	--	--	--	--	--
Class Y: NAV (Inception 12/31/10)	-2.57	-4.31	2.48	--	--	--	--	--
UBS Bloomberg CMCI	-2.56	-4.12	3.00	35.36	-5.97	--	--	6.64

NAV History (Class A)

	12-Month High	12-Month Low	Month-End
	--	--	\$9.33

¹One-month and year-to-date returns are not annualized.

²UBS Bloomberg CMCI live track record (inception) begins on January 1, 2007.

Van Eck CM Commodity Index Fund

August 2011

CMCAX | COMIX | CMCYX

2011 Monthly Returns (%)

	Jan	Feb	March	April	May	June	August	August	Sept	Oct	Nov	Dec	Year
Class A-NAV	3.27	2.62	0.96	2.00	-3.72	-2.68	3.52	-0.74					
UBS Bloomberg CMCI	3.52	2.73	1.01	2.13	-3.66	-2.56	3.59	-0.66					

Returns reflect capital appreciation and the reinvestment of dividends and capital gains, if any, as well as all fees and expenses but do not reflect any sales load. All indices are unmanaged and include the reinvestment of all dividends, but do not reflect the payment of transaction costs, advisory fees or expenses that are associated with an investment in the Fund. An index's performance is not illustrative of the Fund's performance. Indices are not securities in which investments can be made. Results reflect past performance and do not guarantee future results. See the reverse side for complete performance information.

Three-Year Max Drawdown (%) as of 08/31/11

UBS Bloomberg CMCI	-44.44
S&P GSCI Index	-60.32
DJUBS Index	-44.03
S&P 500 Index	-41.82

Three-Year Volatility (%) as of 08/31/11

UBS Bloomberg CMCI	22.29
S&P GSCI Index	29.46
DJUBS Index	21.69
S&P 500 Index	21.50

CMCI Three-Year Correlation as of 08/31/11

BarCap Agg Bond Index	0.14
S&P 500 Index	0.82

Maximum drawdown is the largest negative change in fund value over a given period of time. Volatility is the annualized standard deviation of monthly returns. Correlation describes a complementary or parallel relationship between two investments. The correlation coefficient is a measure that determines the degree to which two variables' movements are associated and will vary from -1.0 to 1.0. -1.0 indicates perfect negative correlation, and 1.0 indicates perfect positive correlation.

Know Your Terms: Contango occurs when the price of a futures contract is above the expected future spot price at the time the contract expires. Negative roll yield is the amount of return lost in a contango market.

Know Your Indices: The Dow Jones-UBS Commodity Index (DJUBS) is composed of futures contracts on 20 physical commodities covering seven sectors, specifically energy, petroleum, precious metals, industrial metals, grains, livestock and softs. Energy exposure is limited to no more than 33%; manager cannot invest above that level no matter how favorable the energy market. The S&P® Goldman Sachs Commodity Index (S&P GSCI) is a composite index of commodity sector returns, representing an unleveraged, long-only investment in commodity futures. High energy concentration; limited diversification. The index benefits when energy is strong, and suffers when energy is weak. Lastly, the S&P® 500 Index consists of 500 widely held common stocks covering industrial, utility, financial and transportation sectors. The Barclays Capital Global Aggregate Bond Index is composed of the mortgage-backed and asset-backed securities and government/credit bonds. All indices are unmanaged and include the reinvestment of all dividends, but do not reflect the payment of transaction costs, advisory fees or expenses that are associated with an investment in the Fund. An index's performance is not illustrative of the Fund's performance. Indices are not securities in which investments can be made.

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You can lose money by investing in the Fund. Any investment in the Fund should be part of an overall investment program, not a complete program. Commodities are assets that have tangible properties, such as oil, metals, and agriculture. Commodities and commodity-linked derivatives may be affected by overall market movements and other factors that affect the value of a particular industry or commodity such as weather, disease, embargoes or political or regulatory developments. The value of a commodity-linked derivative is generally based on price movements of a commodity, a commodity futures contract, a commodity index or other economic variables based on the commodity markets. Derivatives use leverage, which may exaggerate a loss. The Fund is subject to the risks associated with its investments in commodity-linked derivatives, risks of investing in wholly owned subsidiary, risk of tracking error, risks of aggressive investment techniques, leverage risk, derivatives risks, counterparty risks, non-diversification risk, credit risk, concentration risk and market risk. The use of commodity-linked derivatives such as swaps, commodity-linked structured notes and futures entails substantial risks, including risk of loss of a significant portion of their principal value, lack of a secondary market, increased volatility, correlation risk, liquidity risk, interest-rate risk, market risk, credit risk, valuation risk and tax risk. Gains and losses from speculative positions in derivatives may be much greater than the derivative's cost. At any time, the risk of loss of any individual security held by the Fund could be significantly higher than 50% of the security's value. Investment in commodity markets may not be suitable for all investors. The Fund's investment in commodity-linked derivative instruments may subject the fund to greater volatility than investment in traditional securities. For a description of these and other risk considerations, please refer to the Fund's prospectuses, which should be read carefully before you invest. Again, the Fund offers investors exposure to the broad commodity markets, currently, by investing in commodity-linked swaps.

Please call 800.826.2333 or visit vaneck.com for performance information current to the most recent month end and for a free prospectus and summary prospectus. An investor should consider the Fund's investment objective, risks, and charges and expenses carefully before investing. The prospectus and summary prospectus contain this and other information. Please read them carefully before investing.

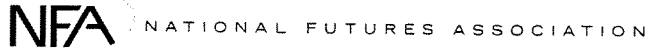
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August 18, 2010

Via E-Mail and Overnight Mail

Mr. David Stawick
Office of the Secretariat
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st, N.W.
Washington, DC 20581

Re: Petition for Rulemaking to Amend CFTC Regulation 4.5

Dear Mr. Stawick:

National Futures Association (NFA) respectfully petitions the Commission under CFTC Regulation 13.2 to amend CFTC Regulation 4.5, which provides an exclusion from the definition of the term "commodity pool operator" for otherwise regulated persons operating certain qualifying entities.¹ Prior to 2003, persons claiming this exclusion had to file a notice of eligibility pursuant to CFTC Regulation 4.5(c) and represent, in part, that the person will operate the qualifying entity such that it (1) will not be, and has not been, marketing participations to the public as or in a commodity pool or otherwise as or in a vehicle for trading in the commodity futures or commodity options markets; and (2) will use commodity futures or commodity options contracts solely for *bona fide* hedging purposes and, with respect to positions held for non-*bona fide* hedging purposes the aggregate initial margin and premiums required to establish such positions will not exceed five percent of the liquidation value of the qualifying entity's portfolio, after taking into account unrealized profits and unrealized losses on any such contracts it has entered into.

For the reasons set forth below, we request that the CFTC amend Regulation 4.5(c) to restore operating restrictions on registered investment companies that are substantially similar to those in effect prior to 2003. The information required by CFTC Regulation 13.2 follows:

¹ NFA withdrew its June 29, 2010 Petition for Rulemaking to Amend CFTC Regulation 4.5 by separate letter dated August 18, 2010.

300 S. Riverside Plaza Suite 1800 Chicago, IL 60606

Permanent Subcommittee on Investigations

EXHIBIT #7c

.781.1467 fax www.nfa.futures.org

NFA

Mr. David Stawick
Page 2

August 18, 2010

I. Text of Proposed Rule Amendments [additions are underlined]

**Part 4 – COMMODITY POOL OPERATORS AND COMMODITY TRADING
ADVISORS**

4.5 Exclusion from the definition of the term “commodity pool operator.”

(c)

(2) The notice of eligibility must contain representations that such person will operate the qualifying entity specified therein in a manner such that the qualifying entity:

- (i) Will disclose in writing to each participant, whether existing or prospective, that the qualifying entity is operated by a person who has claimed an exclusion from the definition of the term “commodity pool operator” under the Act and, therefore, who is not subject to registration or regulation as a pool operator under the Act; *Provided*, that such disclosure is made in accordance with the requirements of any other federal or state regulatory authority to which the qualifying entity is subject. The qualifying entity may make such disclosure by including the information in any document that its other federal or state regulator requires to be furnished routinely to participants or, if no such document is furnished routinely, the information may be disclosed in any instrument establishing the entity’s investment policies and objectives that the other regulator requires to be made available to the entity’s participants; and
- (ii) Will submit to such special calls as the Commission may make to require the qualifying entity to demonstrate compliance with the provision of this § 4.5(c);
- (iii) Furthermore, if the person claiming the exclusion is an investment company registered under the Investment Company Act of 1940, then the notice of



Mr. David Stawick
Page 3

August 18, 2010

eligibility must also contain representations that such person will operate the qualifying entity as described in § 4.5(b)(1) in a manner such that the qualifying entity:

- (a) Will use commodity futures or commodity options contracts solely for bona fide hedging purposes within the meaning and intent of § 1.3(z)(1); Provided, however, That in addition, with respect to positions in commodity futures or commodity option contracts that may be held by a qualifying entity only which do not come within the meaning and intent of § 1.3(z)(1), a qualifying entity may represent that the aggregate initial margin and premiums required to establish such positions will not exceed five percent of the liquidation value of the qualifying entity's portfolio, after taking into account unrealized profits and unrealized losses on any such contracts it has entered into; and, Provided further, That in the case of an option that is in-the-money at the time of purchase, the in-the-money amount, as defined in § 190.01(x) may be excluded in computing such 5 percent;
- (b) Will not be, and has not been, marketing participations to the public as or in a commodity pool or otherwise as or in a vehicle for trading in (or otherwise seeking investment exposure to) the commodity futures or commodity options markets;

Provided further, however, That the making of such representations shall not be deemed a substitute for compliance with any criteria applicable to commodity futures or commodity options trading established by any regulator to which such person or qualifying entity is subject.

II. Nature of NFA's Interest

As you know, NFA is a futures association registered under Section 17 of the Commodity Exchange Act. One of NFA's primary purposes is to ensure the protection of customers participating in the commodity futures markets. Recently, NFA has become aware of at least three entities filing for exclusions under Regulation 4.5 with respect to registered investment companies that they operate. These mutual funds are marketed to customers, including retail investors, as commodity futures investments



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and are indirectly invested substantially in derivatives and futures products. In fact, although these funds are structured differently than public commodity pools and conduct the futures trading through a subsidiary for tax and mutual fund regulatory purposes, their aim is the same—targeting retail investors with in some cases minimum investment amounts of as little as \$1,000 who want exposure to actively managed futures strategies.

Importantly, as noted above, these three funds invest in commodity futures instruments and/or other managed futures trading programs through a wholly-owned and controlled subsidiary. The fund invests up to 25% of its total assets in this subsidiary, and by leveraging assets at a 4 to 1 ratio, a fund is able to achieve a managed futures exposure equal to the full net value of the fund.

NFA is interested in ensuring that registered investment companies that engage in more than a *de minimis* amount of futures trading and that are offered to retail customers or are marketed to retail customers as a commodity pool or otherwise as or in a vehicle for trading in (or otherwise seeking investment exposure to) the commodity futures or commodity options markets are subject to the appropriate regulatory requirements and oversight by regulatory bodies with primary expertise in commodity futures. NFA believes that requiring persons that market commodity funds to the retail public and whose funds engage in more than a *de minimis* amount of futures trading or investment to be registered as commodity pool operators ("CPOs") furthers that goal.

III. Supporting Arguments

CFTC Regulation 4.5 currently makes available to eligible persons an exclusion from the definition of CPO with respect to the operation of certain qualifying entities, including registered investment companies, that would otherwise constitute commodity pools but that are already subject to extensive federal and/or state operating requirements. Prior to 2003, eligible persons claiming this exclusion were required to represent that commodity futures and option contracts were used solely for *bona fide* hedging purposes, and that for positions in commodity futures and option contracts that were not used for *bona fide* hedging purposes, the aggregate initial margin and premiums do not exceed 5% of the liquidating value of the qualifying entity's portfolio after taking into account unrealized profits and losses. In addition, eligible persons were



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required to represent that the qualifying entity will not be, and has not been, marketing participations to the public as or in a commodity pool or otherwise as or in a vehicle for trading in the commodity futures or commodity options markets.

In March 2003, the Commission proposed amendments to Regulation 4.5 to eliminate the limitation on non-hedge trading. At the same time, the Commission proposed formally adopting CFTC Regulation 4.13(a)(4) to provide an additional exemption from CPO registration based *solely* on a pool participant's purported sophistication, without any requirement that the pool operator must be subject to another regulatory scheme and without any restriction whatsoever on the purpose and scope of the pool's commodity interest trading. The Commission further stated that "since the eligible persons and qualifying entities of Rule 4.5 are, as stated in the title of the rule, 'otherwise regulated,' the Commission believes that, like the unregulated CPOs for whom it is proposing relief below, these persons and entities may not need to be subject to any commodity interest trading criteria to qualify for relief under Rule 4.5."²

At this time, the Commission also stated its view that Regulation 4.5's "no-marketing" restriction should remain in place. The Commission noted that eligible persons should remain prohibited from marketing a qualifying entity as a commodity pool or otherwise as a vehicle to trade commodity interests and indicated that this restriction was necessary because members of the retail public may participate in the trading vehicles subject to a Regulation 4.5 exclusion. The Commission nonetheless requested comment on the merits of maintaining this marketing prohibition.³

By letter dated May 1, 2003 to the CFTC, NFA supported maintaining Regulation 4.5's "no marketing" restriction. In particular, NFA stated that "current and proposed Rule 4.5 both provide that the exclusion is not available if the vehicles are marketed as commodity pools. Since Rule 4.5 is an exclusion rather than an exemption, the anti-fraud provisions of Section 4(o) of the CEA do not apply. Investments in these vehicles can be - and often are - sold to unsophisticated customers. While the sale of these investment vehicles is subject to the anti-fraud provisions in other statutes, unsophisticated customers should also have the benefit of Section 4(o) if the investment is marketed as a commodity pool. Therefore, we agree

² See 68 Fed. Reg. 12622, 12626 (March 17, 2003).

³ See *id.*



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that the exclusion should not be available if the vehicles are marketed as commodity pools." NFA felt that with this "no-marketing" restriction in place, it made sense to eliminate the limitation on non-hedge commodity trading due to certain concerns regarding margin levels expressed at that time.

In August 2003, after receiving comments that supported eliminating both the limitation on non-hedge commodity trading and the prohibition on marketing these qualifying entities, the Commission adopted amendments to Regulation 4.5 to eliminate both these provisions. In doing so, the Commission stated that "one commenter agreed with the proposed retention of the 'no marketing' criterion (and with the Commission's rationale therefore) but several commenters disagreed with it. The Commission noted, in part, that these commenters claimed that, in the absence of any trading restriction, the "otherwise regulated nature" of the qualifying entities specified in Regulation 4.5 would provide adequate customer protection."⁴

Over the past several months, at least three entities that previously filed notices for exclusions under Regulation 4.5 with respect to certain registered investment companies launched these mutual funds. These mutual funds are marketed to customers, including retail investors, as commodity futures investments and are indirectly invested via a subsidiary structure substantially in derivatives and futures products. Customers may use an electronic brokerage account to trade one of these mutual funds, which are sold by broker/dealers on internet platforms in which retail investors only need to point and click to either buy or redeem shares in a fund that offers exposure to an actively managed futures product.

NFA staff has reviewed the prospectuses and promotional material prepared for these funds.⁵ One fund's prospectus indicates that it pursues its investment strategy by mainly investing in a combination of exchange traded futures

⁴ See 68 Fed. Reg. 47221, 47223 (August 8, 2003).

⁵ See MutualHedge Frontier Legends Fund—<http://mutualhedge.com/default.aspx>; AQR Fund—<http://www.aqrfunds.com/>; Our_Funds/Individual/FundID_12/Overview/Managed_Futures_Strategy_Fund.fs; and Highbridge Fund—<https://www.jpmorganfunds.com/cm/Satellite?pagename=jpmVanityWrapper&UserFriendlyURL=fundoveview&cusip=48121A696>



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and options contracts, forward contracts, swaps, and other over the counter derivatives and fixed income securities, often referred to as a "managed futures strategy."⁶

This fund's promotional material indicates that the fund's inception date was December 31, 2009, and the fund has a minimum investment amount of \$2,500 (subsequent investments of \$500) and offers two share classes, A and C. Class A has a maximum sales charge of 5.75% and a net expense ratio of 2.20% and Class C has no sales charge but a net expense ratio of 2.95%.⁷ The fund's promotional material also states that the fund is "A Pioneering Managed Futures Investment" that is accessible, comprehensive, innovative, and has proven management.⁸ The material also specifically notes that the fund has a "lower cost structure than most retail managed futures funds" and is "the first mutual fund to generate managed futures returns through net-long, actively managed CTAs." The fund's assets are traded pursuant to five managed futures trading programs. In particular, the fund's prospectus states that the subsidiary's investment adviser (which is also the fund's adviser) expects to invest the assets of the subsidiary in a manner designed to provide exposure to five global macro programs.

In adopting the 2003 changes to Regulation 4.5, the CFTC eliminated the prior "no-marketing" restriction and did not place any qualification standards on the type of customers who may invest in a qualifying entity. Without these types of operating

⁶ A second fund's prospectus states that in order to pursue its investment objective, the fund invests in futures contracts and futures-related instruments including, but not limited to, equity index futures, currency forwards, commodity futures, swaps on commodity futures, fixed income futures, bond futures and swaps on bond futures (collectively, the Instruments) either by investing directly in those Instruments, or indirectly by investing in a subsidiary that invests in those Instruments. The third fund's prospectus states that the fund seeks to achieve its objective by investing in a diversified portfolio of commodity-linked derivatives and fixed income securities. The prospectus additionally states that the fund invests in commodity-linked derivative instruments, such as commodity-linked notes, swap agreements, commodity options, futures and options on futures that provide exposure to the investment returns of the commodities markets without investing directly in physical commodities.

⁷ The other two funds also commenced in January 2010 and these also have various share classes with minimum investment amounts ranging from \$5,000 to \$1 million and \$1,000 to \$1 million, respectively.

⁸ A second fund's Fact Sheet makes similar statements and indicates that "The Fund delivers an active long/short Managed Futures strategy in a mutual fund vehicle." The fund's investment objective states the fund "seeks to generate positive absolute returns."



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restrictions, these mutual funds are marketed and sold to customers, including retail investors, who may be unsophisticated in commodity futures investments. NFA believes that any commodity futures investment that is marketed to retail customers as a commodity pool or otherwise as or in a vehicle for trading or investing in (or otherwise seeking exposure to) the commodity futures or commodity options markets should be subject to the regulatory requirements and protections contained in the CFTC's Part 4 regulations.

In reviewing these funds' prospectuses, NFA found that the offering material omits substantial disclosures that would otherwise be mandated by Part 4. Among other things, the prospectuses do not include detailed information about the fund's futures commission merchants and potential conflicts of interest, and performance information for the fund (assuming it has three months performance) or other funds operated by the investment adviser. Additionally, to the extent the funds' prospectuses state that the fund and/or subsidiary will invest in other actively managed futures trading programs, the prospectuses provide little information about these managed futures trading programs, these programs' fee structures, and the past performance results of their trading managers.

NFA also has customer protection concerns relating to these mutual funds' use of a wholly-owned and controlled subsidiary to invest in commodity futures transactions on behalf of the fund. NFA understands from reviewing some of these funds' prospectuses that the funds' investment in a subsidiary is intended to provide the funds with exposure to futures and commodities in a manner consistent with the limitations of the federal tax requirements in Sub-chapter M of the IRS Code. Sub-chapter M requires, in part, that at least 90% of a fund's income be derived from securities or derived with respect to its business of investment in securities (i.e., qualifying income). The funds rely upon IRS private letter rulings to other mutual funds, which indicate income from a fund's investment in a subsidiary will constitute qualifying income.

However, while these funds' offering materials indicate that the subsidiaries are subject to certain investment restrictions applicable to the funds themselves, these subsidiaries are neither commodity pools regulated by the CFTC and NFA nor registered investment companies. Additionally, the prospectuses make clear that the subsidiaries are not subject to the Investment Company Act of 1940's customer



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protection regime. The vast majority of the regulated funds' holdings appear to be money market instruments to serve as collateral for the subsidiaries' derivatives positions; yet, the subsidiaries' daily operations, including their actual derivatives positions (including the positions' leverage amounts) and fees charged are not entirely transparent.

Given these funds' offerings, NFA proposes the aforementioned amendments to Regulation 4.5 since we believe the premises underlying the Commission's elimination in 2003 of the "no-marketing" and "five-percent trading test" limitations as applied to registered investment companies may no longer be valid. To the extent the Commission used proposed Regulation 4.13(a)(4) as a rationale to eliminate the "five-percent trading test", NFA believes that the Commission should review whether this rationale remains appropriate in light of these actively managed retail futures funds.⁹

NFA believes at this time that Regulation 4.13(a)(4)'s exemption from CPO registration does not support the 2003 elimination of the "five-percent trading test." Specifically, although Regulation 4.13(a)(4) does not contain any restriction on the purpose or scope of a pool's commodity interest trading, we believe a critical distinction between a Regulation 4.5 qualifying entity and a Regulation 4.13(a)(4) pool is the qualifications of the fund participants¹⁰—Regulation 4.13(a)(4)(ii)(A) requires every natural person pool participant to be a "qualified eligible person" as defined in Commission Regulation 4.7(a)(2). In contrast, Regulation 4.5 has no qualification requirement for customers who may invest in a qualifying entity, including a registered investment company. Moreover, NFA strongly believes that in circumstances in which no qualification requirement exists for fund participants, then NFA and the CFTC should

⁹ NFA recognizes that registered investment companies may need to engage in futures transactions for bona fide hedging purposes and believes they should be permitted to engage a *de minimis* amount of speculative futures trading without the necessity to be registered with and regulated by the CFTC.

¹⁰ Another distinction is interests in Regulation 4.13(a)(4) pools are exempt from registration under the Securities Act of 1933 while Regulation 4.5 qualifying entities are operated by otherwise regulated persons. For the reasons explained in this letter, however, NFA believes that to the extent that the Commission's 2003 amendments to Regulation 4.5 were, in part, premised on the "otherwise regulated nature" of the qualifying entities, this premise may no longer be valid.



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have regulatory oversight of collective investment vehicles that engage in more than a *de minimis* amount of futures trading.¹¹

Additionally, to the extent that the Commission's 2003 amendments to Regulation 4.5 were, in part, premised on the "otherwise regulated nature" of the qualifying entities, this premise may no longer be valid. As noted above, despite the fact that these registered investment companies are marketed to retail customers as an actively managed futures fund, they are not subject to customer protection rules entirely comparable to the CFTC's Part 4 Regulations and NFA's Compliance Rules. NFA believes that a registered investment company that is marketed, in part, to unsophisticated retail customers as a commodity pool or otherwise as or in a vehicle for trading in (or otherwise seeking exposure to) the commodity futures or commodity options markets or that engages in more than a *de minimis* amount of non-hedge futures trading should be subject to the CFTC's Part 4 regulatory requirements and protections, and the oversight of the CFTC and NFA who have the experience and expertise in regulating managed retail futures products. The CFTC alone has the Congressional mandate to regulate retail managed futures trading and products, and over the years has developed the specialized body of skill and knowledge necessary to fulfill this mandate.

Additionally, NFA is deeply concerned that a number of CPOs who currently operate public pools will avail themselves of this alternative registered investment company structure. Given our concern with this registered investment company structure and the lack of adequate retail customer protections in some areas comparable to those afforded prospective investors in a public commodity pool subject to Part 4, NFA does not believe that retail futures customers would be served well if this migration were to occur.

¹¹ NFA notes that Commission Regulation 4.13(a)(3) provides an exemption from CPO registration, which requires a pool to meet one of two tests with respect to its commodity interest positions, including positions in security futures products, whether entered into for bona fide hedging purposes or otherwise—the aggregate initial margin and premiums required to establish such positions will not exceed 5% of the liquidation value of the pool's portfolio, after taking into account unrealized profits and unrealized losses on any such positions it has entered into or the aggregate net notional value of such positions does not exceed 100% of the liquidation value of the pool's portfolio, after taking into account unrealized profits and unrealized losses on any such positions it has entered into. Moreover, CFTC Regulation 4.13(a)(3)(iii) requires natural person pool participants to at least meet the accredited investor qualification standards.



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For these reasons, NFA respectfully requests that the Commission amend Regulation 4.5(c) to require a registered investment company claiming an exclusion from the definition of the term "commodity pool operator" to represent in the notice of eligibility that the qualifying entity (i.e. registered investment company) will be operated such that it (1) will not be, and has not been, marketing participations to the public as or in a commodity pool or otherwise as or in a vehicle for trading in (or otherwise seeking investment exposure to) the commodity futures or commodity options markets; and (2) will use commodity futures or commodity options contracts solely for bona fide hedging purposes and, with respect to positions that may be held by the qualifying entity only for non-bona fide hedging purposes the aggregate initial margin and premiums required to establish such positions will not exceed five percent of the liquidation value of the qualifying entity's portfolio, after taking into account unrealized profits and unrealized losses on any such contracts it has entered into.

Lastly, NFA recognizes that, if adopted, the proposed amendments to Regulation 4.5 will impose the same operating restrictions on registered investment companies that were in place prior to 2003. Obviously, since 2003, a number of persons have filed notices of eligibility pursuant to Regulation 4.5(c) on behalf of registered investment companies, and those entities may no longer be eligible for exclusion from CPO registration in the future if the proposed amendments are adopted. Therefore, NFA encourages the Commission to provide adequate time for these registered investment companies to comply with the Commission's applicable regulations or seek the appropriate relief therefrom.

Additionally, to the extent that the Commission has granted operational relief from certain Part 4 Regulations (e.g. disclosure document and reporting and recordkeeping) to exchange traded funds—that are commodity pools organized as Delaware statutory trusts—NFA encourages the CFTC to determine whether it is appropriate to grant similar and/or other relief to public commodity pools and listed pools that may want to continue operating as registered investment companies. If the Commission desires, NFA is willing to participate in discussions in the future with Commission staff to achieve this result, which may necessitate harmonizing CFTC and SEC regulatory requirements.

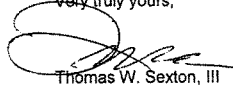
NFA

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NFA respectfully petitions the Commission to amend Regulations 4.5 as described above.

Very truly yours,

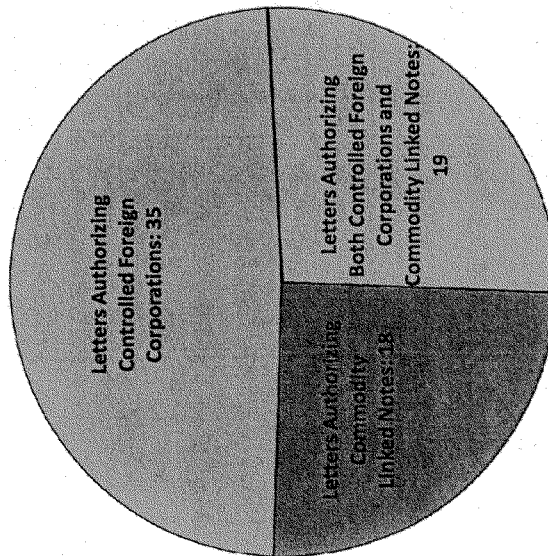


Thomas W. Sexton, III
Senior Vice President
and General Counsel

cc: Via Email:
Honorable Gary Gensler, CFTC Chairman
Honorable Michael Dunn, CFTC Commissioner
Honorable Scott O'Malia, CFTC Commissioner
Honorable Jill E. Sommers, CFTC Commissioner
Honorable Bart Chilton, CFTC Commissioner
Mr. Ananda Radhakrishnan, CFTC Director
Mr. William Penner, CFTC Deputy Director

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**72 IRS Private Letters Authorizing Commodity Investments by Mutual Funds
2006 - 2011**



Data source: Publicly available Internal Revenue Service private letter rulings
Chart prepared by Permanent Subcommittee on Investigations, Nov. 2011

Permanent Subcommittee on Investigations

EXHIBIT #7d

IRS Private Letters Authorizing Commodity Investments by Mutual Funds

	Date	PLR Number	CFC Notes	CFC & Notes	Description
1	7/14/2006	200628001	x		Each fund authorized to invest in commodities-linked notes having the terms and conditions of the note set forth in the PLR.
2	9/15/2006	200637018	x		Each fund authorized to invest in commodities-linked notes having the terms and conditions of the note set forth in the PLR. Hybrid instrument.
3	11/24/2006	200647017		x	Fund authorized to invest in commodities-linked notes having the terms and conditions of the note set forth in the PLR. CFC subsidiary incorporated as an exempted limited company under the laws of another country. Subpart F income.
4	1/5/2007	200701020	x		Master fund authorized to invest in commodities-linked notes having the terms and conditions of the note set forth in the PLR. Fund invests all of its assets in Master fund.
5	2/2/2007	200705026	x		Fund authorized to invest in commodities-linked notes having the terms and conditions of the two notes set forth in the PLR. Section 2(f)(1) of the CEA provides that the CEA is not applicable to a hybrid instrument that is predominantly a security. Notes 1 and 2 are both leveraged.
6	5/18/2007	200720011	x		Fund and Portfolio authorized to invest in commodities-linked notes having the terms and conditions of the two notes set forth in the PLR.
7	6/29/2007	200726026	x		Funds authorized to invest in commodities-linked notes having the terms and conditions of the two notes set forth in the PLR.
8	10/12/2007	200741004	x		Funds authorized to form two CFC subsidiaries as exempted limited companies under the laws of another country. Subpart F income.
9	10/26/2007	200743005	x		Funds authorized to form nine CFC subsidiaries as exempted limited companies under the laws of another country. Subpart F income.
10	11/9/2007	200745008	x		Funds are authorized to invest in commodities-linked notes having the terms and conditions of the note set forth in the PLR.
11	11/9/2007	200745021	x		Funds authorized to invest in commodities-linked notes having the terms and conditions of the two notes set forth in the PLR. Fund A is a series of business trusts. Fund B is a closed end management company. Notes constitute qualifying income to funds under section 851(b)(2).
12	5/30/2008	200822010	x		Funds authorized to form four CFC subsidiaries as exempted limited companies under the laws of another country. Subpart F income.
13	5/30/2008	200822012	x		Fund authorized to invest in commodities-linked notes having the terms and conditions of the two notes set forth in the PLR.
14	8/1/2008	200831019	x		Funds and partnerships authorized to invest in commodities-linked notes having the terms and conditions of the two notes set forth in the PLR.

Data source: Publicly available Internal Revenue Service private letter rulings
Chart prepared by Permanent Subcommittee on Investigations, Nov. 2011

IRS Private Letters Authorizing Commodity Investments by Mutual Funds

	Date	PLR Number	CFC Notes	CFC & Notes	Description
					Fund authorized to invest in commodities-linked notes having the terms and conditions of the four notes set forth in the PLR. CFC subsidiary incorporated as exempted a limited company under the laws of another country. Subpart F income.
15	10/3/2008	200840039		x	Fund authorized to invest in commodities-linked notes having the terms and conditions of the six notes set forth in the PLR. Fund authorized to form and invest a percentage of funds in two CFC subsidiaries incorporated as exempted limited companies under the laws of another country. Subpart F income.
16	10/17/2008	200842014		x	Fund authorized to invest in a commodities-linked note.
17	11/7/2008	200845013	x		Fund authorized to invest in commodities-linked notes having the terms and conditions of the two notes set forth in the PLR. Fund authorized to form a CFC subsidiary incorporated as an exempted limited company under the laws of another country. Subpart F income.
18	3/20/2009	200912003		x	Each of three funds authorized to form a CFC subsidiary as a Type A company under the laws of another country. Subpart F income.
19	5/29/2009	200922010	x		Fund authorized to form a CFC subsidiary as a Type A company giving limited liability to all shareholders. Subpart F income.
20	6/5/2009	200923011	x		Fund authorized to invest in commodities-linked notes having the terms and conditions of the four notes set forth in the PLR. Fund authorized to form a CFC subsidiary as a Type A company under the laws of another country. Subpart F income.
21	7/31/2009	200931003		x	Fund authorized to invest in commodities-linked notes having the terms and conditions of the four notes set forth in the PLR. Fund authorized to form a CFC subsidiary incorporated as a Type A company under the laws of another country. Subpart F income.
22	7/31/2009	200931008		x	Funds authorized to form four CFC subsidiaries, each as a company under the laws of another country. Subpart F income.
23	8/7/2009	200932007	x		Fund authorized to form a CFC subsidiary incorporated as a Type A company under the laws of another country. Subpart F income.
24	9/4/2009	200936002	x		Fund authorized to invest in commodities-linked notes having the terms and conditions of the two notes set forth in the PLR. Fund authorized to form a CFC subsidiary incorporated as a Type A company under the laws of another country. Subpart F income.
25	9/25/2009	200939017		x	Each of 96 funds authorized to invest in one more commodities-linked notes. Fund 1 authorized to form a CFC subsidiary incorporated as a Type A company under laws of another country. Subpart F income.
26	11/13/2009	200946036		x	Funds authorized to form four CFC subsidiaries as a Type A company under the laws of another country. Subpart F income.
27	11/20/2009	200947032	x		

Data source: Publicly available Internal Revenue Service private letter rulings
Chart prepared by Permanent Subcommittee on Investigations, Nov. 2011

IRS Private Letters Authorizing Commodity Investments by Mutual Funds

	Date	PLR Number	CFC	Notes	CFC & Notes	Description
28	11/20/2009	200947026	x			Fund authorized to form a CFC subsidiary as a Type A company giving limited liability to all shareholders. Subpart F income.
29	12/24/2009	200952019		x		Funds authorized to invest in commodities-linked notes having the terms and conditions of the two notes set forth in the PLR.
30	2/5/2010	201005023	x			Fund authorized to form a CFC subsidiary as a company under the laws of another country. Subpart F
31	2/19/2010	201007044	x			Fund authorized to form a CFC subsidiary as a company under the laws of another country. Subpart F
32	5/21/2010	201020003	x			Fund authorized to form a CFC subsidiary as a company under the laws of another country. Subpart F income.
33	6/18/2010	201024004	x			Fund authorized to form a CFC subsidiary as a Type A company giving limited liability to all shareholders. Subpart F income.
34	6/18/2010	201024003	x			Fund authorized to form a CFC subsidiary under the laws of another country. Subpart F income.
35	6/25/2010	201025031			x	Fund authorized to invest in commodities-linked notes having the terms and conditions of the note set forth in the PLR. Fund authorized to form a CFC subsidiary incorporated as a Type A company under the laws of another country. Subpart F income.
36	7/2/2010	201026017	x			Funds authorized to form six CFC subsidiaries as companies under the laws of another country. Subpart F income.
37	7/30/2010	201030004			x	Funds authorized to invest in commodities-linked notes having the terms and conditions of the note set forth in the PLR. Fund authorized to form nine CFC subsidiaries as Type X companies. Subpart F income.
38	8/6/2010	201031007		x		Fund seeks a long-term total return in excess of inflation. Fund authorized to invest in three notes. Note 2 discusses leverage. Note 3 discusses knock-out and automatic redemption.
39	8/27/2010	201034011			x	Each of six funds is permitted to invest in either certain structured notes or in a CFC. CFC subsidiaries incorporated as exempted limited companies under the laws of another country. Subpart F income.
40	9/17/2010	201037012			x	Fund authorized to invest in commodities-linked notes having the terms and conditions of the four notes set forth in the PLR. Fund authorized to form two CFC subsidiaries incorporated as Type A companies under the laws of another country. Subpart F income.
41	9/17/2010	201037014	x			Funds authorized to form two CFC subsidiaries as Type A companies giving limited liability to all shareholders. Subpart F income.
42	10/1/2010	201039002			x	Fund authorized to invest in two commodities-linked notes. Fund authorized to form two CFC subsidiaries incorporated as Type A companies under the laws of another country. Subpart F income.
43	10/15/2010	201041033	x			Fund authorized to form two CFC subsidiaries authorized to form as limited companies incorporated under the law of another country. Subpart F income.

Data source: Publicly available Internal Revenue Service private letter rulings
Chart prepared by Permanent Subcommittee on Investigations, Nov. 2011

IRS Private Letters Authorizing Commodity Investments by Mutual Funds

	Date	PLR Number	CFC Notes	CFC & Notes	Description
44	10/22/2010	201042015	x		Fund authorized to form a CFC subsidiary organized as a Type X company under the laws of another country. Subpart F income.
45	10/22/2010	201042001	x		Fund authorized to form a CFC subsidiary authorized under the laws of another country. Subpart F income.
46	10/29/2010	201043016		x	Six funds authorized to invest in commodities-linked notes having the terms and conditions of the note set forth in the PLR. Funds discuss knock out dates and leverage factors.
47	10/29/2010	201043017	x		Fund authorized to form a CFC subsidiary organized as a Type X company under the laws of another country. Subpart F income.
48	12/3/2010	201048021	x		Funds authorized to form five CFC subsidiaries incorporated as Type A companies. Subpart F income.
49	12/3/2010	201048022	x		Funds authorized to form nine CFC subsidiaries incorporated as Type A companies. Subpart F income.
50	12/10/2010	201049015	x		Funds authorized to form four CFC subsidiaries. One subsidiary authorized to form as a Type X company and three subsidiaries authorized to form as Type Y companies. Subpart F income.
51	12/23/2010	201051014	x		Fund authorized to form a CFC subsidiary as a Type X company under the laws of another country. Subpart F income.
52	1/14/2011	201102055		x	Fund authorized to invest in one commodities-linked note and one CFC subsidiary as a Type X company under the laws of another country. Subpart F income.
53	1/14/2011	201102047	x		Fund authorized to form a CFC subsidiary as a Type A company giving limited liability to all shareholders. Subpart F income.
54	1/21/2011	201103019		x	Funds authorized to invest in commodities-linked notes having the terms and conditions of the note set forth in the PLR.
55	1/21/2011	201103033		x	Funds A, B and Portfolio authorized to invest in one commodities-linked note. Fund B and Portfolio each authorized to form two CFC subsidiaries as companies under the laws of another country. Subpart F income.
56	1/21/2011	201103009	x		Fund authorized to form a CFC subsidiary as a company under the laws of another country. Subpart F income.
57	1/21/2011	201103017	x		Fund authorized to form a CFC subsidiary as a company under the laws of another country. Subpart F income.
58	1/28/2011	201104013		x	Fund authorized to invest in commodities-linked notes having the terms and conditions of the four notes set forth in the PLR. Fund authorized to form a CFC subsidiary as a Type A company under the laws of another country. Subpart F income.
59	2/18/2011	201107012		x	Fund authorized to invest in four commodities-linked notes. Fund authorized to form two CFC subsidiaries as companies under the laws of another country. Subpart F income.

Data source: Publicly available Internal Revenue Service private letter rulings
 Chart prepared by Permanent Subcommittee on Investigations, Nov. 2011

IRS Private Letters Authorizing Commodity Investments by Mutual Funds

	Date	PLR Number	CFC Notes	CFC & Notes	Description
60	2/25/2011	201108003	x		Funds authorized to invest in a commodities-linked note having the terms and conditions set forth in the PLR. The note can be leveraged.
61	2/25/2011	201108018		x	Fund authorized to invest in commodities-linked notes having the terms and conditions of the four notes set forth in the PLR. Fund authorized to form two CFC subsidiaries as Type A companies under the laws of another country. Subpart F income.
62	2/25/2011	201108008	x		Funds authorized to form six CFC subsidiaries as companies under the laws of another country. Subpart F income.
63	4/1/2011	201113015		x	Fund authorized to invest in commodities-linked notes having the terms and conditions of the note set forth in the PLR.
64	4/22/2011	201116014	x		Funds authorized to form three CFC subsidiaries as companies under the law of another country. Subpart F income.
65	5/20/2011	201120017	x		Fund authorized to form a CFC subsidiary as a Type A company giving limited liability to all shareholders. Subpart F income.
66	6/3/2011	201122012	x		Fund authorized to form a CFC subsidiary as a Type A company giving limited liability to all shareholders. Subpart F income.
67	7/15/2011	201128022	x		Fund represents that its CFC subsidiary will qualify as an association taxable as a corporation. Subpart F income.
68	7/22/2011	201129002	x		Fund authorized to form a CFC subsidiary as a Type A company giving limited liability to all shareholders. Subpart F income.
69	8/5/2011	201131001		x	Portfolio authorized to invest in four commodities-linked notes. Portfolio authorized to form a CFC subsidiary as a Type X company under the laws of another country. Subpart F income.
70	8/12/2011	201132008	x		Fund authorized to form CFC subsidiary as a Type A company giving limited liability to all shareholders. Subpart F income.
71	8/26/2011	201134014	x		Fund authorized to form a CFC subsidiary as a Type A company giving limited liability to all shareholders. Subpart F income.
72	9/2/2011	201135001		x	Funds authorized to invest in two commodities-linked notes. Note A deals with a leveraged note, and Note B will pay a monthly coupon in arrears.
		TOTAL	35	18	19

Data source: Publicly available Internal Revenue Service private letter rulings
Chart prepared by Permanent Subcommittee on Investigations, Nov. 2011

Analysis: High-frequency trade fires up commodities



Fri, Jun 17 2011

By David Sheppard and Jonathan Spicer

NEW YORK (Reuters) - When natural gas prices dropped by 8 percent in a matter of seconds in the early hours of Asian trade last week, one New York-based hedge fund manager said he didn't have to think twice.

"The moment I heard, I ran, literally ran, to my computer and started buying," he said. "It was clear it was an HFT algo gone bad and I could profit on the rebound off the lows."

He wouldn't have been the only one.

Since the infamous "flash crash" in equity markets in May 2010, that was exacerbated by high-frequency trading (HFT), seasoned traders say that violent, often inexplicable price moves are becoming more common, and allow those who are fast enough to book a quick profit as prices bounce straight back up.

In commodity markets, which have been hit by a series of mini flash crashes over the last 18 months, experts say there could now be an influx of more high-speed computer-based traders that have honed their techniques in the cut-throat equities markets -- the fastest and most electronic on earth.

Though such firms have traded commodities for years, some traders and experts say they are now applying new and more aggressive strategies that have stunned traditional players.

Such high-frequency trading -- in which rapid-fire machines place thousands of very short-term bets, making markets and profiting on tiny price imbalances -- could double from around 15 percent in two to three years, leaving commodity exchanges and regulators running to catch up.

Jeffrey Sprecher, CEO of commodity futures powerhouse IntercontinentalExchange Inc, told reporters last week exchanges are working on ways to target "unintended" price spikes, without losing the benefits -- and volumes -- HFT firms bring.

"I think it's incumbent on the exchanges to solve this. I think customers are going to lose faith in us if we don't."

Permanent Subcommittee on Investigations

EXHIBIT #8

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HFT AND THE MAY 5 OIL CRASH

Commodity traders are increasingly blaming computer-driven activity for a series of anomalous price movements ranging from quick blips in natural gas and cocoa to deeper, longer-lasting jolts like the one that shook oil on May 5.

On that day, traders were shocked by the speed and violence of a record \$13 intraday plunge, as sell-stop after sell-stop was triggered, despite the absence of a major news event.

"I think there are some new algorithms in commodities that we've seen in currency markets before that are designed to sniff out the stops," said Paul Rowady, a senior analyst at TABB Group, a firm that specializes in capital markets research.

"Whenever there is an event that causes prices to move they try to sniff out the stops in both directions. The market can suddenly shoot up, and then back down again after an event and it leaves traders disoriented, wondering what happened."

High-frequency traders are frustrated by the criticism and what they call mischaracterizations. Several told Reuters they reduce volatility by quickly bringing prices back in line after larger, long-term players place their bets.

"May 5 was a price discovery process influenced by real fundamental changes in people's views on the oil market. It wasn't a liquidity blip," said an oil-market high-frequency trader who requested anonymity.

And yet some of the world's biggest oil hedge funds appeared to have been victims of the slide, not catalysts.

SEEKING NEW PASTURES

All signs point to continued growth of HFT in commodities.

It is partly in response to increased competition and narrowing profit margins in U.S. equities, where high-frequency trade is estimated to have declined from a year ago, along with lower volumes and volatility. It is still, however, thought to be involved in more than half of all trading in the market.

Additionally, for HFT, there is an allure in playing in markets where heightened volatility is becoming the norm.

"Whenever there are spikes in markets, high-frequency traders gather data on it," said Louis Liu, founder of Matrix Trading Technologies LLC, a New York-based high-frequency trading technology firm. The May 5 oil crash "could encourage them to enter" energy futures trading, he said.

William McNeill, managing director of trading at HTG Capital Partners, a Chicago-based proprietary HFT firm echoed that view: "I think you'll definitely see an increase in people market-making in the oil product set. If there's moderate volatility ... there's probably ample opportunity to take risk."

Rowady at TABB Group said he wouldn't be surprised to see HFT volumes double in energy markets in the next two to three years, saying oil and natural gas "fit the bill" for HFT firms.

But the growth of HFT, while undoubtedly bringing some benefits to the wider market like lower trading fees, won't be without risk.

"When you have highly complicated automated systems operating in highly complex markets then there is the risk that the permutations of what can occur are beyond what you're able to model," Rowady said. "Sometimes the only way to find that problem is to stumble over it."

HFT firms in commodity markets have found themselves under intense scrutiny before.

In 2009, the U.S. Commodity Futures Trading Commission charged traders in the Chicago office of Netherlands-based HFT firm Optiver with attempting to move oil prices to their advantage with a rapid-fire trading tool they nicknamed the "Hammer."

And in 2010, HFT firm Infinium Capital Management found itself under investigation after its newest trading algorithm ran amok, sparking a brief surge in oil prices that racked the firm with a million dollar loss as the program sent up to 3,000 buy orders a second. [ID:nN25119290]

While experienced high-frequency traders agree that causing sudden movement in prices is not in their collective interest, the Optiver and Infinium cases are a reminder that HFT firms can shift prices either by practice or design.

GETTING FASTER

CME Group Inc, which runs the New York Mercantile Exchange (NYMEX), home of the world's most actively traded crude oil contract and the natural gas contract where last week's 8 percent crash occurred, said automated trading, including both HFT and slower computer-generated trades, accounted for almost a third of energy futures volume in the fourth quarter of 2010, in a report published on its website.

The Aite Group consultancy estimates that specifically high-frequency trade in energy futures already accounts for around 15 percent of all volume.

But illustrating the controversial nature of growing HFT trade, CME Group told Reuters it had decided not to make its first-quarter report available to the public.

Regulators are desperately trying to keep up with the fleet-footed traders that always seem one step ahead, but so far haven't indicated any major plans to restrict their practices. Short of a major change in stance from regulators and exchanges, traditional traders may just need to learn to adapt.

"Ultimately what they're doing is within the rules," said Tim Quast at ModernIR, which advises many S&P 500 companies on the impact speculation, HFT and fund flows can have on their stock price. "They're just faster and better at operating within the rules than others."

(Reporting by David Sheppard and Jonathan Spicer; additional reporting by Janet McGurty in New York; editing by Jonathan Leff, Marguerita Choy and Lisa Shumaker)



FOOD SPECULATION

<http://www.wdm.org.uk/stop-bankers-betting-food/hundreds-economists-tell-g20-regulate-speculation-food-prices>

450 economists tell the G20: regulate speculation on food prices

11 October 2011

Dear G20 Finance Ministers,

We write to you ahead of the October meeting of the G20 Finance Ministers to urge you to commit with your counterparts to take effective action to curb excessive speculation on food commodities. Excessive financial speculation is contributing to increasing volatility and record high food prices, exacerbating global hunger and poverty.

While there are many pressures on food prices, fundamental changes in supply and demand cannot fully account for the dramatic price fluctuations that have occurred in recent years.

In June, a report for the G20 by international organisations including the IMF and the OECD noted that "too much speculation can cause frequent and erratic price changes" in futures markets. Evidence suggests that financial speculators are less likely to make trading decisions based on information regarding supply and demand and are more prone to herding behaviours than commercial traders. Excessive speculation undermines the price discovery function of futures markets, driving real prices away from levels determined by supply and demand.

The High Level Panel of Experts on food security for the Committee on World Food Security at the FAO reported in July that "tighter regulation of speculation is necessary." The panel suggested that "increasing transparency, by requiring exchange trading and clearing of most agricultural commodity contracts, and setting lower limits for noncommercial actors could be the first set of measures taken by the countries that house major commodity exchanges."

Increasing market transparency is vital, but will not go far enough to tackle excessive financial speculation. We therefore urge you to support the establishment of position limits to cap the proportion of agricultural commodity derivatives markets that can be held by financial speculators. Limits could be set at a level that would maintain sufficient liquidity in the markets while preventing an excessive concentration of purely financial actors. The US has already passed legislation including provisions to introduce such limits and the G20 should act to prevent regulatory arbitrage between exchanges.

Position limits would be more effective in tackling excessive speculation than position management powers, which rely on the use of judgement by exchanges and provide little assurance that powers will be exercised effectively. Clear limits would provide regulatory certainty, promoting stable and sustainable derivatives markets to the benefit of food producers, consumers and broader economic stability.

Permanent Subcommittee on Investigations

EXHIBIT #9

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With around 1 billion people enduring chronic hunger worldwide, action is urgently needed to curb excessive speculation and its effects on global food prices.

Yours sincerely,

cc: Michel Barnier, European commissioner for internal market and services

Signed

Mr Abdulhafiz Ahmed Abdisubhan, Finance and Economic Development Bureau, ETHIOPIA

Charles Abugre, Regional Director (Africa), The United Nations Millennium Campaign, Nairobi, KENYA

Prof Nicola Acocella, Department of Methods and Models for Economics, Territory and Finance, Faculty of Economics, University of Rome, ITALY

Dr Funda Rana Adacay, Associate Professor in Economics, Anadolu Univeristy, Eskisehir, TURKEY

Dr Ipek Ilkkaracan Ajas, Associate Professor of Economics, Istanbul Technical University, TURKEY

Dr Alpaslan Akcoraoglu, Associate Professor of Economics, Gazi University, TURKEY

Prof A. Haroon Akram-Lodhi, Chair of the Department of International Development Studies, Trent University Peterborough, CANADA

Mr Tanweer Ali, Lecturer in Finance, Empire State College, State University of New York, USA

Marzouq Alnurf, Department of Economics, University of Massachusetts at Amherst, USA

Wilfried Altzinger, Department of Economics, Vienna University of Economics, AUSTRIA

Dr Francisco Alvarez Cuadrado, Associate Professor, Department of Economics, McGill University, CANADA

Dr Rui Henrique Alves, Assistant Professor at the Faculty of Economics, University of Porto, PORTUGAL

Dr Bruno Amoroso, Department for Society and Globalization Roskilde, University Denmark, DENMARK

Prof Paolo Andrei, Professor in Business Economics, University of Parma, ITALY

Rania Antonopoulos, Senior Scholar and Director of Gender Equality and the Economy Program, Levy Economics Institute, USA

Dr Ozlem Arpac Arconian, Department of Economics, School of Oriental and African Studies, University of London, UK

Prof Alessandro Arrighetti, Professor of Economics, University of Parma, ITALY

Prof Wiji Arulampalam, Department of Economics, University of Warwick, UK

Prof Thankom Arun, Director of Institute of Global Finance and Public Policy, Lancashire Business School, University of Central Lancashire, UK

Dr Michael Ash, Associate Professor of Economics and Public Policy and Chair, Department of Economics, University of Massachusetts Amherst, USA

Prof Venkatesh Athreya, Professor of Economics, Bharathidasan University, Tiruchirapalli, INDIA

Jonathan Adabre Atia, Policy Analyst, Integrated Social Development Centre, GHANA

Fiona Atkins, Lecturer in Economics, Birkbeck University of London, UK

Dr Rohit Azad, Assistant Professor, Faculty of Economics, South Asian University, New Delhi, INDIA

Prof M. V. Lee Badgett, Professor of Economics and Director for Center for Public Policy and Administration, University of Massachusetts Amherst, USA

Dean Baker, Co-Director, Center for Economics and Policy Research, USA

Dr Dean Baker, Center for Economic and Policy Research, Washington, DC, USA

Prof Radhika Balakrishnan, Professor of Women's and Gender Studies Rutgers, The State University of New Jersey, former Professor of Economics and International Studies at Marymount Manhattan College, USA

Prof Erol Balkan, Professor of Economics, Hamilton College, New York, USA

Dr Nesecan Balkan, Department of Economics, Hamilton College, USA

Dr Nina Banks, Associate Professor of Economics, Bucknell University, USA

Prof Drucilla K. Barker, Director Women's & Gender Studies, Phd in Economics, University of South Carolina, Columbia, USA

Prof David Barkin, Distinguished Professor of Economics, Universidad Autonoma Metropolitana-Xochimilco, Mexico City, MEXICO

Dr John Barnshaw, Department of Sociology, University of South Florida, USA

Dr Stephanie Barrientos, Senior Lecturer, Institute of Development Policy and Management, Associate Director Brooks World Poverty Programme, University of Manchester, UK

Michael Barrow, Senior Lecturer in Economics, School of Business, Management and Economics, University of Sussex, UK

Prof Hans-Heinrich Bass, Professor of International Economics, Bremen University of Applied Sciences, GERMANY

Dr PL Beena, ICSSR General Fellow, Institute for Studies in Industrial Development, New Delhi, INDIA

Riccardo Bellofiore, Department of Economic Science, University of Bergamo, ITALY

Prof Lourdes Beneria, Professor Emerita, Department of City and Regional Planning, Cornell University, USA

Prof Gunseli Berik, Economics Department, University of Utah, USA

Prof Jacques Berthelot, Emeritus professor of Economics, Ecole Nationale Supérieure Agronomique de Toulouse, FRANCE

Prof Sheila Bhalla, Professor at the Institute for Human Development, New Delhi, INDIA

Dr Ravi Bhandari, Associate Professor and Chevron Chair of Development Economics, Saint Mary's College of California, USA

Prof Cyrus Bina, Distinguished Research Professor of Economics, University of Minnesota, USA

Dr Stephanie Blankenburg, Department of Economics and CISD, School of Oriental and African Studies, UK

Prof Patrick Bond, Professor of Development Studies, University of KwaZulu-Natal, SOUTH AFRICA

Dr A. J. C. Bose, Associate Professor, Department of Economics, Shri Ram College of Commerce, University of Delhi, INDIA

Sam Boshra, Economist and former Income Analyst with Statistics Canada, CANADA

Dr Roger Even Bove, Department of Economics & Finance, West Chester University, USA

Dr Christopher Bowdler, University Lecturer in Economics and Fellow of Oriel College, University of Oxford, UK

Dr James K. Boyce, Department of Economics, University of Massachusetts, Amherst, USA

Dr Manuel Branco, Associate Professor of Economics, University of Évora, PORTUGAL

Prof Luiz Carlos Bresser-Pereira, Professor Emeritus of Economics, Getulio Vargas Foundation, Sao Paulo, BRAZIL

Dr Kate Bronfenbrenner, Senior Lecturer, Cornell School of Industrial and Labor Relations, USA

Dr Reiner Buchegger, Associate Professor, Johannes Kepler University, AUSTRIA

Dr Jorge Buzaglo, Associate Professor of Economics, University of Goteburg, SWEDEN

Prof Antonio Callari, Sigmund M. and Mary B. Hyman Professor of Economics, and Director of the Local Economy Center, Franklin and Marshall College, Lancaster, USA

Prof Jim Campen, Professor Emeritus of Economics, University of Massachusetts, Boston, USA

Dr Michele Cangiani, Associate Professor of Economic Sociology, Foscari Venezia University, ITALY

Dr Michael Carter, Associate Professor of Economics, Chair of Economics Department, University of Massachusetts, Lowell, USA

Prof Carlos Nuno Castel-Branco, Director of Institute of Social Economics Studies, MOZAMBIQUE

Prof Sergio Cesaratto, Professor of Economics University of Siena, ITALY

Rakesh Chandra, Junior Research Fellow, Center for the Study of Regional Development, Jawahar Lal Nehru University, New Delhi, INDIA

Shouvik Chakraborty, Assistant Professor, Indian School of Business and Finance (ISBF), New Delhi, INDIA

Malini Chakravarty, Senior Economist, International Development Economics Associates (IDEAs), New Delhi, INDIA

Prof Nirmal K. Chandra, Professor of Economics (Retd), Indian Institute of Management Calcutta, INDIA

Prof C. P. Chandrasekhar, Centre for Economic Studies and Planning Jawaharlal Nehru University New Delhi, INDIA

Dr Ha-Joon Chang, Reader, Faculty of Economics, University of Cambridge, UK

Dr Anup Chatterjee, Associate Professor in Economics, ARSD College, University of Delhi, INDIA

Prof Monojit Chatterji, Bonar Professor of Applied Economics, University of Dundee, UK and Bye Fellow in Economics and Director of Studies in Economics, Sidney Sussex College, Cambridge, U.K

Prof Sudip Chaudhuri, Professor of Economics, Indian Institute of Management, Calcutta, INDIA

Pallavi Chavan, Economist, INDIA

Prof Robert Chernomas, Department of Economics, University of Manitoba, CANADA

Dr Lynne Chester, Department of Political Economy, University of Sydney, AUSTRALIA

Prof Victoria Chick, Emeritus Professor of Economics, University College London, UK

Prof Wittayakorn Chiengkul, Professor of Political Economy, Dean of Social Innovation College, Rangsit University, THAILAND

Prof Anis Chowdhury, Professor of Economics, University of Western Sydney, and Co-editor of the Journal of the Asia Pacific Economy, AUSTRALIA

John Christensen, Economic Adviser and Director, Tax Justice Network, London, UK

Kimberly Christensen, Visiting Faculty Member in Economics and Public Policy, Sarah Lawrence College in Bronxville, New York, USA

Dr Mammen Chundamannil, Head of Forest Economics, Kerala Forest Research Institute, INDIA

Dr Edward J. Clay, Senior Research Associate, Overseas Development Institute, London, UK

Prof Pavel Isa Contreras, Professor of Economics, Santo Domingo, DOMINICAN REPUBLIC

Eileen Cook, Scottish Agricultural College, Scotland, UK

Dr Eugenia Correa, Department of Economics, National Autonomous University of Mexico, MEXICO

Prof Marcella Corsi, Professor of Economics, Sapienza University of Rome, ITALY

Prof Carmen Costea, Professor of International Business and Commerce, ASE Bucharest, Founder and President of Alternative Sciences Association, ROMANIA

Prof Christopher Cramer, Professor of the Political Economy of Development, SOAS, UK

Prof James Crotty, Professor Emeritus of Economics and Helen Sheridan Memorial Scholar, UMASS Amherst, USA

Antonio Cuerpo, Economist and Researcher, University Complutense of Madrid, SPAIN

Dr Carlo D'Ippoliti, Assistant Professor of Economics, Sapienza University of Rome, ITALY

Dr Omar S. Dahi, Assistant Professor of Economics, Hampshire College, USA

Dr Gareth Dale, Senior Lecturer in Politics & International Relations, Brunel University, London, UK

Dr Anita Dancs, Assistant Professor, Department of Economics, Western New England University, USA

Dr Charles Danreuther, School of Politics and International Studies, University of Leeds, UK

Dr Guglielmo Forges Davanzati, Associate Professor of Economics, Faculty of Political Sciences, University of Salento, Lecce, ITALY

Prof Chuck David, Professor of Labor Studies, Indiana University, USA

Paul Davidson, Editor of Journal of Post Keynesian Economics, Fellow at Bernard Schwartz Center for Economic Policy Analysis, USA

Prof Joaquim P. de Andrade, Professor of Economics, University of Brasilia, BRAZIL

Dr Elisabetta de Antoni, Associate Professor, Department of Economics, Trento University, ITALY

Dr Catherine de Fontenay, Associate Professor, Melbourne Business School, University of Melbourne, AUSTRALIA

Dr Jan-Emmanuel De Neve, Assistant Professor in Political Economy and Behavioural Science, University College London, UK

Prof Carmen Diana Deere, Distinguished Professor of Food & Resource Economics and Latin American Studies, University of Florida, USA

Benny Dembitzer, Visiting Lecturer in Macroeconomic Theory, Greenwich Business School, University of Greenwich, UK

Dr Firat Demir, Assistant Professor of Economics, University of Oklahoma, USA

Dr Andy Denis, Senior lecturer in political economy, City University London, UK

Dr Richard Denniss, Executive Director, The Australia Institute, AUSTRALIA

Prof Radhika Desai, Author, Department of Political Studies, University of Manitoba, CANADA

Prof Sergio Destefanis, Professor of Economics, University of Salerno, ITALY

Dr Stephen Devereux, Research Fellow, Institute of Development Studies, University of Sussex , UK

Ashok M. Dhareshwar, Retired World Bank Economist and visiting faculty at Indian Institute of Management, Calcutta

Swati Dhingra, Lecturer in Economics, London School of Economics, UK

Prof Robert Dixon, Professor of Economics, University of Melbourne, AUSTRALIA

Prof Thomas L. Dobbs, Professor Emeritus of Economics, South Dakota State Univeristy, USA

José Domingo Villadeamigo, Research Fellow, CEPED, Institute of Economics, FCE-UBA, ARGENTINA

Prof Daniel Drache, Senior Research Fellow and Professor of Political Science, Robarts Centre for Canadian Studies, CANADA

Sarah Dustin, Independent Scholar, University of New Hampshire, USA

Prof Amitava Krishna Dutt, Professor of Economics and Political Science, University of Notre Dame, USA

Dr Graham Dyer, Economics Department, SOAS, University of London, UK

Prof Gary A Dymski, Professor of Economics, University of California, Riverside, USA

Dr Michael Edwards, Senior Lecturer in the Economics of Planning and Leverhulme Emeritus Fellow, The Bartlett School, University College London, UK

Prof Frank Ellis, Professorial Fellow, School of International Development, University of East Anglia, UK

Prof Wolfram Elsner, Author and Professor of Economics, Economics and Business Studies, University of Bremen, GERMANY

Prof Diane Elson, Phd in Economics, Professor at the Centre for Research in Economic Sociology and Innovation, Department of Sociology, University of Essex, UK

Prof Gerald Epstein, Professor of Economics and Co-Director of Political Economy Research Institute (PERI), University of Massachusetts, USA

Dr M. Mustafa Erdogan, Associate Professor of Economics, Marmara University, TURKEY

Prof Korkut Erturk, Professor of Economics, University of Utah, USA

Mr Ismail Erturk, Senior Lecturer in Banking, Manchester Business School, UK

Prof Jerry Evensky, Professor of Economics, Syracuse University, USA

Prof Guilhem Fabre, Professor of Economics and Chinese Studies, University of Le Havre, FRANCE

Prof Susan Feiner, Professor of Economics and of Women and Gender Studies, University of Southern Maine, USA

Prof Leonardo Felli, Professor of Economics, London School of Economics and Political Science, UK

Dr Jesus Ferreiro, Associate Professor of Economics, University of the Basque Country, SPAIN

Prof Ben Fine, Department of Economics, School of Oriental and African Studies, London, UK

Dr Kade Finnoff, Assistant Professor, Department of Economics, University of Massachusetts, Boston, USA

Prof Mahir Fisunoglu, Professor of Economics, Cukurova University, TURKEY

Mahir Fisunoglu, Department of Economics, Cukurova University Adana, TURKEY

Prof Maria S. Floro, Department of Economics, American University, Washington, USA

Prof Giuseppe Fontana, Professor of Monetary Economics, Head of Economics, Leeds University Business School, University of Leeds, UK

Prof Alan Freeman, Visiting Professor of London Metropolitan University, UK

Dr Ines Freier, Economist, GERMANY

Dr Jose Ricardo Fucidji, Assistant Professor, Department of Economics, UNESP, BRAZIL

Dr Kevin Gallagher, Associate Professor of International Relations and Director of Global Development Policy Program, Boston University, USA

Dr Clara Garcia, Associate Professor, Department of Economics, Complutense University of Madrid, SPAIN

Prof Christian Gehrke, Department of Economics, University of Graz, AUSTRIA

Prof J. George, Chief Promoter, Strategic Economic Management Initiative in Governance, University of Delhi, INDIA

Dr Susan George, Political economist, Transnational Institute

Salvador H. Geranil, Vice Char of Philippine Network of Rural Development Institutes, PHILIPPINES

Prof Jayati Ghosh, Professor of Economics, Jawaharlal Nehru University, INDIA

Prof Andrea Ginzburg, Professor of Economics, University of Modena and Reggio Emilia, ITALY

Dr Mwangi wa Githinji, Assistant Professor of Economics, Thompson Hall, University of Massachusetts, USA

Dr David Gold, Associate Professor, Phd Economics, International Affairs Program, The New School, New York, USA

Francois Gobbe, Coordinator Kairos Europe WB, BRUSSELS

Prof Don Goldstein, Professor of Economics, Allegheny College, Meadville, USA

Dr Sara Gorgoni, Lecturer in Economics and Business, Business School, University of Greenwich, UK

Rahul Goswami, Social Sector Researcher, National Agriculture Innovation Project, Ministry of Agriculture, INDIA

Prof Ian Gough, Emeritus Professor, University of Bath, and Professorial Research Fellow, London School of Economics, UK

Dr Krishn A. Goyal, Convener & Head of Management Department, Bhupal Nobles College, Udaipur, INDIA

Prof Ilene Grabel, Department of Economics, University of Denver, USA

Prof John Groenewegen, Professor of Economics of infrastructures, Delft University of Technology, NETHERLANDS

Joseph Halevi, Department of Political Economy, University of Sydney, AUSTRALIA

Prof Ferda Halicioglu, Professor of Economics, Yeditepe University, TURKEY

Dr Peter Hall, Associate Professor, Urban Studies, Simon Fraser University, CANADA

Dr David Hall-Matthews, Senior Lecturer in International Development School of Politics and International Studies, University of Leeds, UK

Leslie Hamilton, Associate Lecturer in Economics, Leeds Metropolitan University, UK

Prof Geoff Harcourt, Visiting Professorial Fellow at Australian School of Business, University of New South Wales, AUSTRALIA

Prof Jane Harrigan, Department of Economics, SOAS, University of London, UK

Prof Gillian Hart, Chair of Development Studies, University of California, Berkeley, USA

Dr Neil Hart, Senior lecturer, School of Economics and Finance, University of Western Sydney, AUSTRALIA

Prof Martin Hart-Landsberg, Professor of Economics, Lewis and Clark College, USA

Dr Ingrid Hartmann, Agricultural Economist, Berlin, GERMANY

Dr Joop Hartog, Emeritus Professor of Economics, Amsterdam School of Economics University of Amsterdam, NETHERLANDS

Dr James Heintz, Associate Research Professor, Political Economy Research Institute, University of Massachusetts, USA

Anton Hellesøy, Economist and Independent consultant, NORWAY

Andrew Hepburn, Commodity Analyst, CANADA

Dr Barry Herman, Visiting Senior Fellow, Graduate Program in International Affairs, The New School, New York, USA

Arturo Hermann, Senior Research Fellow at ISTAT, Rome, ITALY

Dr Adam Hersh, Economist, Center for American Progress, USA

Dr Gillian Hewitson, Department of Political Economy, University of Sydney, AUSTRALIA

Nicholas Hildyard, Director of The Corner House, UK

Prof Susan Himmelweit, Professor of Economics, Faculty of Social Sciences, Open University, UK

Prof Geoffrey M. Hodgson, Research Professor in Business Studies, University of Hertfordshire, UK

Dr Raul Hopkins, Consultant on agricultural issues and information technologies, Lima, PERU

Dr David Hudson, Lecturer in Political Economy, Department of Political Science, University College London, UK

David Hulme, Professor of Development Studies, School of Environment and Development, University of Manchester, Head, Institute for Development Policy and Management, Executive Director, Brooks World Poverty Institute, CEO, Effective States and Inclusive Development, UK

Veronika Hummer, German Institute for Economic Research, Berlin, GERMANY

Prof Grazia Ietto-Gillies, Emeritus Professor of Applied Economics, London South Bank University, UK

Dr Katsushi Imai, Associate Professor in Development Economics, Department of Economics and Brooks World Poverty Institute, University of Manchester, UK

Gustavo Indart, Senior Lecturer, Department of Economics, University of Toronto, CANADA

Dr Davide Infante, Associate Professor of Political Economy Department of Economics and Statistics University of Calabria, ITALY

Prof George Irvin, Professorial Research Associate in Economics, SOAS, University of London, UK

Prof Toru Iwami, Professor of Economics, University of Tokyo, JAPAN

Dr Johannes Jäger, University of Applied Sciences BFI Vienna, AUSTRIA

Prof Jesper Jespersen, Professor of Economics, Roskilde University, DENMARK

Ravinder Jha, Lecturer, University of Delhi, INDIA

Anne Marie John, Economist, Economic Research Foundation, New Delhi, INDIA

Prof James Johnson, Department of Political Science, University of Rochester, New York, USA

Dr Michael Johnson, Associate Professor at School of Social Science and International Studies, University of New South Wales, Sydney, AUSTRALIA

Prof Sir Richard Jolly, Institute of Development Studies, University of Sussex, UK

Mr Tinu Joseph, Jawaharlal Nehru University, New Delhi, INDIA

Prof P.N. Junankar, Professorial Visiting Fellow, School of Economics, University of New South Wales and Emeritus Professor, University of Western Sydney, AUSTRALIA

David Kane, Associate for Latin America and Economic Justice, Maryknoll Office for Global Concerns, USA

Woojin Kang, Researcher, Crawford School of Economics and Government, Australian National University, AUSTRALIA

Dr Nikolaos Karagiannis, Associate Professor of Economics, Department of Economics & Finance, Winston-Salem State University, North Carolina, USA

Dr Zahra Karimi, Assistant Professor of Economics, University of Mazadaran, IRAN

Prof Massoud Karshenas, Professor of Economics, School of Oriental and African Studies, University of London, UK

Dr Emily Kawano, Executive Director, Center for Popular Economics & Solidarity Economy Network, USA

Prof Cristobal Kay, Emeritus Professor, International Institute of Social Studies, Erasmus University Rotterdam, NETHERLANDS.

Dr Steve Keen, Associate Professor in Economics and Finance, University of Western Sydney, AUSTRALIA

Prof Saul Keifman, Professor of Economics and Chair of the Economics Major School of Economics Sciences, University of Buenos Aires, ARGENTINA

Prof Neil M. Kellard, Professor of Finance, Essex Business School, University of Essex, UK

Dr Stephanie A. Kelton, Associate Professor of Economics, University of Missouri-Kansas City, USA

Ahmet Kerem Özdemir, Research and Teaching Assistant, Finance Department, School of Business Administration, Istanbul University, TURKEY

Dr Prue Kerr, Department of Economics, University of Adelaide, South Australia, AUSTRALIA

Prof Farida C Khan, Professor of Economics, University of Wisconsin - Parkside, USA

Prof Sushil Khanna, Professor of Economics and Strategic Management, Indian Institute of Management Calcutta, INDIA

Prof Mushtaq Husain Khan, Department of Economics, School of Oriental and African Studies, University of London, UK

Kijong Kim, Research Scholar, The Levy Economics Institute of Bard College Blithwood, New York, USA

Prof Mary C King, Professor of Economics, Portland State University, Oregon, USA

Dr Godbertha Kinyondo, Lecturer in Economics, Mzumbe University, Dar es Salaam Business College, TANZANIA

Prof Nikoi Kote-Nikoi, Professor of Economics, S.I.T Graduate Institute, Vermont, USA

Dr David Kristjanson-Gural, Associate Professor of Economics, Social Justice College, Lewisburg, USA

Mr Andrey Kuleshov, Economist at the Common Fund for Commodities, Amsterdam, NETHERLANDS

Dr Uday Kumar, Associate Professor and Coordinator, Department of International Business, University College Mangalore, INDIA

Dr C. Nalin Kumar, Assistant Professor of Economics and Policy Research, Indian Institute of Plantation Management Bangalore, INDIA

Prof Amiya Kumar Bagchi, First Chancellor, Tripura Central University, Director Institute of Development Studies Kolkata, Calcutta University Alipore Campus, INDIA

Prof Sarosh Kuruvilla, Professor, School of Industrial and Labor Relations, Cornell University, USA

Dr Pierre Lacour, Clinical Assistant Professor, Coordinator of Economics, New York University, USA

Dr Thomas Lambert, Lecturer in Economics, Indiana University Southeast, New Albany, USA

Prof Michael Landesmann, Professor of Economics and Scientific Director, Vienna Institute for International Economic Studies, AUSTRIA

Stewart Lansley, Research Fellow in Economics, University of Bristol, UK

Alessandra Ianza, Chief Economist, Prometeia Spa Financial Consulting, ITALY

Dr Alberto Lanzavecchia, Assistant Professor in Corporate Finance University of Padova, ITALY

Prof Costas Lapavistas, Department of Economics, School of Oriental and African Studies, University of London, UK

Prof Marc Lavoie, Department of Economics, University of Ottawa, CANADA

Alejandro Ignacio Lazarte, MA, Zurich Financial Services, SWITZERLAND

Dr Jonathan Leape, Senior Lecturer in Economics, London School of Economics and Political Science, UK

Prof Dennis Leech, Professor of Economics, Warwick University and Research Associate, CPNSS, London School of Economics, UK

Prof Margaret Levenstein, Professor of Business Economics and Public Policy, University of Michigan, USA

Dr Minqi Li, Associate Professor, Department of Economics, University of Utah, USA

Dr Dan Li, Assistant Professor in Finance, School of Economics and Finance University of Hong Kong, HONG KONG

Dr Carlos F. Liard-Muriente, Associate Professor and Chair of the Department of Economics, Central Connecticut State University, USA

Thomas Lines, Author of Making Poverty: A History, UK

Prof Sumanasiri Liyanage, Professor of Economics, University of Peradeniya, SRI LANKA

Juan José Llach, Director, Center for the Study of Government, Business, Society and the Economy, IAE Business School, Universidad Austral, ARGENTINA

Prof John Loxley, Department of Economics, University of Manitoba, CANADA

Prof Miguel Martinez Lucio, Manchester Business School, Manchester University, UK

Dr Hans-Jochen Luhmann, Research co-ordinator of future energy and mobility structures, Wuppertal-Institut, GERMANY

Prof Nora Lustig, Samuel Z. Stone Professor of Latin American Economics, Tulane University, USA

Prof Arthur MacEwan, Professor Emeritus of Economics, University of Massachusetts, Boston, USA

Mario Machungo, Economist and Chairman of Banco Internacional de Mocambique, Maputo, MOZAMBIQUE

Dr Donald MacLaren, Associate Professor and Director of Asian Economic Centre, University of Melbourne, AUSTRALIA

Dr Rasigan Maharajh, Chief Director, Institute for Economic Research on Innovation, Tshwane University of Technology, SOUTH AFRICA

Dr Fadhil A. Mahdi, Senior Economist, Formerly Chief of the Economics Analysis Division, United Nations Economic and Social Commission for Western Asia

Dr Kamil Mahdi, Economist, Visiting Senior Fellow, Middle East Centre, London School of Economics, UK

Dr Chinglen Maisnam, Assistant Professor of Economics, Manipur University, INDIA

Casmir Makoye, Director of SME Competitiveness Facility, Dar Es Salaam, TANZANIA

Dr Stanley Malinowitz, Associate Professor of Economics, Universidad Nacional de Colombia, COLOMBIA

Steve Mandel, Research Associate, Department of International Development, Birmingham University, UK

Jens Martens, Director, Global Policy Forum Europe, GERMANY

Dr Nuno Miguel Ornelas Martins, Assistant Professor, Faculty of Economics and Management, Portuguese Catholic University, PORTUGAL

Dr Pietro Masina, Associate Professor of Applied Economics, University of Naples, ITALY

Dr Thomas Masterson, Research Scholar, Levy Economics Institute of Bard College, USA

Prof Julie Mattaei, Professor of Economics, Wellesley College, USA

Dr Reza Mazhari, Assistant Professor in Economics, Gonbad Kavoss, IRAN

Dr Kathleen McAfee, Associate Professor in International Relations and Political Economy, San Francisco State University, USA

Dr Elaine McCrate, Associate Professor, Economics and Women's Studies, University of Vermont, CANADA

Prof Terrence McDonough, Department of Economics, National University of Ireland, Galway, IRELAND

Dr Margaret McKenzie, Lecturer in Economics, Deakin University, AUSTRALIA

Dr Robert McMaster, Business School, University of Glasgow, Glasgow, UK

Dr Andrew Mearman, Associate Head of Accounting, Economics and Finance Department, University of the West of England, UK

James Medway, Senior Economist, New Economics Foundation, UK

Prof Michael Meeropol, Visiting Professor of Economics, City University of New York, USA

Dr Tesfa Mehari, International Partnerships Coordinator, Department of International Business & Economics, University of Greenwich, UK

Dr Martin Melkonian, Adj. Associate Professor of Economics, Hofstra University, USA

Prof Mary Mellor, Emeritus Professor of Social Science, Northumbria University, UK

Dr Emel Memis, Assistant Professor of Economics, Ankara University, TURKEY

Dr Helen Mercer, Senior Lecturer Business Economics, Business School, University of Greenwich, UK

Prof Peter B. Meyer, Professor Emeritus of Urban Policy and Economics and President and Chief Economist of the E.P Systems Group, Inc

Prof John Miller, Professor of Economics, Wheaton College, Norton, USA

Prof Marco Missaglia, Professor of International Economics and General Equilibrium Modelling, University of Pavia, ITALY

Dr Rudra Narayan Mishra, Assistant Professor of Economics, Gujarat Institute of Development Research, Ahmedabad, INDIA

Prof Nobuki Mochida, Professor of Economics, University of Tokyo, JAPAN

Prof Oudebji Mohamed, Professor of International Economic Law of Development, Marrakech, MOROCCO

Prof Mritiunjoy Mohanty, Professor, Economics Group, Indian Institute of Management Calcutta, Kolkata, INDIA

Prof Simon Mohun, Emeritus Professor of Political Economy, Queen Mary, University of London, UK

Prof Mario Morroni, Professor of Economics, Department of Economics, University of Pisa, ITALY

Dr John Morrow, Research Economist, CEP at London School of Economics, UK

Dr Tracy Mott, Associate Professor and Department Chair of Economics, University of Denver, USA

Prof Sam Moyo, African Institute for Agrarian Studies (AIAS), ZIMBABWE

Prof Ananya Mukherjee-Reed, Professor and Chair, Department of Political Science, York University, Toronto, CANADA

Richard Murphy, Director, Tax Research UK

Sreeram Mushty, Freelance Economist & Chartered Accountant, MS Sastri Chambers, Vijayawada, INDIA

Shri Sanat Kumar Naik, Economist, State Bank of India, INDIA

Nitya Nanda, Fellow, Centre for Global Agreements, Legislation and Trade (GALT), Resources, Regulation and Global Security Division, The Energy and Resources Institute (TERI), New Delhi, INDIA

Dr Corinne Nativel, Senior Lecturer in Social Sciences, University of Franche-Comté, FRANCE

Prof Vincent Navarro, Professor of Public Policy, The Johns Hopkins University, USA

Dr Ioana Negru, Senior Lecturer in Economics, Anglia Ruskin University, UK

Dr Michaela Neumayr, Economist, Vienna University of Economics and Business, AUSTRIA

Paul Newlin, Lecturer, Environmental Policy, Amherst College & University of Massachusetts, USA

Dr Howard Nicholas, Senior Lecturer in Economics, Erasmus University of Rotterdam, NETHERLANDS

Prof Eric Nilsson, Professor of Economics, California State University, USA

Prof Augusto Ninni, Professor of Industrial Organization at the University of Parma, ITALY

Prof Machiko Nissanke, Professor of Economics, SOAS, University of London, UK

Dr Hassan E. Oaikhenan, Department of Economics & Statistics University of Benin, NIGERIA

Prof Mehmet Odekon, Professor of Economics, Skidmore College, USA

Prof Rod O'Donnell, Professor of Economics, University of Technology, Sydney, AUSTRALIA

Samuel O. Oloruntoba, Doctoral Candidate and Lecturer, Department of Political Science, University of Lagos, NIGERIA

Dr Wendy Olsen, Senior Lecturer in Socio-Economic Research, University of Manchester, UK

Prof Mojubaolu Olufunke Okome, Professor of Political Science, Brooklyn College, CUNY, New York, USA

Prof G. Omkarnath, Department of Economics, University of Hyderabad, INDIA

Dr Ozlem Onaran, Senior Lecturer in Economics, University of Westminster, UK

Prof Ahmet Oncu, Professor of Economics, Sabanci University, TURKEY

Noemi Levy Orlik, Economic Lecturer, School of Economics, UNAM, MEXICO

Dr Quentin Outram, Senior Lecturer in Economics, Leeds University Business School, UK

Dr Carlos Oya, Senior Lecturer in Political Economy of Development, School of African and Oriental Studies, University of London, UK

Dr Adam Ozanne, Senior Lecturer in Economics, University of Manchester, UK

Prof Mustafa Ozer, Professor of Economics, Anadolu University, TURKEY

Dr Ilhan Ozturk, Assistant Professor and Coordinator, International Relations & Erasmus, Cag University, TURKEY

Dr Aaron Pacitti, Assistant Professor of Economics, Siena College, USA

Adel Paighami, Dean of Interdisciplinary Research Center for Social Sciences, Economics Faculty, Imam Sadiq University, IRAN

Dr Parthapratim Pal, Associate Professor of Economics, Indian Institute of Management Calcutta, INDIA

Radhakrushna Panda, Senior Research Officer, Centre for Microfinance Research, Bankers Institute of Rural Development, INDIA

Prof Dimitri Papadimitriou, President and Professor of Economics, Levy Economics Institute, New York, USA

Prof Man Seop Park, Professor of Economics, Korea University, SOUTH KOREA

Dr Raj Patel, Author and Research Fellow, School of Development Studies, University of KwaZulu-Natal, Durban, SOUTH AFRICA

Prof Ruth Pearson, Professor of International Development, University of Leeds, UK

Jamie Peck, Research Chair in Urban and Regional Political Economy, University of British Columbia, CANADA

Prof Fernando Pellerano, Professor of Economics, Universidad Autónoma de Santo Domingo, DOMINICAN REPUBLIC

Dr Michael Perelman, Professor of Economics, California State University, USA

Prof Virginie Pérotin, Professor of Economics, Leeds University Business School, UK

Dr Karl Petrick, Assistant Professor, Department of Economics, Western New England University USA

Ann Pettifor, Director of Policy Research in Macroeconomics, UK

Dr Lynda J. Pickbourn, Assistant Professor of Economics, Keene State College, USA

Prof J F Pixley, Honary Professorial Research Fellow, Global Policy Institute, London Metropolitan University, UK

Prof Robert Pollin, Department of Economics and Political Economy Research Institute (PERI), University of Massachusetts-Amherst, USA

Prof Alexander Cotte Poveda, Professor of Economics, University of La Salle, USA

Prof Bernard van Praag, University of Amsterdam, AMSTERDAM

Ms Sajin Prachason, Sustainable Agriculture Foundation, THAILAND

Prof Eleuterio F. S. Prado, Professor of Political Economy, University of Sao Paulo, BRAZIL

Prof Robert E. Prasch, Professor of Economics, Middlebury College, USA

Dr Renee Prendergast, Reader, Queen's University Management School, Belfast, NORTHERN IRELAND

David Primack, Executive Director, International Lawyers and Economists Against Poverty (ILEAP), CANADA

Prof Adam Przeworski, Carroll and Milton Petrie Professor, Department of Politics, New York University, USA

Prof Alicia Puyana Mutis, Latin American Faculty of Social Sciences, Flasco, MEXICO

Mr Hugo Radice, Life Fellow, School of Politics and International Studies, University of Leeds, UK

Dr Kunibert Raffer, Associate Professor, Department of Economics, University of Vienna, AUSTRIA

Dr Anton Rainer, Federal Ministry of Finance, Vienna, AUSTRIA

Prof Indira Rajaraman, Honorary Visiting Professor, Indian Statistical Institute, INDIA

Prof V. K. Ramachandran, Professor, Indian Statistical Institute, Kolkata, INDIA

Prof K.V. Ramaswamy, Professor, Indira Gandhi Institute of Development Research, INDIA

Prof Paolo Ramazzotti, Professor of Economic Policy, University of Macerata, ITALY

Prof D. Narasimha Reddy, Professor of Economics, University of Hyderabad, INDIA

Howard Reed, Director, Landman Economics, UK

Prof Michael Reich, Professor of Economics and Director of Institute for Research on Labour and Employment, University of California at Berkeley, USA

Dr Paolo de Renzio, Senior Research Fellow, International Budget Partnership, Research Associate, Global Economic Governance Programme, University of Oxford, UK

Prof Colin Richardson, Adjunct Professor of Economics Centre for International Security Studies, University of Sydney, AUSTRALIA

Prof Christopher Ritson, Professor Emeritus, Trustee Director of the Food Ethics Council and Professor of Agricultural Marketing, Newcastle University Agricultural Building, UK

Prof Michael T. Rock, Samuel and Etta Wexler Professor of Economic History, Bryn Mawr College, USA

Dr Leopoldo Rodriguez, Associate Professor in International Development Studies, Portland State University, USA

Prof Alessandro Roncaglia, Professor of Economics, Sapienza University of Rome, ITALY

Prof Sergio Rossi, Professor of Economics, University of Fribourg, SWITZERLAND

Prof Roy J. Rotheim, Professor of Economics, Skidmore College, New York, US

Dr B. P. Syam Roy, IAS (Retd), West Bengal, INDIA

Prof Guillermo Rozenwurcel, Director of IDEAS Centre, San Martin National University, ARGENTINA

Dr Kobil Ruziev, Lecturer in Economics, Programme Director MSc Banking and Financial Regulation, School of Management and Business Aberystwyth University, UK

Muhammad Sabir, Principal Economist, Social Policy and Development Centre, PAKISTAN

Dr Peter Sai-Wing Ho, Associate Professor of Economics, University of Denver, USA

Prof Wiemer Salverda, Director of AIAS, and special Chair Labour Market and Inequality, University of Amsterdam, NETHERLANDS

Dr Wiemer Salverda, General Director of AIAS, and special Chair Labour Market and Inequality, University of Amsterdam, NETHERLANDS

Dr Diego Sanchez-Ancochea, University Lecturer in the Political Economy of Latin America, University of Oxford, UK

Dr Sankaran Sarkar, Assistant Professor of Finance, NIIT University, Rajasthan, INDIA

Prof Rubens R. Sawaya, Professor of Economics, Sao Paul Catholic Pontificia University, BRAZIL

Prof Malcolm Sawyer, Professor of Economics, University of Leeds, UK

Dr Harwood D. Schaffer, Research Assistant Professor, Agricultural Policy Analysis Center, Department of Agricultural and Resource Economics, University of Tennessee Institute of Agriculture, USA

Prof Hans Schenk, Chaired Professor of Economics, Department of Economics, Utrecht University, NETHERLANDS

Dr Ted P. Schmidt, Associate Professor of Economics and Finance SUNY, USA

Karin Schoenpflug, Economist, Institute for Advanced Studies, University of Vienna, AUSTRIA

Dr Evert Schoorl, Economist and Director of graduate studies, Groningen University, NETHERLANDS

Dr Juliet Schor, Phd Economics, Boston College, USA

Dr Molly Scott Cato, Reader in Green Economics, Cardiff School of Management, UK

Prof Mario Seccareccia, Department of Economics, University of Ottawa, Ontario, CANADA

Prof Stephanie Seguino, Department of Economics, University of Vermont, USA

Professor Sunanda Sen, Visiting Professor, Jamia Millia Islamia University, New Delhi, INDIA

Dr Esther-Mirjam Sent, Professor of Economics at Radboud University, Nijmegen, the Netherlands and Member of the Senate of the Netherlands, NETHERLANDS

Prof Ardeshtir Sepehri, Professor of Economics, University of Manitoba, CANADA

Dr John Serieux, Associate Professor of Economics, University of Manitoba, CANADA

Prof Mark Setterfield, Professor of Economics and Chair Department of Economics, Trinity College, Hartford, USA

Prof Anwar Shaikh, Professor of Economics, New School of Social Research, New York, USA

Reader Benjamin Shepherd, Food Security in Asia Program, Centre for International Security Studies, University of Sydney, AUSTRALIA

Prof Tokutaro, Shibata, Professor of Economics, University of Tokyo, JAPAN

Sabira Ahamed Shine, Research Associate, ICSSR Research Project, School of Management Studies, Cocin University of Science and Technology, INDIA

Dr Chen Shuoying, Assistant Professor, Chinese Academy of Social Sciences, CHINA

Dr Kalim Siddiqui, Senior Lecturer in International Economics, Business School, University of Huddersfield, UK

Prof Francesco Silva, Professor of Economics, Milano-Bicocca University, ITALY

Prof Maria Luiza Falcão Silva, Professor of Economics, University of Brasília, BRAZIL

Dr John Simister, Department of Economics, SOAS, University of London, UK

Dr John Simister, Senior teaching fellow, Economics department, School of Oriental and African Studies, University of London, UK

Dr Pritam Singh, Reader in Economics, Oxford Brookes University, UK

Prof Anna Soci, Professor of Economics at the University of Bologna, ITALY

Prof Funmi Soetan, Professor of Economics and Director at Center for Gender and Social Policy Studies, Obafemi Awolowo University, NIGERIA

Dr Stefano Solari, Associate Professor of Political Economy, Padova University, ITALY

Dr Somannavar, Department of Economics, KLE Society's Lingaraj College, Karnataka, INDIA

Prof Cem Somel, Professor of Economics, Abant Izzet Baysal University, TURKEY

Dr Godwin Sree Kulakkal, Assistant Professor, Department of Economics, Government College for Women, Kerala, INDIA

Prof Ravi S. Srivastava, Professor of Economics, Centre for the Study of Regional Development, Jawaharlal Nehru University, New Delhi, INDIA

Dr Eduardo Stachman, Assistant Professor, Department of Economics, Sao Paul State University, BRAZIL

Prof Howard Stein, Professor of Development Economics, Afroamerican and African Studies, University of Michigan, USA

Prof Engelbert Stockhammer, Professor of Economics, Kingston University, UK

Dr Servaas Storm, Department of Economics of Innovation, Delft University of Technology, Delft, NETHERLANDS

Dr Eduardo Strachman, Assistant Professor of Economics, Sao Paulo State University, BRAZIL

Larry D. Su, Senior Lecturer, School of Business, University of Greenwich, UK

Dr David Sunderland, Reader and Principal Lecturer, University of Greenwich, UK

Prof Madhura Swaminathan, Indian Statistical Institute, INDIA

Dr Valeria Szekeres, Associate Professor of Economics, Obuda University, Budapest, HUNGARY

Dr Szabolcs Szikszai, Senior Lecturer in Finance and Economics, University of Pannonia, HUNGARY

Prof Giulio Tagliavini, Professor of Business Finance, Parma University, ITALY

Prof Haruhito Takeda, Economic Historian, Faculty of Economics, Tokyo University, Japan

Dr John M. Talbot, Senior Lecturer in Sociology, Department of Sociology, Psychology and Social Work University of the West Indies, JAMAICA

Dr Jeff Tan, Assistant Professor of Development Studies, Aga Khan University, UK

Prof Ke Tang, Hangqing Advanced Institute of Economics and Finance and School of Finance, Renmin University of China, CHINA

Dr Pavlina R. Tcherneva, Assistant Professor of Economics, Franklin and Marshall College, USA

Dr Khemararat T. Teerasuwannajak, Department of Economics, Chulalongkorn University, THAILAND

Biige Terzioglu, Department of Economics, Isik University, Istanbul, TURKEY

Dr Jose Rafael Tesoro, Lecturer in Economics, University of Buenos Aires, ARGENTINA

Mr Albin Tharcis, Assistant Professor of Economics, St Xavier's College, INDIA

- Dr Frank Thompson, Lecturer in Economics, Residential College, University of Michigan, USA
- Prof Mario Tiberi, Professor of Political Economy, Sapienza, University of Rome, ITALY
- Dr Gunther Tichy, Austrian Institute of Economic Research, AUSTRIA
- Prof Chris Tilly, Professor of Urban planning and sociology and Director, Institute for Research on Labor and Employment UCLA, Los Angeles, USA
- Dr Zdravka Todorova, Assistant Professor, Department of Economics, Raj Soin College of Business, Wright State University, Ohio, USA
- Prof Mario Tonveronachi, Professor of Financial Systems, University of Siena, ITALY
- Prof Jan Toporowski, Professor of Economics and Finance, School of Oriental and African Studies, University of London, UK
- Prof Mariano Torras, Professor of Economics, Adelphi University, USA
- Dr Andres Torres, Distinguished Lecturer, Department of Latin American and Puerto Rican Studies, Lehman College/CUNY, New York, USA
- Dr Oscar Ugarteche, Institute of Economic Investigations, UNAM, Ciudad University, MEXICO,
- Dr Mehmet Ugur, Reader in Political Economy, International Business and Economics, University of Greenwich Business School, UK
- Prof Vittorio Valli, Professor of Economic Policy, Turin University, ITALY
- Prof Rolph van der Hoeven, Professor of Employment and Development Economics, International Institute of Social Studies (ISS), Erasmus University, NETHERLANDS
- Prof Irene van Staveren, Professor of Pluralist Development Economics, ISS, Erasmus University Rotterdam, NETHERLANDS
- Dr Elisa Van Waeyenberge, Lecturer in Economics, School of Oriental and African Studies, University of London, UK
- Roberto Veneziani, Senior Lecturer, School of Economics and Finance, Queen Mary University of London, UK
- Dr Matias Vernengo, Associate Professor of Economics, University of Utah, USA
- Dr Rudi von Arnim, Assistant Professor of Economics, University of Utah, USA
- Andrew Watt, Senior Researcher in Economics, European Trade Union Institute
- Prof John Weeks, Professor Emeritus of Economics, School of Oriental and African Studies, UK
- Dr Scott A. Weir, Wake Technical Community College, Raleigh, NC, USA
- Mark Weisbrot, Co-Director of Center for Economic and Policy Research, Washington, USA

Prof Thomas E. Weisskopf, Professor Emeritus of Economics, University of Michigan, USA

Prof Philip B. Whyman, Director, Lancashire Institute for Economic and Business Research, University of Central Lancashire, UK

Dr Jeannette Wicks-Lim, Assistant Research Professor, Political Economy Research Institute, University of Massachusetts, Amherst, USA

Prof Rorden Wilkinson, Professor of International Political Economy, School of Social Sciences and Research Director, Brooks World Poverty Institute, University of Manchester, UK

Timothy A. Wise, Director, Research and Policy Program, Global Development and Environment Institute, Tufts University, Medford, USA

Dr Martin Wolfson, Associate Professor of Economics, University of Notre Dame, USA

Prof Enrico Wolleb, Director ISMERI EUROPA, Roma, ITALY

Dr Andrew Wood, Reader in Finance, Essex Business School, University of Essex, UK

Prof Chenggang Xu, Quoin Professor in Economic Development, University of Hong Kong, HONG KONG

Prof Mo Yamin, Professor of International Business, Manchester Business School, UK

Dr Yavuz Yasar, Associate Professor, Department of Economics, University of Denver, USA

Prof Erhan Yildirim, Department of Economics, Cukurova University, Adana, TURKEY

Prof Brigitte Young, Institute for Political Science, University of Muenster, GERMANY

Dr Elizabeth Young, Lecturer in Food and Agriculture, University of Staffordshire, UK

Dr June Zaccane, Associate Professor of Economics (Emerita), Hofstra University Hempstead, New York, USA

Prof Angelika Zahmt, Professor of Economics, Bund fur Umwelt und Naturschutz, GERMANY

Nimrod Zalk, Deputy Director-General, Industrial Development Division, Department of Trade and Industry, SOUTH AFRICA

Dr Luisa Zanchi, Lecturer in Economics, University of Leeds, UK

STATEMENT FOR THE
RECORD



Mr. Gerry Ramm
Inland Oil Company
Ephrata, Washington
On behalf of the
Petroleum Marketers Association of America and the
And the New England Fuel Institute (NEFI)

Testimony for the
Homeland Security and Governmental Affairs
Permanent Subcommittee on Investigations
United States Senate
Washington, DC

November 3, 2011

Permanent Subcommittee on Investigations
EXHIBIT #10

Honorable Chairman Levin, Ranking Member Dr. Coburn and distinguished members of the subcommittee, thank you for the invitation to submit the following testimony. I appreciate the opportunity to provide some insight on the extreme volatility and high oil prices seen in recent months on energy commodity markets.

1. Introduction

My name is Gerry Ramm and I am the Immediate Past Chairman of the Petroleum Marketers Association of America (PMAA) and a current member of PMAA's Executive Committee. PMAA is a national federation of 48 state and regional trade associations representing over 8,000 independent petroleum marketing companies. These companies own 60,000 convenience store/gas stations and supply gasoline and diesel fuel to an additional 40,000 stores. Also, PMAA member companies sell at retail 90 percent of the heating oil consumed in the U.S.

I also work for Inland Oil Company in Ephrata, Washington. My Dad started Inland Oil Company in 1946 after he returned from duty in World War II. Today we operate seven gas stations and convenience stores and we also supply fuel to eight independent dealers.

Also joining PMAA in these comments is the New England Fuel Institute. NEFI is a member of the Petroleum Marketers Association of America and an independent trade association that has represented the home heating industry for 70 years. NEFI represents approximately 1,200 home heating fuel retailers and related services companies, most of which are small, multi-generational family owned- and operated-businesses.

I first want to point out that we strongly support the free exchange of commodity futures on open, well regulated and transparent exchanges that are free of manipulation. I am grateful to have this chance to express our support for the Commission's effort to establish speculative position limits for the energy markets and to provide our comments as to how they may be implemented in a sound and workable fashion.

2. Excessive Speculation Causes Volatility and Price Spikes at the Pump, Not Petroleum Marketers

Excessive speculation on oil futures exchanges is the fuel extreme volatility in prices at the pump in recent years. In April 2011, Goldman Sachs warned clients to lock-in trading profits before oil and other markets reversed suggesting speculators were boosting crude prices as much as \$27 a barrel which translates in upwards of 40-60 cents-per-gallon at the pump. Goldman noted that every one million barrels of oil held by speculators contributed to an 8-10 cent rise in oil price. This comment came as the CFTC found that speculators made up more than 70 percent of the open interest of positions held overnight in crude oil futures, whereas, physical end-users (like my company) made up less than 30 percent. Additionally, the CFTC reported in July 2011, that almost 95 percent of U.S. crude oil futures volume was generated by day trading. The last time I testified on this subject before Congress in 2008, one floor trader bought 1,000 barrels, the smallest amount permitted, and sold it immediately for \$99.40 at a \$600 loss on January 3, 2008. The trader deliberately pushed the price of a barrel of crude oil over \$100 just because he wanted to tell his grandchildren that he was the first person ever to buy crude oil over \$100.¹

PMAA has previously expressed the need for effective regulation of excessive amounts of speculative activity in the energy markets. In testimony before the CFTC over the last several years, we outlined how the price of crude oil and energy products have become increasingly determined by distortions in the market attributable to speculative trading by large-scale, institutional investors not the law of supply and demand. For example, in 2008, the price of crude oil rose from less than \$50 a barrel in January to over \$147 in July, and then dropped to just \$33 in December. Not much has changed in 2011. From late 2010 into the summer of 2011, oil prices rose dramatically, which curtailed the travel budgets for average Americans, and caused an overall drag on the

¹ (BBC News, 2008)

economy as the costs of business overhead soared. The spring and summer of 2011 run-up in prices occurred notwithstanding the sluggish state of the economy, high inventory levels, and steady supplies.

3. The High Cost of Oil and Refined Products Hurt Petroleum Marketers

The effect of excessive speculation on small business petroleum marketers is a major problem. In recent years, gasoline and heating oil retailers saw profit margins from fuel sales fall to their lowest point in decades as oil prices surged. Gasoline retailers do not benefit from high crude oil or gasoline prices. Because they operate in such a competitive environment, the higher prices climb, the further margins are squeezed. Thus, rising gasoline prices not only hurt motorists, but gasoline station owners as well. Of the 160,000 U.S. retail gasoline locations, 99 percent are owned by independent businesses, not the major oil companies. While those small businesses may sell a particular brand of gasoline, they do not share in any of the profits (or losses) generated by refiners and big oil companies. The major integrated oil companies have essentially removed themselves from the retail gasoline business because they see that the retail environment is not very profitable for gasoline sales.

In order to remain competitive, retail station owners offer the lowest price for motor fuels so that they generate enough customer traffic inside the store where station owners can make a modest profit by offering drink and snack items. Because petroleum marketers and station owners must pay for the inventory they sell, their lines of credit approach their limit due to the high costs of gasoline, heating oil and diesel when crude prices go up. This creates a credit crisis with marketers' banks, which creates liquidity problems and may force petroleum marketers and station owners to close up shop. Both the Michigan Petroleum Association (MPA) and the Oklahoma Petroleum Marketers and C-Store Association (OPMCA) agree that excessive speculation is bad for business and can see firsthand how prices do not reflect fundamentals. "Oklahoma petroleum marketers are detrimentally affected by volatile and high gasoline prices. All we ask for is a fair price resulting from supply and demand fundamentals, not Wall Street's money influence that now influences prices at the pump," said Oklahoma Petroleum Marketers and C-Store Association Executive Director, Bill Maxwell.

4. Cash-Settled Contracts Impact Physical Prices

PMAA and NEFI have concluded that excessive speculation on energy commodity markets has driven up the price of crude oil (and, consequently, all refined petroleum products) without the supply and demand fundamentals to justify the recent run-up. Large purchases of crude oil futures contracts by speculators have, in consequence, created an additional paper demand for oil which drives up the prices of oil for future delivery. This has the same effect that additional demand for contracts for the delivery of a physical barrel today drives up the price for oil on the spot market. Basically, a futures contract bought by a speculator has the same effect on demand for a barrel that results from the purchase of a futures contract by a petroleum marketer. The very definition of cash-settled contracts as "look-alikes" means that what occurs in the financially-settled markets directly affects what occurs in the physical market.

The Commission's initial proposed rule on position limits was to create a separate "conditional spot month position limits" for certain cash-settled contracts under Section 151.4(a)(2) that is five times the spot month limit (or 125 percent of deliverable supply) if the trader does not have a hedge exemption, if the positions are held exclusively in cash-settled contracts, and if the trader holds physical commodity positions that are less than or equal to 25 percent of deliverable supply. The conditional spot month limits could apply to passive investors (i.e., index funds) and therefore used as an evasion of more stringent spot month limits.

Given that the spot month is the period when the futures price converges with the underlying spot price as time approaches the contract's month of delivery, allowing five times leverage in the cash-settled "look alike" contract could be susceptible to arbitrageurs shorting or buying financially-settled contracts. This event could potentially disrupt the liquidation of the physically-settled futures contracts. Since the physically-settled contract and the linked cash-settled contract are economically equivalent, this could result in a traders'

migration to the cash-settled contract rather than trading in the physically-settled contract which could potentially prevent hedgers from fulfilling the delivery of physical contract due to less liquidity in the physically-settled contract. The very definition of these contracts as "look-alikes" means that what occurs in the financially-settled markets directly affects what occurs in the physical market.

Volatility and increased options costs would likely ensue if the financial-settled contract is able to enjoy five times leverage which could disrupt or unduly influence the price discovery function of the physical market leaving PMAA and NEFI member companies very few options to hedge effectively. There is the possibility that options costs may exceed profit margins for many of PMAA and NEFI's member companies because higher conditional spot month limits may restrict the physical players' ability to compete for spot month speculative trading interests. Companies won't be able to hedge, whether in the petroleum, airline or agriculture business and it will affect long-term planning for these companies. Volatility created by cash-settled paper players has already increased option hedging costs which prevent end-users from using these tools to hedge in the marketplace.

PMAA and NEFI were pleased to see that the Commission reversed its initial conditional spot month limit rule. The final rule treats the physically-settled contract and the cash-settled "look alike" contracts the same (1:1 ratio for oil and refined products). PMAA and NEFI argued that given that most cash-settled contracts take place on unregulated exchanges granted through the Commission's "no-action letters," there's no need to treat physically-settled contracts and cash-settled "look-alike" contracts differently since they are economically equivalent.

5. *West Texas Intermediate Crude Oil Contract vs. Brent Crude Oil Contract*

A recent phenomenon in the oil markets is the price spread between the *Brent crude oil* contract and the *light sweet West Texas Intermediate (WTI) crude oil* contract. With WTI supplies well above its five year average, demand down by five percent and the Euro weakened against the dollar (the dollar has strengthened considerably), oil prices should be low. Since oil is priced in dollars that would mean that oil should be much cheaper, but prices have remained high. Some experts believe the loss of Libya's 1.7 million barrels-per-day supply has caused the Brent contract price run-up. However, Saudi Arabia raised production unilaterally after failing to convince other OPEC members to agree to a coordinated increase to meet a shortfall in supplies from Libya.

The *Oil Price Information Service* recently reported that U.S. coastal markets would see higher prices compared to the middle of the country. Last month, the Pacific Northwest saw prices soar some 35 cents over the futures, even as Chicago and Gulf Coast spot gasoline moved below the RBOB benchmark. Crude oil for refiners in the central US is essentially 50-75 cents-per-gallon cheaper than product in the coastal areas because they are tied to the Brent contract.

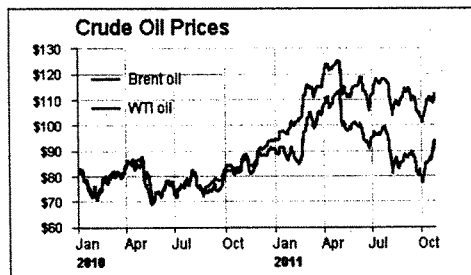
West Texas Intermediate Crude Oil (Symbol: CL)

- Price \$89 a barrel
- Traded on regulated exchange (NYMEX)
- **Delivered at Cushing, OK**
- NYMEX raised margins on traders (more money down)
- Prior to 2005, Prices based on inventory levels.
- Now, based on money flows.
- The "Financialization of oil."

Brent Crude Oil Contract (Symbol: BZ)

- Price: \$106 per barrel
- Traded on over-the-counter OTC market -- ICE.
- ICE/CME lists Brent. CME enforces limits
- ICE doesn't enforce position limits.
- Traders -- highly leveraged bets on the Brent contract
- Brent is highly speculative
- **Not based off inventories, no delivery point.**
- US East coast gasoline prices now based off Brent contract, not WTI contract
- Now, based on money flows, the "dark market" deals.
- Higher leverage = higher prices.

Since there is no delivery point and no inventory level for the Brent crude oil contract, how would the CFTC determine deliverable supply for Brent crude? The position limits final rule only applies to WTI crude, gasoline and heating oil, but would not apply to the Brent contract. What is interesting is that the ICE Brent crude futures contract is a deliverable contract based on EFP (exchange for product) with the option to cash-settle (99.9 percent of these contracts are cash-settled anyway). Since much of the US market is now priced off the Brent contract, the CFTC should be examining the price discovery and fundamentals of the Brent contract. Therefore, PMAA and NEFI urge the Subcommittee to examine whether the CFTC has the authority to determine deliverable supply for the Brent contract and how the contract works in the marketplace between the CME and ICE?



6. PMAA and NEFI's Position on Energy Position Limits

Section 737 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act") requires the CFTC to establish within 180 days of its enactment speculative position limits for commodities that had been exempt under the Commodity Exchange Act.² These "exempt commodities" include energy-related commodities (i.e., crude oil, gasoline, natural gas and heating oil) as well as metals. PMAA and NEFI are strongly supportive of the immediate implementation of position limits. We believe that establishing appropriate and meaningful speculative position limits is essential in establishing the proper price functioning of the energy derivative markets.

It is well established that the CFTC's primary statutory mandate is to foster fair, open and efficient functioning of the commodity markets as a hedging and price discovery tool for bona-fide physical hedgers. PMAA and NEFI believe that the proposed position limits are critical to fulfilling this mandate and thereby protecting market users and the public from undue burdens that may result from "excessive speculation." Section 737 of the Dodd-Frank Act is a clear expression by the Congress that "excessive speculation" is bad for the markets, market participants, American consumers and the welfare of the broader economy.

(i) *To diminish, eliminate, or prevent excessive speculation as described under this section;*

(ii) *To deter and prevent market manipulation, squeezes, and corners;*

(iii) *To ensure sufficient market liquidity for bona fide hedgers; and*

² 180 days after enactment was January 17, 2011.

(iv) *To ensure that the price discovery function of the underlying market is not disrupted and to establish position limits for Swap Dealers.*

7. Final Rule on Energy Position Limits

The CFTC's final rule imposes spot month, single-month, and all-months combined speculative position limits on specified physical commodity futures and options contracts ("referenced futures contracts") and physical commodity swaps that are economically equivalent to such contracts (together, "referenced contracts"). The Commission will impose non-spot speculative position limits for referenced contracts to single-months and to all-months-combined and will determine the non-spot month limits by using a formula based on open interest. The aggregate all-months-combined and single-month position limits would each be equal to 10 percent of the first 25,000 contracts of the "average all-months-combined aggregated open interest" with a marginal increase of 2.5 percent of the open interest for amounts above 25,000 contracts.

PMAA and NEFI are concerned that the public has received inaccurate information from the CFTC on the periodic review of spot-month position limits for energy contracts. We were of the understanding that the spot month position limits would be reviewed at least once a year indicated during the October 18th CFTC public hearing, but the final rule published in the Federal Register indicated that energy contracts would be reviewed every two years. PMAA and NEFI urge the Subcommittee to clarify with the CFTC on the periodic review of spot-month position limits for energy contracts.

We support the Commission's final rule to immediately implement speculative position limits for the spot months as mandated by the Dodd-Frank Act. However, the final formula for determining both spot-month and non-spot month position limits does not adequately address all four goals of speculative position limits as mandated by the Dodd-Frank Act. The CFTC will need to revisit this issue in the near future to better fulfill Congressional intent and the CFTC's stated mission. First, the spot-month limit of 25 percent of open interest is far too generous. The Commission will need to consider lowering the stated limit to a level that is more consistent with existing limits referenced agricultural commodities (to which the Commission is proposing to maintain under "Legacy Limits") or that are more reflective of existing accountability limits for referenced energy contracts on Designated Contract Markets. Second, instead of relying on an open interests based formula for determining position limits, we believe that the Commission should determine an acceptable aggregate level of speculation and set individual trader limits to be reflective of that aggregate level. The Commission should consider setting separate, lower position limits for passive long traders (*i.e.*, index funds, exchange traded funds, and other similar vehicles that generally buy without regard to price), and should require that positions of passive long speculators who follow the same trading strategy be aggregated for purposes of applying the position limits. In moving forward with a phased approach for implementing position limits, the Commission needs to assess all of its data requirements and to assure that necessary data to support full analysis of speculative position limit issues will be available to the Commission.

Additionally, PMAA and NEFI are concerned that the non-spot month position limits that would result from the final rule would be so high as to be ineffective. The Commission acknowledges that the proposed framework sets high position levels. These levels are equivalent to the largest positions held by market participants. PMAA and NEFI believe the proposed position limits fail to address the overall impact of speculators on the futures, options and swaps markets. Position limits that only target very large positions intended to manipulate the market do not address the problem of the cumulative effect of a large number of speculators with significant positions. PMAA and NEFI also believe that the CFTC should retain exclusive discretion in determining "deliverable supply" for the purposes of establishing speculative position limits. When determining "deliverable supply" and when formulating limits, the Commission should consult with and solicit information from market experts, including appropriate governmental entities (*i.e.*, the Department of Energy's Energy Information Administration and the U.S. Department of Agriculture) and academics. The final rule did not incorporate our concerns with estimation of deliverable supply.

8. PMAA-NEFI Support Delta Airlines' Stance on Position Limits

We note that Delta Airlines Comment letter regarding the 2010 Proposed Rules on Speculative Position Limits (Apr. 26, 2010) pointed out that in 2000 the percentage of hedging open interest to speculative open interest in the oil market was estimated to have been approximately 61 percent hedgers to 39 percent speculators. During the 2000 to 2003 time period, which is the period immediately prior to the unprecedented run-up in speculative trading, the market functioned well and was orderly. There is no evidence of insufficient liquidity for hedgers during this period. In contrast, it is estimated that by 2009 the percentage of hedging open interest to speculative open interest essentially reversed, although the amount of hedging open interest stayed relatively constant.

Delta Air Lines offered an illustrative methodology for this calculation in its advance comment letter filed with the CFTC.³ The basic concept is that speculative activity above the amount necessary to provide market liquidity for the trading of bona fide hedgers and to provide for efficient price discovery is, by definition, excessive. Specifically, for the oil futures market, the period between 2000 and 2003 is identified as the most recent period during which the futures market operated in an orderly manner. During this "base period," in the case of the oil futures market, hedgers constituted approximately 60 percent of the market open interest and speculators constituted the remaining approximately 40 percent. Delta Air Lines recommended establishing a "Speculative Open Interest Target" on an annual basis by looking at the immediately preceding year's hedging open interest and calculating the amount of speculative open interest that would be necessary to maintain the same ratio between hedging and speculative trading as existed during the base period. The speculative position limit level that applies to individual traders would then be set at a level intended in very rough terms to maintain this ratio of speculative to bona fide hedging trading, thus meeting the four criteria of the Dodd- Frank Act. PMAA and NEFI endorse Delta Air Lines suggested methodology.

Conclusion

Ultimately, affordable consumer energy will not result from what the CFTC finalized recently. A number of other factors play into affordable energy including an all of the above approach on energy policy which includes oil exploration, increased use of alternatives such as ethanol and biodiesel, and a sound monetary policy coupled with a well-regulated, transparent, and stable energy futures and swaps market.

We and our customers need you and the CFTC to take a stand against excessive speculation that artificially inflates energy prices. We appreciate the work that has been done to date and look forward to working with members of this Subcommittee and the CFTC to ensure that end-users are heard first, not Wall Street banks. Many PMAA members rely on these markets to hedge product for the benefit of their business planning and their consumers. Reliable futures markets are crucial to the entire petroleum industry. Let's make sure that these markets are competitively driven by supply and demand.

Thank you again for allowing me the opportunity to submit these comments on behalf of PMAA and NEFI.

³ Advance comment letter from Delta Air Lines, Inc. (Dec. 13, 2010) at 8-14, available at http://www.cftc.gov/ucm/groups/public/@swaps/documents/dsubmission/dsubmission26_121310-1.pdf



Consumer Federation of America

November 3, 2011

The Honorable Carl Levin
Chairman
Committee on Homeland Security and Governmental Affairs
Address
Address

Chairman Levin and Members of the Committee,

In the three weeks since we prepared the attached study of oil price speculation, the price of crude oil has increased by over \$17 per barrel, which leads us to conclude that our estimate that U.S. households will spend a record \$2900 on gasoline this year is on the low side.

In the three weeks since we prepared the attached study, big oil (ExxonMobil, Chevron, Shell, BP, Conoco), which always profits from high oil prices, reported an increase of \$50 billion in profits from January to September 2011 compared to the same period in 2010. This underscores the gross inequities and economic distortion that excessive speculation imposes on the American people and the economy.

Market fundamentals cannot explain these price movements or obscene oil company profits. This pricing behavior is the result of the "financialization" of commodities and the failure of regulators to prevent excessive speculation. The shenanigans on Wall Street are devastating Main street. Needlessly high prices for petroleum products will drain about \$200 billion out of the economy. Since consumer spending is the main driver of the U.S. economy, when speculators, oil companies, and OPEC rob consumers of that much spending power, the inevitable result is a dramatic reduction of economic activity and employment.

In the three weeks since we prepared the report the Commodity Futures Trading Commission adopted rules that, while a step in the right direction, are far too timid to control excessive speculation. These hearings must be the start of a process in which Congress demands much stronger and more aggressive measures to reign in excessive speculation and return commodity markets to their proper function, which is to support the real economy.

The complete report is available at
www.consumerfed.org/pdfs/SpeculationReportOctober13.pdf. Should you have any questions or need additional information please feel free to contact us at (202) 387-6121.

Sincerely,

Dr. Mark Cooper
Director of Research
Consumer Federation of America

1620 I Street, N.W., Suite 200, Washington, D.C. 20006 (202) 387-6121 Fax (202) 265-7989
www.consumerfed.org

Permanent Subcommittee on Investigations

EXHIBIT #11



Consumer Federation of America

1620 I Street, N.W., Suite 200 • Washington, DC 20006

EXCESSIVE SPECULATION AND OIL PRICE SHOCK RECESSIONS

A CASE OF WALL STREET “*DÉJÀ VU*” ALL OVER AGAIN

Mark Cooper
Director of Research

October 2011

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Executive Summary

PURPOSE

Since the oil price spikes of 2001 the Consumer Federation of America has been calling on federal regulators to protect consumers from the ravages of market power and excessive speculation that afflict a commodity that is vital to daily life and a huge factor in household budgets. The Commodity Futures Tradition Commission (CFTC) is poised to adopt a rule that could significantly reduce the blight of excessive speculation, if it places meaningful limits on the amount of oil that large speculators are allowed to hold under contract in commodity markets.

This paper examines the causes and consequences of the oil price spike of 2010-2011. It begins with an estimate of the burden that speculative bubbles in energy commodities place on American consumers and the economy. By building on analyses and testimony offered by the Consumer Federation of America during the rapid expansion of oil commodity market trading and the escalation of price in the mid-2000s, the paper shows that excessive speculation, not market fundamentals caused the spike in oil prices. The movement of trading and prices in the three years since the speculative bubble in oil burst in 2008 provides even stronger evidence that excessive speculation is a major problem that afflicts the oil market and the economy.

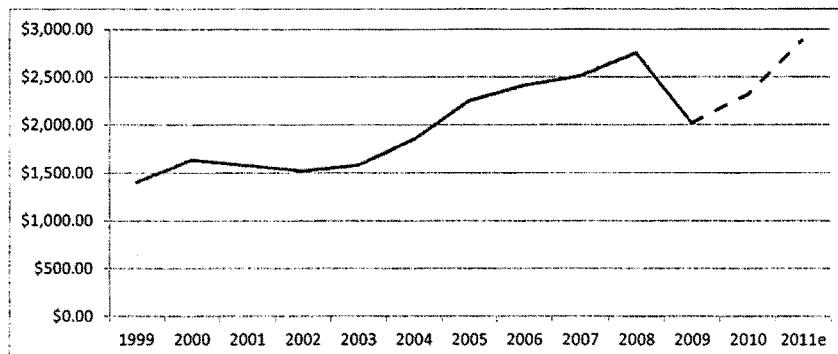
The deregulation of trading and the relaxation of rules on banks in the early 2000s that "financialized" commodities are identified as the policies that triggered excessive speculation. For decades, commodity markets had provided a mechanism to smooth the flow of commodities between those who produce them and those who consume them. The "financialization" of commodities undermined the proper functioning of commodity markets,

Failing to provide effective oversight of speculation, policy makers allowed the enrichment of Wall Street speculators through financialization of commodities like oil, at the expense of the real economy on Main Street. Thus, the paper offers a powerful justification for the CFTC to establish strong position limit rule as a means of protecting consumers and the economy from the severe harm that oil price spike driven by excessive speculation cause.

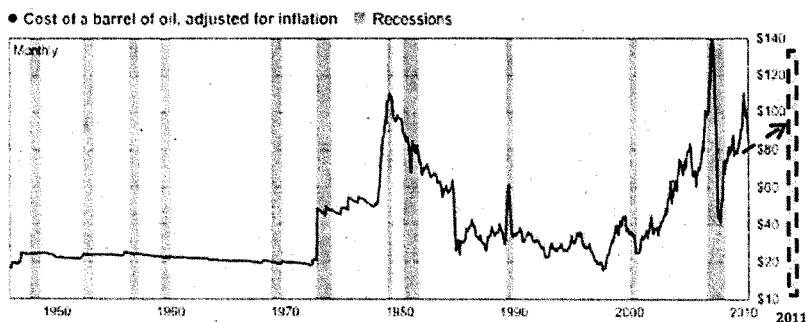
The Impact of Excessive Speculation

Section II finds that excessive speculation in crude oil commodity markets will result in household gasoline expenditures that will set a record high in 2011, as shown in Exhibit ES-1. As a result speculation will add \$600 to the average household expenditures on gasoline in 2011, resulting in the highest level of spending ever of almost \$2900.

However, gasoline accounts for less than half of all oil products consumed in the U.S. When the cost of other petroleum products that ultimately end up in the goods and services that consumers purchase are included the burden will be more than twice as heavy. With excessive speculation adding about \$30 per barrel to the cost of oil in 2011, the total drain on the economy from speculation driven excessive costs rises to more than \$200 billion this year. That \$200 billion price tag for excessive speculation is equal to over 1 percent of gross domestic product and 2 percent of consumer spending. Transferring that much purchasing power from consumers on Main Street to speculators on Wall Street puts a severe drag on the economy. As shown in Exhibit ES-2, the five previous oil price spikes since World War II have all resulted in recessions. Whether or not the current price spike sends the economy into recession, it is clear that rising oil prices have already dampened economic growth.

EXHIBIT ES-1: ANNUAL HOUSEHOLD EXPENDITURES ON GASOLINE (REAL \$2010)

Sources: Bureau of Labor Statistics, *Consumer Expenditure Survey*, various issues; Energy Information Administration, *Prices, Gasoline*; Short Term Energy Outlook, September 7, 2011.

EXHIBIT ES-2: OIL PRICE SHOCKS AND ECONOMIC RECESSIONS

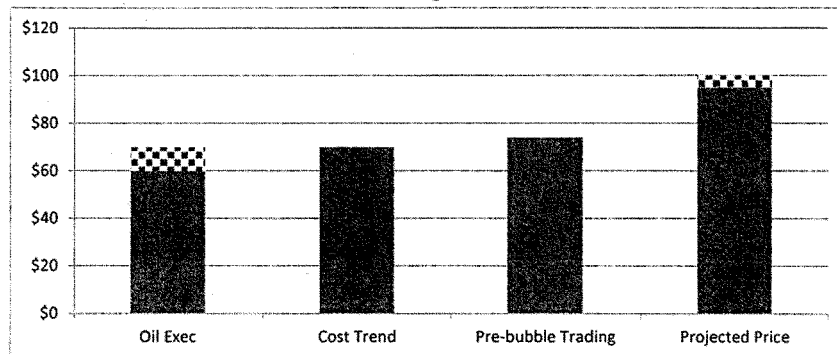
Source: Jeff Rubin, "Oil Prices Caused the Current Recession," *The Oil Drum*, November 5, 2008, 2012 price and recession added by author

We use three approaches to estimate the size of the speculative premium consumers are paying – oil industry estimates of the cost of crude, the long term trend of costs and pre-Bubble trading. As shown in Exhibit ES-3, absent excessive speculation, the price of crude would be in the range of \$60 to \$75 per barrel. With crude prices likely to be in the range of \$95-\$100 per barrel in 2011, a speculative premium of \$30/bbl is reasonable to use as a basis for estimating the effect of excessive speculation. Additional evidence from market analysts also support this estimate

Market Fundamentals are Not Good Predictors of Oil Prices in the 2000s

Section III examines trends in oil prices, cost and supply and demand factors to demonstrate that "market fundamentals" ceased to be good predictors of oil prices in the mid-

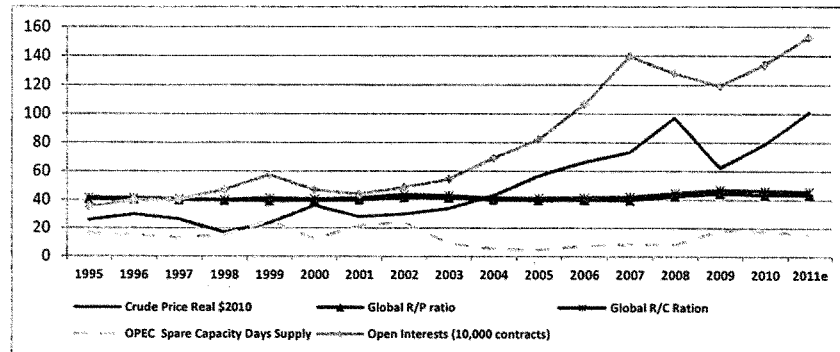
Exhibit ES-3: Estimated 2011 Price of Crude Compared to Estimated 2011 Prices, without Excessive Speculation



Source: See Sections III and IV for the methods used to derive these estimates; hatched areas are high estimates.

2000s. As shown in Exhibit ES-4, not only did oil prices fail to track costs during the speculative bubbles of 2002-2008 and 2010-2011, but the other “market fundamentals” were generally constant over the decade of the 2000s. To the extent that there were changes in these fundamentals, they were either out of sync with the direction of change in price or moving in the wrong direction.

EXHIBIT ES-4: MARKET FUNDAMENTALS, TRADING VOLUMES AND THE PRICE OF CRUDE



Source: BP Statistical Review of World Energy, Full Report, June 2011, Richard Newell, *Energy and Financial Market Overview: Crude Oil Price Formation*, May 5, 2011, p. 29, EIA, *Performance Profiles of Major energy Companies*, Finding Costs; Commodity Futures Trading Commission, <http://www.cftc.gov/MarketReports/CommitmentsOfTraders/Index.htm>, Energy Information Administration, Cushing Crude Future, contract 1, http://www.eia.gov/dnav/pet/pet_pri_fut_s1_d.htm.

Over the course of the last decade, the global reserve to production and reserve to consumption ratios were almost flat. In fact, they were rising slightly over the decade. OPEC spare capacity, measured in terms of the number of days of spare capacity to meet global demand, shows some variation over the decade. However, the low levels of spare capacity in the early part of the

decade occurred well before the major price run up began. On the other hand, in recent years spare capacity is relatively high, when prices are rising. This hardly seems to be a good candidate to explain rising prices. Even using OPEC spare capacity to predict prices, it does not suggest a price above \$60.

Trading as a predictor of Price

Section IV examines the role of trading and speculation in triggering dramatic increases in the level and volatility of crude oil prices. Exhibit ES-4 includes the trading changes along with the market fundamentals. It is obvious to the naked eye that trading tracked prices and fundamentals well until the mid-2000s. When fundamentals lost touch with price, trading and prices continued to vary together. Clearly, the normal relationship between cost fundamentals and price was disrupted in the mid-2000s and increases in trading activity are a good candidate for the cause of the change. Statistical analysis confirms the obvious; trading is a better predictor of price than market fundamentals. In 2004 the number of contracts began to increase more quickly than the historical trend. Then in 2006 through mid-2008, trading increased dramatically. During the gyrations of crude prices in the past half-decade, price has tracked trading much more closely than cost.

The size of the increase in trading is quite remarkable, given that there had been a stable market for decades. From 2003 to the peak in 2008, the number of barrels of oil under contract increased three-fold. Moreover, since the value of oil was also increasing dramatically, the amount of money flowing into this market was even larger. From the end of 2003, when the total value of open interests was about \$19 billion, until the peak in mid-2008, when the value of open interests was over \$154 billion, there was an eight-fold increase in the size of the market. This is a classic bubble.

The bursting of the bubble was equally dramatic. In the third quarter of 2008, as pressure from congress and the public outcry over oil prices forced the Commodity Futures Trading Commission to begin investigating excessive speculation, speculative money fled the market. By mid-September, before Lehman Brothers went bankrupt precipitating the financial meltdown, the oil price bubble had burst. In just three months, the value of open interests had declined by about 50% and the price of oil had fallen over 50%. By the end of the year, the bubble had completely deflated. The price of WTI crude was down to \$38/bbl and the value of open interests was down to \$43 billion. The amount of money that had exited the commodity market in just six months was five times as large as the entire market five years earlier. This is a classic bubble bursting.

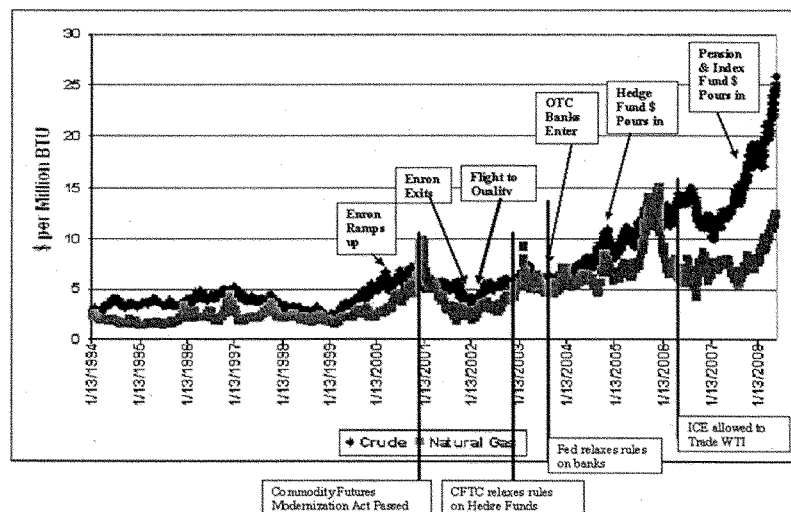
The policies necessary to prevent a recurrence of the bubble and burst cycle have not yet been adopted and the inaction has allowed the bubble to reflate. The value of open interests has been rising sharply for almost a year, and reached \$150 billion at the peak, almost twice what it was in early 2010.

Bad Policy Opened the Door to Excessive Speculation

Section IV describes the policies that allowed the radical change in commodity markets. As shown in Exhibit ES-5, a series of policy decisions opened the door to excessive speculation and huge quantities of funds flowed into the oil futures market. The influx of funds was the result of the new types of traders who entered the market and the "financialization" of the commodities.

The rapid rise and fall of Enron should have been a loud warning that the “Enron Loophole” and its “asset-lite” business model were dangerous, but policy makers did not heed it. After the Enron bankruptcy and the recession of 2001-2002 had driven money out of commodity markets in what was ironically called “a flight to quality,” traders were ready to re-enter the energy markets. Instead of restoring sound regulation, policy makers relaxed rules that had restricted access to these markets to allow the big commercial banks and hedge funds to enter. Goldman Sachs and Morgan Stanley who were progressively deregulated throughout the 2000s led the charge. They generated huge profits and bonus pools that attracted the interest of a wide range of investors. When oil futures became an investment good, with skyrocketing prices driving huge Wall Street profits, index traders and pension fund money flowed in to further inflate the bubble.

EXHIBIT ES-5: PUBLIC POLICY AND THE INFLUX OF SPECULATIVE FUNDS



Source: The Failure of Federal Authorities to Protect American Energy Consumers From Market Power and Other Abusive Practices, *Loyola Consumer Law Review*, 19:4 (2007).

Policies to Prevent Excessive Speculation

Section V explains the economic mechanisms that link the increase in the volume and volatility of trading to higher prices. It offers a brief discussion of policy recommendations. As noted above, because the problem was created by bad policy, it can and must be fixed by good policy. An essential first step is adoption of a strong position limit rule by the CFTC. This will reduce the amount of trading and prevent a few very large traders from putting upward pressure on prices.

I. INTRODUCTION

PURPOSE

Since the oil price spikes of 2001 the Consumer Federation of America¹ has been calling on federal regulators to protect consumers from the harm of market power and excessive speculation that afflict a commodity that is vital to daily life and a huge factor in household budgets. This paper shows that the immense burden that speculative bubbles in energy commodities place on American consumers not only ravages household budgets, it dampens economic growth and destroys jobs.

The paper builds on and extends analyses and testimony offered by the Consumer Federation of America, during the rapid expansion of oil commodity market trading and the escalation of price in the mid-2000s.² The explanation offered at that time showed that excessive speculation was a major cause of the wild gyrations of oil prices. The movement of trading and prices in the three years since the speculative bubble in oil burst in 2008 provides even stronger evidence that excessive speculation is a major problem that afflicts the oil market.

The Commodities Futures Trading Commission (CFTC) is poised to adopt a rule that could significantly reduce the harm of excessive speculation,³ if it places meaningful limits on the amount of oil that large speculators are allowed to own (positions limits). This paper makes the case for strong rules to dampen excessive speculation. Position limits are one of several important tools to accomplish this goal.

¹ CFA is an association of more than 300 consumer organizations, low income, and nonprofit groups, formed in 1968 to advance the consumer interest through research, education, and advocacy.

² The major pieces of testimony include: "Testimony of Mark Cooper, Oversight of Energy Markets and Oil Futures Contract," Joint Hearing of the Senate Appropriations Subcommittee on Financial Services and General Government and the Committee on Agriculture, Nutrition and Forestry United States Senate, June 17, 2008; "Testimony of Mark Cooper on Excessive Speculation In Energy Commodities," Agriculture Committee, United States House of Representatives, July 10, 2008; "State Regulators, Commodity Markets, And The Collapse Of Market Fundamentalism," Joint Session of the Consumer Affairs and Gas Committees on "Excessive Speculation in Natural Gas Markets: How To Safeguard Consumers," National Association of Regulatory Utility Commissioners, February 17, 2009; "Statement of Mark Cooper on Excessive Speculation in Commodity Market and the Collapse of Market Fundamentalism," Permanent Subcommittee on Investigations Committee on Homeland Security and Government Affairs, Hearing on Excessive Speculation in the Wheat Market, United States Senate, July 21, 2009.

Broader analyses of energy markets include: Mark Cooper, *The Role of Supply, Demand and Financial Commodity Markets in the Natural Gas Price Spiral*, (A Report Prepared for the Midwest Attorney General Natural Gas Working Group, Illinois, Iowa, Missouri, and Wisconsin, March, 2006); *The Role of Supply, Demand, Industry Behavior and Financial Market in the Gasoline Price Spiral* (for the Wisconsin Attorney General, August, 2006); *The Failure of Federal Authorities to Protect American Energy Consumers From Market Power and Other Abusive Practices*, *Loyola Consumer Law Review*, 19:4 (2007).

Examination of the broader issue of excessive financialization and the collapse of market fundamentalism can be found in, "Testimony of Dr. Mark Cooper Too Big to Fail? The Role of Antitrust Law in Government-Funded Consolidation in the Banking Industry," Subcommittee on Courts and Competition Policy, Committee on the Judiciary, United States House of Representatives, March 17, 2009; "Testimony of Barbara Roper before the Senate Banking Committee regarding Enhancing Investor Protection and the Regulation of Securities Markets," March 26, 2009; Mark Cooper and Barbara Roper, *Reform of Financial Markets: the Collapse Of Market Fundamentalism and the First Steps to Revitalize the Economy*, (Consumer Federation of America, April 2009).

³ Keefe, Bruyette & Woods, *Exchange Order Execution*, *North American Equity Research*, September 6, 2011.

Outline

The paper is organized as follows. Section II uses an estimate of the size of the price spike of 2010-2011 caused by excessive speculation to measure the burden that it places on household budgets and the harm that it does to the economy. This establishes the fact that excessive speculation is an important problem that deserves careful attention and vigorous efforts from policy makers to reduce or eliminate the problem.

Section III examines the role of market fundamentals in the recent price spikes. It shows that trends in oil production costs, supply, demand and spare capacity do not provide good explanations for the recent gyrations in price.

Section IV shows that trading behavior tracks more closely to the recent changes in prices than market fundamentals. The discussion moves beyond correlation to identify the policy decisions that triggered the explosion of trading.

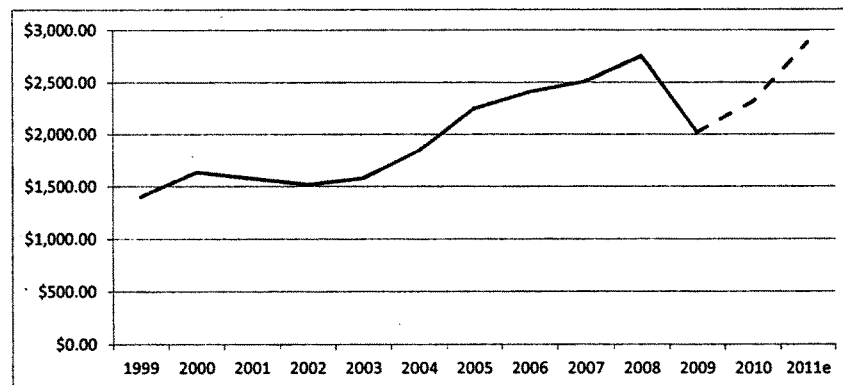
Section V explains the economic mechanisms that link the increase in the volume and volatility of trading to higher prices. It concludes with a brief discussion of policy recommendations.

II. THE IMPACT OF OIL PRICE SPIKES ON HOUSEHOLDS AND THE ECONOMY

Increased Cost for Consumers and the Economy

Using the latest estimates for gasoline prices from the Energy Information Administration and for gasoline consumption from the Bureau of Labor Statistics, we estimate that American households will spend more on gasoline in 2011 than ever – almost \$2,900.⁴ Even adjusted for inflation, as shown in Exhibit II-1, this is more than households spent in 2008, which was the last time excessive speculation gripped the oil market. Based on the estimates of excessive crude prices provided in the next section, gasoline prices will be too high by 70 cents per gallon this year. That means that the average household will spend almost \$600 more on gasoline than it would have if prices had not been distorted by excessive speculation.

EXHIBIT II-1: ANNUAL HOUSEHOLD EXPENDITURES ON GASOLINE (REAL \$2010)



Sources: Bureau of Labor Statistics, *Consumer Expenditure Survey*, various issues; Energy Information Administration, *Prices, Gasoline*; *Short Term Energy Outlook*, September 7, 2011.

Since gasoline represents less than half of all petroleum product supplied, and the cost of other petroleum products ultimately ends up in the prices of goods and services that consumers purchase, the total burden on households will be more than twice as high. Using an estimate of \$30/bbl as the increase in crude prices caused by excessive speculation, the oil price bubble will rob consumers of over \$200 billion this year.

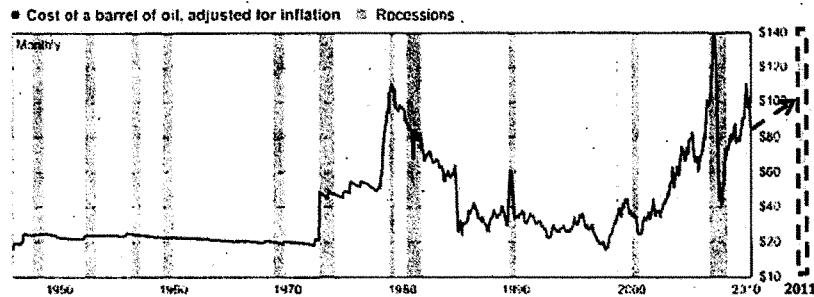
The Recessionary Impact of Oil Price Spikes

When speculation induced price spikes enrich Wall Street commodity traders, oil companies and OPEC by draining purchasing power out of the economy, the ultimate effect is to lower economic growth and reduce employment. In fact, as shown in Exhibit II-2,

⁴ This estimate of consumption is adjusted downward to account for the price elasticity of demand.

every major oil price spike since World War II has been followed by an economic recession and four of the past five recessions have been preceded by a major oil price increase. It would appear that the price increase of late-2010/early-2011 may make it six out of seven.⁵

EXHIBIT II-2: OIL PRICE SHOCKS AND ECONOMIC RECESSIONS



Source: Jeff Rubin, "Oil Prices Caused the Current Recession," *The Oil Drum*, November 5, 2008, 2012 price and recession added by author

In the current environment, where household budgets are already under extreme strain because of the bursting of the housing bubble and high levels of unemployment, the economy is even more fragile than before the last speculation induced recession. Thus, high oil prices are more likely to impose hardship on consumers and do damage to the economy. Even if we do not fall into a recession, there is no doubt that economic growth and employment will suffer as a result of the oil price shock.⁶

The speculation driven oil price spike of 2007-2008 resulted in the largest price spike in absolute terms ever, even larger than the OPEC oil embargo and the fall of the Shah of Iran. The following recession that followed the 2007-2008 oil price spike, was the worst recession since the great depression. Of course, the financial meltdown played a big part in the severity of the recession. However, as discussed below, the speculative bubble in oil

⁵ Vivienne Walt, "Is the Fed to Blame for Soaring Global Oil Prices?", *Time*, January 7, 2011. Here we go again: the spike in global oil prices that preceded the Great Recession is being repeated. Just three years ago, the price of oil futures on the New York Mercantile Exchange hit \$100 per bbl. for the first time, bringing dire warnings about looming economic hardship. Sure enough, the world economy entered its worst downturn since the Depression just months after oil prices peaked at a record \$147 per bbl. in July 2008. Now the doomsayers are back, as oil futures crept above \$92 per bbl. this week — their highest level since 2008....Fatih Birol, chief economist at the Paris-based International Energy Agency, which represents the world's industrialized oil-consuming countries, warned on Monday, Jan. 3, that oil prices are expected to reach \$100 per bbl. again soon, threatening the economic recovery by hugely increasing the energy bills of countries, factories, cities and drivers.

⁶ Gregory White, "Barclays on How the Oil Price Spike Could Crash the HousingMarket Again," *Business Insider*, March 6, 2011; Robert Rapier, "The vicious Circle of Oil Price Induced Recessions," *OilPrice.com*, April 12, 2011; "The 2011 Oil shock: More of a Threat to the World Economy Than Investors Seem to Think," *The Economist*, March 3, 2011; James Cook, "When Oil Prices Double: Recession Often Follows," *The Fiscal Times*, April 25, 2011; Alex Koalski, "Consumer Spending in the U.S. Unexpectedly Stagnated in May as Prices Climbed," *Bloomberg*, June 27, 2011, "consumer spending unexpectedly stagnated in May as employment prospects dimmed and rising inflation caused Americans to cut back...Economic growth slowed in the first quarter after surging energy costs strained consumer finances."

burst before the financial meltdown and the onset of the recession. Moreover, both the speculative bubble and the financial meltdown teach the same lesson – excessive financialization poses a serious threat to the real economy.

One of the primary manifestations of the economic slowdown caused by oil price spikes is a reduction in employment. Estimating job impacts has become a national pastime in which we choose not to engage. The multipliers of spending depend on many factors, but rising gasoline prices are particularly burdensome. They not only reduce household budgets, but much of the money leaves the economy to pay for imported oil. Increasing profitability of oil companies and the earning of speculators are likely to have much smaller multiplier effects than consumer spending. This is a primary reason that past oil price spikes have invariably caused recession and that the 2008-2009 recession was so severe. We believe that any reasonable consumer spending multiplier will show that there are hundreds of thousands of jobs at risk.

Early in the spring, an analyst from Barclays, summed up the potential harm of rising oil prices and made it particularly relevant by drawing a link between oil prices and the housing crisis, which was still ongoing, drawing together the key themes of reduced consumption expenditure, the outflow of resources from oil importing nations, and the severe impact that the 2008 price spike had on the economy.

The main effect is on consumption via gasoline and energy prices. As consumption in general accounts for 60% of GDP, the effect is large. In oil exporters this effect will be offset by windfall revenues from the higher oil prices, so the overall effect is unclear. In our view, the oil price increase in 2008 significantly contributed to the recession and the financial crisis in the U.S., which then spread globally. By raising CPI inflation, it reduced real disposable income and, hence, the purchasing power of the average households, leading to a contraction in real consumer spending and lowering the ability to repay mortgages.⁷

The inability to afford the oil price increase plays an important part in James Hamilton's explanation of why the oil price increase of 2007-2008 caused a recession. Hamilton charts the impact of oil price increases on key consumer durables like autos and housing, both of which were devastated by the great recession. With households and the economy still vulnerable as a result of the "great recession" it is reasonable to suggest that the effect of the 2010-2011 price spike will be swifter and larger than the historical pattern.

⁷ Gregory White, "Barclays on How the Oil Price Spike Could Crash the Housing Market Again," *Business Insider*, March 6, 2011.

⁸ Causes and Consequences of the Oil Price Shock of 2007-08," *Brookings Papers on Economic Activity*, spring, 2009, p. 38)

III. THE ROLE OF MARKET FUNDAMENTALS IN THE RECENT PRICE SPIKES

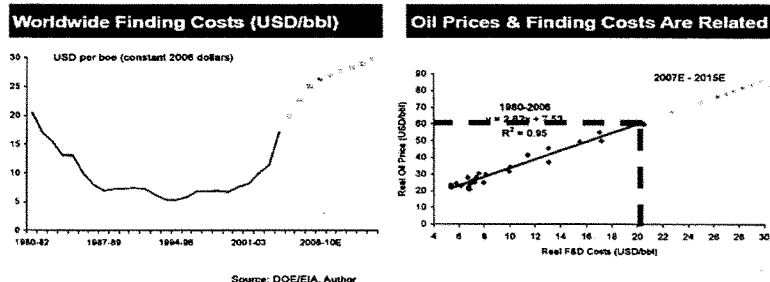
This section examines the role of market fundamentals in the recent price gyrations. It begins with the cost of production, and then examines other market factors.

Cost

Exhibit III-1 presents the trend of crude oil costs presented in Congressional testimony by an independent oil industry analyst in 2008, at the height of the previous oil price spike. This analysis was included in our 2008 testimony because it provides an independent estimate of the cost of crude.⁹ The underlying data is from the Energy Information Administration. The most recent data available at the time was for 2006. The EIA data is presented in three year moving averages.

Exhibit III-1:

What Does It Cost to Find a Barrel?



Testimony of Adam Sieminski, Subcommittee on Oversight and Investigations, Committee on Energy and Commerce, U.S. House of Representatives, June 23, 2008, p. 7.

The point of Sieminski's analysis was to respond to a Goldman Sachs projection of \$200 dollar oil in the 2012-2013 time frames that was getting a lot of attention at the time.¹⁰ The author projected a continuation of increases through 2015 and concluded that a cost of "\$80/bbl in the 2012-2013 time frame is very consistent with this data" and that the figure of \$200/bbl "seems like a stretch." Looking at the data available for the most recent period (2006-2008) a price of about \$60/bbl was consistent with the historical trend.

⁹ The implied price of crude of \$75 per barrel is consistent with the direct estimate of the relationship between finding and development costs of \$25 dollars per barrel, in the Sieminski Analysis presented to the Subcommittee on Oversight and Investigations.

¹⁰ Goldman Sachs engaged in a series of releases hyping high prices over the spring of 2008, ending with the prediction of \$200 oil. As discussed below, Goldman Sachs was the key speculator during the spike, as discussed in section IV. Global: Energy: Oil, \$100 Oil Reality, part 2: Has the Super-Spike End Game Begun?, May 5, 2008; Morgan Stanley, Commodity Shipping: Current Crude Oil Shipping Patterns Suggest \$150/bbl WTI by July 4th, June 5, 2008; Javier Blas and Chris Flood, "Analyst warns of oil at \$200 a barrel," *FT.Com*, May 6 2008

Sieminski's analysis, based on EIA data, was supported by an analysis prepared by the Japanese Ministry of Economy Trade and Industry (METI). The oil, free of the distortion of excessive speculation, was in the range of \$50-\$60 per barrel.

According to the METI paper, during the second half of 2007, when the physical price of West Texas Intermediate crude averaged \$US90 a barrel, market speculation, geopolitical risk and currency factors were responsible for \$US30-\$US40 of the price.

The average WTI "fundamental price," consistent with the underlying supply/demand situation, was around \$US60/barrel during the December half-year, according to the paper, citing research for the Institute of Energy Economics in Japan.

Last week the benchmark WTI futures contract touched \$US135/bbl, more than double the level of a year previously.

"We cannot say exactly what the fundamental price is at the moment," a METI official said yesterday. "But we believe the increases this year in the market price have much to do with the influx of speculative money."

Oil industry executives, testifying in April 2008 said that the price should be in the range of \$35 to \$90, with a mean of less than \$60.¹¹

Sieminski assumed that crude oil finding costs would continue to increase. In fact, contrary to the expectation at the time, in 2009 the EIA found that "average worldwide finding costs for the FRS companies decreased \$5.79 per boe (barrel of oil equivalent) of reserves added in the 2007-2009 period compared to the 2006-2008 period." Interestingly, North American supplies of oil exhibited large cost reductions. "The U.S. Offshore, fell the most in 2007-2009, \$23.02, and lost its position as the highest cost region. Canada displayed a large decline in part likely because of the inclusion of oil sands in 2009.- Although data for 2010 and 2011 are not yet available from the EIA, other sources indicate that, while finding costs rose in 2010, they had not reached the level that obtained in 2006-2008."¹²

Exhibit III-2 extends the long term cost trend to 2010 and 2011. It uses the relationship between the EIA data for the period from 1994-2009, adds in the increase observed in 2010, and assumes that finding costs increase at the underlying rate projected by Sieminski, but from the lower observed base in 2009. This puts the cost in 2011 at \$70 per barrel. In fact, recently the CEO of Exxon testified that absent speculation, the cost of oil would be in the range of \$60-\$70 per barrel. Thus absent excessive speculation, the price of crude would be in the range of \$60 to \$75 per barrel. With crude prices likely to be in the range of \$95-\$100 per barrel in 2011, a speculative premium of \$30/bbl is

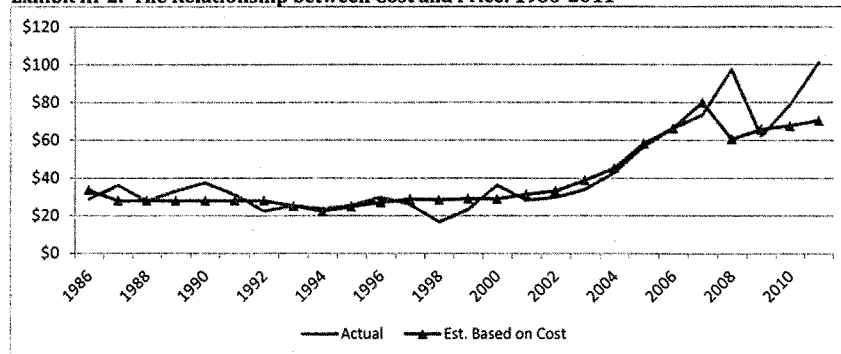
¹¹ Peter Alford, "Japan Blames Speculators for Oil Hike," May 28, 2008, reporting on Akira Yanagisawa, *Decomposition Analysis of the Soaring Crude Oil Prices: Analyzing the Effects of Fundamentals and Premium* (Institute of Energy Economics, March 2008).

¹² J. Stephen Simon, Senior Vice President ExxonMobil, put the cost at \$50-\$55. John Hofmeister, President of Shell Oil Co. put the cost at \$35-\$60 per barrel. John Lowe, Executive Vice President of ConnocoPhillip, put the figure at \$90 per barrel, which appears to include OPEC cartel rents (Select Committee on Energy Independence and Global Warming, April 1, 2008).

¹³ Walt, "Soaring Global Oil Prices."

reasonable to use as a basis for estimating the effect of excessive speculation. Additional evidence from market analysts also supports this estimate. Thus, using \$30/bbl as the size of the speculative bubble is conservative.

Exhibit III-2: The Relationship between Cost and Price: 1986-2011



Source: EIA, Performance Profiles of Major energy Companies, Finding Costs; Energy Information Administration, Cushing Crude Future, contract 1, http://www.eia.gov/dnav/pet/pet_pri_fut_s1.d.htm

The bottom line take away from this cost analysis is that for a couple of decades, from the mid-1980s until the mid-2000s, there was a very close relationship between the cost fundamentals and the price of crude. Clearly, the normal relationship between cost fundamentals and price was disrupted in the mid-2000s. In the next section we show that increases and wild gyrations of commodity trading are much better candidates to explain the radical shift in prices.

Supply, Demand and Excess Capacity

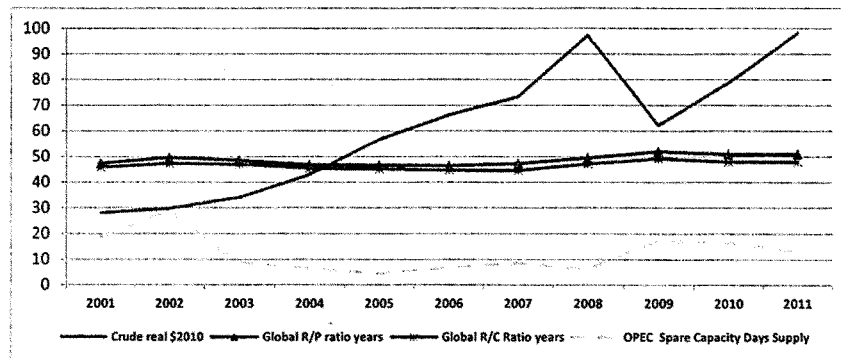
While cost is a critically important market fundamental, there are other market forces that are offered as explanations for the recent price spikes.¹⁴ As shown in Exhibit III-3, over the course of the last decade, the reserve to production and reserve to consumption ratios were almost flat. In fact, they were rising slightly over the decade. As noted above, declining costs for North American supplies has played a role in keeping supply ratios up. New fields and technologies are playing a part as well compared to the early 2000s. In 2010-2011 supply and demand were not driving prices up.

OPEC spare capacity, measured in terms of the number of days of supply to meet global demand, shows some variation over the decade. However, the low levels of spare capacity in the early part of the decade occurred well before the major price run up began. On the other hand, in recent years spare capacity is relatively high, when prices are rising. Spare Capacity in 2011 was almost three times as high as 2008, measured in terms of days

¹⁴ Paul Krugman, "Fuel on the Hill," New York Times, June 27, 2008; Joe Nocera, "Easy Target, But Not the Right One," New York Times, June 28, 2008, p. B8; Sebastian Mallaby, "Nixonian Fallacy," Washington Post, June 30, 2008; Robert J. Samuelson, "Who's Behind High Prices," Washington Post, July 1, 2008.

of supply.¹⁵ This hardly seems to be a good candidate to explain rising prices. In fact, some observers of the market have noted that supplies and spare capacity are plentiful.

EXHIBIT III-3: MARKET FUNDAMENTALS AND THE PRICE OF CRUDE



Sources: Energy Information Administration, Cushing Crude Future, contract 1, http://www.eia.gov/dnav/pet/pet_pri_fut_s1_d.htm, Richard Newell, *Energy and Financial Market Overview: Crude Oil Price Formation*, May 5, 2011, p. 29.

Today, however, there is enough spare oil warehoused, and demand remains relatively weak after two years of recession. Even if supplies tighten, some specialists believe that more oil could be brought to the surface fairly quickly. Saudi Arabia, the world's biggest producer and the powerhouse of OPEC, which produces about 40% of the world's oil, is pumping well below its capacity. And as international oil companies revamp Iraq's giant fields after years of stagnation, growth in that country's output in the next few years will boost global supplies. "There is spare capacity in OPEC," says Olivier Jakob, managing director of PetroMatrix, an energy-analysis firm in Switzerland. "The financial picture is very different from 2008."

The current spike in oil futures, say Birol and Jakob, is a product of excess supply — of speculative dollars, billions of which are flowing into U.S. commodities markets.¹⁶

In fact, the correlation between OPEC spare capacity and prices is much weaker than the correlation we observe for speculation in the next section. Moreover, even if we use the best-fit relationship between OPEC spare capacity and the price of oil, we would project the price for crude in 2011 at considerably less than \$60, given the level of spare capacity, which is almost three times as high as it was in 2008.

This critique of market fundamental as an explanation for recent price spikes should not be misinterpreted as a claim that market fundamentals do not matter. They do, but not as explanatory factors for recent price spikes. Market fundamentals are important in two

¹⁵ National Bank financial Group, *Oil Price: OPEC Spare Capacity Greatly contrasts with 2008*, March 9, 2011.

¹⁶ Walt, "Soaring Global Oil Prices."

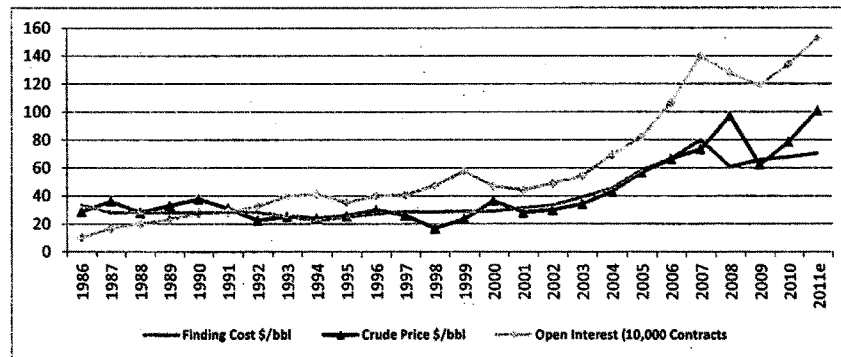
respects. First they influence the long term trend of prices. Second, as discussed in Section V, they create the conditions for excessive speculation. The basic conditions make the market vulnerable to manipulation and excessive speculation, which requires special vigilance from policy makers, vigilance they have failed to exercise.

IV. THE STRONG LINK BETWEEN SPECULATION AND PRICE SPIKES

Prices and Trading Covary Strongly

The alternative explanation for the wild gyrations of prices in the 2000s offered by CFA and supported by an increasing number of studies is that the growth of speculation increased the volume, volatility and level of oil (and commodity) prices. Exhibit IV-1 adds the number of open interest contracts for West Texas Intermediate crude oil to the earlier graph that showed price and global finding costs. Open interest is the standard measure of trading. Each contract represents 1,000 barrels of oil. West Texas Intermediate is the benchmark crude for U.S. oil prices.

EXHIBIT IV-1: OPEN INTERESTS IN WTI, CRUDE PRICES, AND FINDING COSTS



Source: Refiner Acquisition Cost, see Exhibit 2; Richard Newell, *Energy and Financial Market Overview: Crude Oil Price Formation*, May 5, 2011, p. 29.

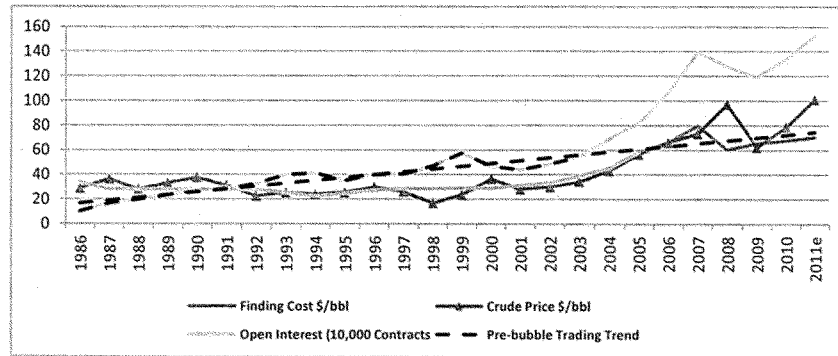
Trading, costs and prices moved closely together until early in the 2000s. In 2004 the number of contracts began to increase more quickly than the historical trend. The deviation of trading in 2004 above the underlying trend was the largest such deviation to date. Then in 2006 through mid-2008, trading increased dramatically. During the gyrations of crude prices in the past half-decade, price has tracked trading much more closely than cost.

The size of the increase in trading is quite remarkable, given that there had been a stable market for two decades. From 2003 to the peak in 2008, the number of barrels of oil under contract increased three-fold. Moreover, since the value of oil was also increasing dramatically, the amount of money flowing into this market was even larger. From the end of 2003, when the total value of open interests was about \$19 billion, until the peak in mid-2008, when the value of open interests was over \$154 billion, there was an eight-fold increase in the size of the market.

The bursting of the bubble was equally dramatic. In the third quarter of 2008, as pressure from congress and the public outcry over oil prices forced the Commodity Futures Trading Commission to begin investigating excessive speculation, speculative money fled the market. By mid-September, before Lehman Brothers went bankrupt precipitating the financial meltdown, the oil price bubble had burst. In just three months, the value of open interests had declined by about 50% and the price of oil had fallen over 50%. By the end of the year, the bubble had completely deflated. The price of WTI crude was down to \$38/bbl and the amount value of open interests was down to \$43 billion. The amount of money that had exited the commodity market in last six months of 2008 was five times as large as the entire market five years earlier. This is a classic bubble.

Based on the observation that the change in trading began in 2004, Exhibit IV-2 projects oil prices on the basis of the pre-bubble trend in 1986-2003. The price projected is quite close to the underlying cost trend. Once again, this analysis supports the conclusion that a substantial speculative premium is being extracted from consumers.

Exhibit IV-2: Projecting Prices Based on Pre-bubble Trends



Source: Refiner Acquisition Cost, see Exhibit 2; Richard Newell, *Energy and Financial Market Overview: Crude Oil Price Formation*, May 5, 2011, p. 29.

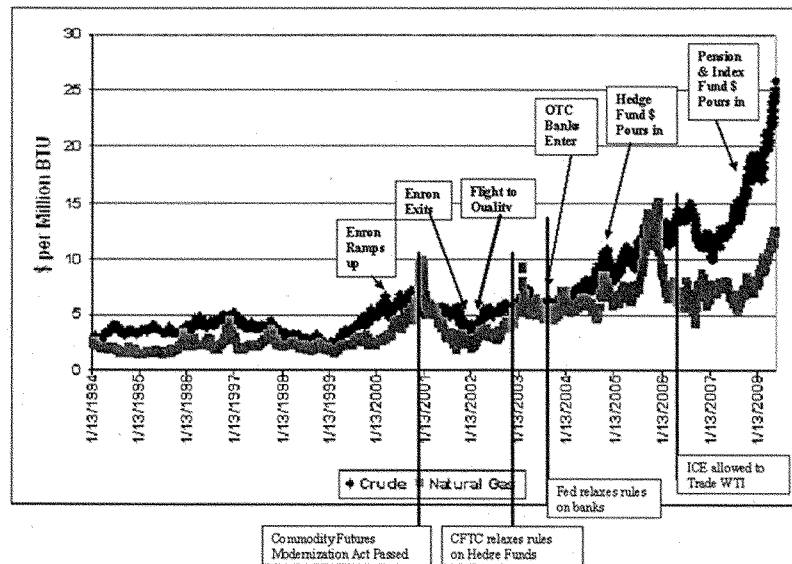
How Bad Policy Caused Excessive Speculation

This analysis shows that speculation is a very good candidate for the factor that is driving up oil prices and the radical change in trading patterns on the basis of the covariation of prices and trading activity. In our earlier testimony and analysis we have provided evidence to support interpreting this correlation as causation.

First, there was a set of policy decisions that opened the door to excessive speculation and huge quantities of funds flowed into the oil futures market through the openings provided by policy (See Exhibit IV-3). The influx into the oil trading market after 2005 was important not only because of the amount of money that poured into the market,

but also because of the new types of traders who entered the market, which brought about the "financialization" of the market as discussed below.

EXHIBIT IV-3: PUBLIC POLICY AND THE INFLUX OF SPECULATIVE FUNDS



Source: "Statement of Mark Cooper on Excessive Speculation in Commodity Market and the Collapse of Market Fundamentalism," Permanent Subcommittee on Investigations Committee on Homeland Security and Government Affairs, Hearing on Excessive Speculation in the Wheat Market, United States Senate, July 21, 2009.

The first major policy change was the passage of the Commodity Futures Modernization Act (CFMA). The CFMA made it more difficult to detect excessive speculation and market manipulation, and it opened the door to many other types of transactions that raise concerns.

Before passage of the bill in December 2000, the government retained authority over fraud and manipulation in the over-the-counter derivatives markets. In addition, market participants were restricted under Rule 35 from conducting over-the-counter markets like an exchange.

The CFMA was a major bill that drastically reduced the level of prudential regulation of derivatives markets. It reduced transparency and the government's surveillance abilities over exchange-traded derivatives, and it completely eliminated or

"excluded" federal derivatives regulation of the over-the-counter market. Enron operated in that completely deregulated environment."¹⁷

The prospects for manipulation increased substantially with the passage of the Commodity Futures Modernization Act of 2000 (Act). The Act authorized trading in single-stock futures and narrow-based index instruments, and the Act specifically permitted cash settlements. These new instruments will not necessarily have liquid underlying securities. Further, all else equal, fewer numbers of securities will be easier to manipulate than larger numbers."¹⁸

The rapid rise and fall of Enron should have been a loud warning alarm that the "Enron Loophole" and its "asset-lite" business model were dangerous, but policy makers did not hear it. After the Enron bankruptcy and the recession of 2010-2011 had driven money out of commodity markets in what was ironically called "a flight to quality,"¹⁹ traders were ready to re-enter the markets and policy makers invited them in. Policy makers obliged by relaxing rules that had restricted access to these markets.

In the post-Enron period the rules of entry were relaxed to let more entities into these lightly regulated or unregulated markets.

Some lawmakers and consultants argue the government has done little to shore up the energy markets most susceptible to manipulation. The Federal Reserve relaxed rules in 2003 so that Commercial banks like Citigroup would take possession of physical commodities like oil in storage tanks... The move allowed the banks to serve as dealers in commodity derivatives...

"It is an effort by banks to move into the terrain that Enron abandoned in their bankruptcy..."

As early as October 2002, less than a year after Enron declared bankruptcy, the Commodity Futures Trading Commission started to write rules exempting commodity hedge funds from regulatory oversight.²⁰

By late 2003 the big banks and large speculators began to enter and accelerate trading to deliver the consumer from the doldrums of low, stable prices.

Wall Street banks are notoriously fickle about their commitment to commodities trading. But the eye-popping profits earned by the market leaders, Goldman Sachs and Morgan Stanley, have spurred other banks to get into the game. In 2004, Goldman Sachs and Morgan Stanley earned about \$2.6 billion combined from commodities trading, most of that from energy.

The new hedge funds are sucking scarce talent away from the banks. At least 450 hedge funds with an estimated \$60 billion in assets are focused on energy and the environment, including 200 devoted exclusively to various energy strategies.²¹

¹⁷ Dodd, Randall, "Untangling Enron: The Reforms We Need," *Challenge*, March-April, 2002, pp. 72-73.

¹⁸ Hans R. Dutt and Lawrence E. Harris, "Position Limits for Cash-Settled Derivative Contracts," *Journal of Futures Markets*, 25: 2005, p. 948.

¹⁹ Peter Fusaro, "Hedge Funds: The Next Wave in Energy Trading," *PRMIA: Members Update*, July 2004, #7, p. 4.

²⁰ Alexei Barrionuevo, "Energy Trading, Without a Certain 'E'," *New York Times*, January 15, 2005, p. 3-3.

By mid-2004 a front page *Wall Street Journal* article entitled, "Oil Brings Surge in Speculators Betting on Prices" drew the connection between increasing trading activity and rising prices. It noted that oil had become an investment commodity.

Oil has become a speculator's paradise. Surging energy prices have attracted a horde of investors – and their feverish betting on rising prices has itself contributed to the climb.

These investors have driven up volume on commodities' exchanges and prompted a large push among Wall Street banks and brokerage firms to beef up energy trading capabilities. As the action picked up in the past year, those profiting include large, well-known hedge funds, an emerging group of high-rollers, as well as descendants of once-high flying energy-trading shops such as Enron Corp...²¹

The process of the continual influx of money results in too much money chasing too few goods. When risk capital seeking higher returns starts to chase a commodity that is relatively fixed in supply and demand in the short and midterms, it is hard to imagine that it will not have an impact on prices. In the same article from 2004, Alan Greenspan offered precisely this view of what had begun to happen in the financial markets.

"The marked rise in the net long positions of noncommercial investors in oil futures and options since May 2003 has increased net claims on an already diminished global level of commercial crude and produce inventories," said Federal Reserve Chairman Alan Greenspan in June of this year. Oil prices accordingly have surged."²²

Most attention was focused on oil because that was a more mature market, but the effect was seen as spreading to natural gas and other energy commodities.

More than 200 hedge funds already play or are set to play in energy commodities markets, and they are primed to bring more risk capital to bear in those markets. Evidence of their trading activities is already speculated to account for the much higher crude oil prices seen in recent months, and some analysts suggest that hedge fund activity may account for up to \$8 per barrel of total price. Additional evidence of their influence has been the 55% growth in open interest on NYMEX crude, heating oil, and gasoline contracts over the past year and the more violent and volatile intraday trading during recent months. What happened in oil has spread to gas, power, and coal.²³

The figure of \$8 per barrel as a "hedge fund activity premium" in oil is a stunning number for mid-2004. It represents approximately 20 percent of the refinery acquisition cost in 2004 and two-thirds of the \$12 increase in refinery acquisition costs between 2002 and 2004.

²¹ Barrionuevo, "Energy Trading."

²² "Oil Brings Surge in Speculators Betting on Prices: Large Investors Playing Ongoing Rise is Increasing Demand and Price Itself," August 24, 2004, p. A-1.

²³ Id., p. A-2.

²⁴ Fusaro, Peter, "The Rise of Financial Energy Trading Markets: Enter the Hedge Funds," *Insight*, October 2004, p. 3.

Six months later the *New York Times*, in an article entitled "Energy Trading, Without a Certain E," described the activities of energy hedge funds against the backdrop of the impending Enron trials, noting that "some industry officials question whether the funds are contributing to higher energy prices, or at least stoking more price volatility."²⁵ While the "E" in the *New York Times* headline was intended to refer to Enron, it actually could stand for the huge sums of energy futures contracts that are traded without being backed by the underlying assets or equity.

By April 2006 the surge in trading had become frenzy, according to a front-page *New York Times* article – "Trading Frenzy Adds to Jump in Price of Oil."²⁶ The central anomaly was just as striking to the CEO of a major oil company in 2006 as it was to the CEO of ExxonMobil earlier this year. He made the same point – physical market conditions cannot explain financial market behaviors – "It is the case," according to BP's chief executive, Lord Browne, "that the price of oil has gone up while nothing has changed physically."

The asset-lite model of Enron was proliferating across the commodity markets. Because there are few requirements for backing, entry is extremely easy and trading can escalate rapidly. "The hedge funds are borrowing as much as 10 times what they invest in some trades, analysts and traders say, contributing to short term volatility that has complicated the energy purchases of many large energy users."²⁷ There were doubts about the ability of the firms to withstand the risk, at least for a time.

But with the revival comes questions from some financial market analysts about whether energy trading will be better able to withstand another potential meltdown... The latest ramp-up in trading has also been marked by an air of secrecy underscored by the proliferation of hundreds of hedge funds that are speculating on everything from crude oil to electricity in both regulated and unregulated markets. Many funds are being aided by investment from banks, which are also buying up distressed power plants and other remnants of the collapsed sector..."

As volatility and price rise, it becomes more difficult for the commercial traders, the firms that need the underlying physical commodity, to stay in the markets. They do not have the resources to play in the market. The big bankers and large traders thrive through speculation while physical traders are strangled.

Hedge funds bring increased sophistication, liquidity, and the risk culture and trading acumen to bear on energy commodities markets. Seeking new opportunities to obtain greater returns, hedge funds see energy markets as providing that opportunity. Likewise, the investment banks have a risk trading culture, deep pockets, and access to both physical and financial traders. Even the energy companies with surviving trading arms are now partnering with investment banks to sustain and improve trading operations while obtaining access to increased expertise, more sophisticated tools, and risk capital. Moreover, we have the

²⁵ Alexei Barrionuevo, "Energy Trading, Without a Certain 'E'," *New York Times*, January 15, 2005, p. 3-3.

²⁶ Jad Mouawad and Heather Timmons, "Trading Frenzy Adds to Jump in Price of Oil," *New York Times*, April 29, 2006, A-1.

²⁷ *Id.*, p. 3-3.

²⁸ *Id.* p. 3-3.

multinational oil and gas companies with the balance sheet to put their capital at risk. It is no accident that BP is the No. 1 gas trader and in the top five in power trading. BP has the balance sheet and supply to play in this new financial market.²⁹

Developments since 2008 confirm this view of excessive speculation. Over the course of the summer of 2008, Congressional scrutiny³⁰ and the public outcry over high gasoline prices pushed the CFTC to take measures to address some of the most egregious mistakes that had been made in adopting public policies that led to excessive speculation.³¹ Poorly regulated foreign commodity exchanges were challenged; the misclassification of commodity traders was corrected; and information was demanded from traders.³² Speculative money was driven out of the commodity market.

From the peak price of oil of over \$145/barrel on Thursday July 3, 2008, to the Friday before the Lehman Brothers bankruptcy triggered the market meltdown, the price of oil had fallen by \$44/barrel. The bubble had begun to deflate. By the time the first of the Wall Street bail out money had been spent in early October, the price of oil had come down by another \$13 per barrel and was at levels that had not been seen in a year. When liquidity was further drained from the market by the recession and the financial meltdown, the bursting of the speculative bubble was complete. Excessive liquidity had pushed oil prices to outrageous levels; when the liquidity was driven out of the market, the prices plummeted. The amount of money that flowed out of the open positions in the third quarter of 2008 was three times as large as the value of the entire market in 2004, just four years earlier.

The repeated bubble and burst pattern has sensitized some analysts to the fact that the financial markets have lost touch with physical markets. Thus a CNN report from march 2011 quotes one analyst who concludes that the "speculators now own nearly six times as many barrels of oil... as can be stored at the WTI trading hub in Cushing Oklahoma," a level that another analyst called "extraordinary."³³

The role of speculation is so pronounced in the 2010-2011 spike, that even firms that play heavily in the market, like Goldman Sachs, recognized that speculation was playing a role. In mid-April it "caused a stir in the commodities trading world when it named "excessive speculation" the culprit for inflating oil prices."³⁴ "Specifically, Goldman Sachs warned clients on Monday to lock-in trading profits before oil and other markets

²⁹ Fusaro, *Enter the Hedge Funds*, p.3

³⁰ Yanagisawa, Siemiski, "Testimony of Roger Diwan Regarding Energy Speculation: Is greater Regulation Necessary to Stop Price Manipulation," Subcommittee on Oversight and Investigations, Committee on Energy and Commerce, U.S. House of Representatives, June 23, 2008; Testimony of Michael Masters, Managing Member/Portfolio Manager, Masters Capital Management, LLC, Committee on Homeland Security and Governmental Affairs, United States Senate, May 20, 2008; "Testimony of Fadel Gheit," Subcommittee on Oversight and Investigations, Committee on Energy and Commerce, U.S. House of Representatives, June 23, 2008; Thomas Evans, *Citi Futures Perspectives*, July 3, 2008; Lehman Brothers, *Oil Cot-com*, May 29, 2008.

³¹ Fusaro, Peter, "The Rise of Financial Energy Trading Markets: Enter the Hedge Funds," *Insight*, October 2004, p. 3.

³² Maria Herbst, "Under Pressure from Congress - and Runaway Oil Prices - U.S. Regulators are Moving to Exert Greater Oversight," June 2009; Robert Campbell, "Big CFTC Data Revision Raises Oil Traders' Eyebrows," Reuters, August 5, 2008; Gregory Moeck and Athena Velie, "A New Era of Regulation Has Already Begun, Commodities Now," March 2009.

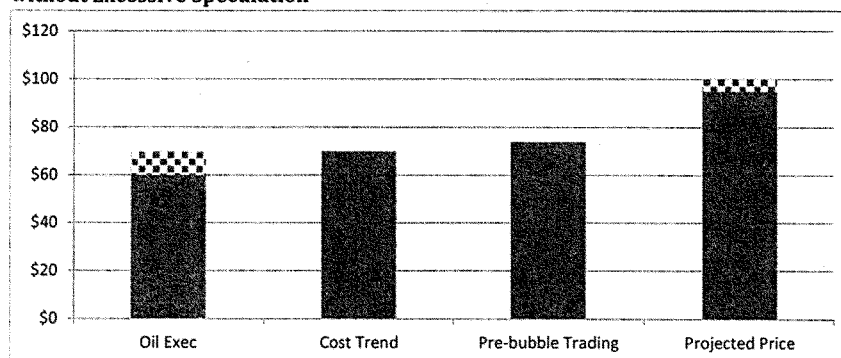
³³ Colin Barr, "Speculators Double down on Oil," *CNNMoney*, March 7, 2011.

³⁴ Daniel J. Weis and Valeri Vasquez, "Oil Roulette," *Climate Progress*, April 29, 2011.

reverse, with the bank's estimates suggesting speculators are boosting crude prices as much as \$27 a barrel."³³

The foregoing analyses provide solid evidence that the price of crude oil would be in the range of \$60-\$70 per barrel absent the distorting effect of excessive speculation. With the average price of crude oil in the U.S. likely to be in the range of \$95 to \$100 per barrel this year, as summarized in Exhibit IV-4. Thus, a reasonable estimate of the burden of excessive speculation for this year is a \$30 per barrel.

Exhibit IV-4: Estimated 2011 Price Crude Compared to Estimated 2011 Prices, without Excessive Speculation



³³ Stuart Burns, "Goldman Sachs Calls the Top in Oil and Metals: Clients Advised to Close Positions, *Oilprice.com*, April 14, 2011.

V. POLICY IMPLICATIONS

Causal Mechanisms that Link Excessive Speculation to Price and Economic Inefficiency

Markets afflicted by excessive speculation are inefficient, allowing supranormal trading profits,³⁶ increase volatility that leads to higher risk premiums and lower production as producers exercise their option to hold assets in the ground.³⁷ The impact falls heaviest on commercial traders.

Even when the settlements of cash-settled contracts are not purposefully manipulated, the settlement mechanism may increase underlying volatility when hedgers unwind their hedges if they have no incentive to control their trading costs. This generally is the case when hedgers trade out of their positions at the same prices that determine the final cash settlement price. The resulting price uncertainty reduces trading by risk-averse producers and thus produces deadweight losses.³⁸

Thus, four key factors serve to drive the price spiral higher: volume, volatility, risk and transaction costs. The structure and availability of markets plays a role in allowing the volumes to increase.

Changes in the way oil is traded have contributed their part as well. On NYMEX, oil contracts held mostly by hedge funds – essentially private investment vehicles for the wealthy and institutions, run by traders who share risk and reward with their partners – rose above one billion barrels this month, twice the amount held five years ago.

Beyond that, trading has also increased outside official exchanges, including swaps or over-the-counter trades conducted directly between, say, a bank and an airline...

Such trading is a 24-hour business. And more sophisticated electronic technology allows more money to pour into oil, quicker than ever before, from anywhere in the world.³⁹

The influx of new money is sustained by movements of different institutions and individuals into the market.

Everybody is jumping into commodities and there is a log of cash chasing oil," said Philip K. Verleger Jr., a consultant and former senior advisor on energy policy at the Treasury Department.⁴⁰

³⁶ Shambora, William E. and Rosemary Rossier, "Are There Exploitable Inefficiencies in the Futures Market for Oil," *Energy Economics*, January, 2007.

³⁷ Litzenger, Robert H. and Nir Rabinowitz, "Backwardation in Oil Futures Markets: theory and Empirical Evidence," *Journal of Finance*, 5: 1995.

³⁸ Dutt, Hans R. and Lawrence E. Harris, "Position Limits for Cash-Settled Derivative Contracts," *The Journal of Futures Markets*, 2005, p. 497.

³⁹ Mouawad and Timmons, "Trading Frenzy," A-1.

⁴⁰ Mouawad and Timmons, "Trading Frenzy," A-1.

The hedge funds have come roaring into the commodities market, and they are willing to take risks," said Brad Hintz, an analyst with Sanford Burnstein & Company, an investment firm in New York...

Pension funds have been particularly active in the last year, said Frederic Lasserre, the head of commodity research at Societe Generale in Paris. These investors, seeking to diversify their portfolios have added to the buying pressure on limited commodity markets.⁴¹

There are a variety of structural and behavioral ways that financial commodity markets can push prices up. Volatility and churn can be costly. Brokers take fees and traders take a spread on every transaction. Volatility increases risk, which then demands rewards. Producers, in turn, want volatility insurance. If each of these factors creates a small increase in price, it adds up to substantial increases given the amount of money involved. Volatility also raises the cost by building in a premium.

Increased volatility increases the value of producers' *operating options*, options to produce now (at an "exercise price" equal to marginal production cost and with a "payoff" equal to the spot price), rather than waiting for possible increases or decreases in price. These options add an opportunity cost to current production: namely, the costs of exercising the options rather than preserving them. This and increase in volatility increases the opportunity cost of current production.⁴³

As prices and volatility rise in a market, it gets harder and harder to convince people who have the physical commodity in the ground to part with it. They have to be bribed with higher prices to lift the oil not only because they can expect a higher price in the future, but also because they demand a higher risk premium to insure against the chance that they are selling at the bottom of volatile price swings. This basic fact has been clear in the academic literature for quite some time⁴⁴ and it is finally penetrating to the popular press.

⁴¹ Mouawad and Timmons, "Trading Frenzy," A-1.

⁴² Hans R. Dutt and Lawrence E. Harris, "Position Limits for Cash-Settled Derivative Contracts, *The Journal of Futures Markets*, 25 (2005), p. 497, "Even when the settlement of cash-settled contracts are not purposefully manipulated, the settlement mechanisms may increase underlying volatility when hedgers unwind their hedges if they have no incentive to control their trading costs. This generally is the case when hedgers trade out of their positions at the same price that determine the final cash settlement price." Robert J. Pyndyck, "The Dynamics of Commodity Spot and Futures Markets: A Primer," *The Energy Journal*, 22(2001), p. 12, emphasis in original, "Increased volatility increases the value of producers' *operating options*, options to produce now (as an "exercise price" equal to the marginal production cost and with a "pay-off" equal to the spot prices), rather than waiting for possible increases or decreases in price. These options add an opportunity cost to current production: namely the cost of exercising the option rather than preserving them. This increase in volatility increases the opportunity cost of current production." Although Stephen Craig Pirrong, *The Economics, Law and Public Policy of Market Power Manipulation* (Boston, Kluwer, 1996), focuses on market manipulation, the conditions that facilitate manipulation also facilitate excessive speculation, particularly with the influx of new money, "[B]y demanding excessive deliveries a long induces distortion in the spatial and temporal distribution of consumption, transportation and storage. Shorts must pay current owners of the commodity increasingly higher prices in order to compensate current owners of the commodity for the surplus foregone. pp. 24-25). "[A] trader who does not possess any informational advantage is able to acquire market power as long as the flow of orders from other traders to the futures market is sufficiently volatile and large relative to the size of deliverable supply... Put another way, the existence of "nose traders" makes fraud possible." (p. 12)

Another financial factor behind the price rise that hasn't been talked about much on Capitol Hill or elsewhere is reduced hedging by oil companies on futures markets, says Larry Goldstein, a longtime energy analyst. In the past, crude producers would offer buyers a portion of their energy output in future years in order to protect themselves if prices pulled back. But energy companies got burned as prices kept rising during the past two years and have since cut back on selling untapped production – forcing prices for energy futures even higher.⁴³

Traders can profit from a rising price in a variety of ways. As long as there is more new money coming in that is willing to bid the price up, the old money in the market benefits by staying long. Given the entry of a series of new pots of money – first banks, then hedge funds, then pension funds, then index funds – this upward spiral is sustainable and profitable. Further, it is easier to ensure the inflow of funds when you are “advising” the new money what to do. It is easier to sustain the upward spiral of prices when you are hyping the market with reports about how high the prices will go.⁴⁴ Traders can engage in wash trades to push the price up. As account values rise, excess margins and special miscellaneous accounts allow the trader to take money out or leverage more trading, to keep the upward spiral going. Traders and exchanges benefit from transaction fees that grow with value.

With hundreds of billions of dollars at stake and a vital commodity gyrating wildly in price around a dramatic upward trend, one would think that policymakers would examine these markets closely, but that was not the case.

Historically, most hedge fund managers have not been required to register with the U.S. Securities and Exchange Commission (SEC) and, therefore, have not been subject to regular SEC oversight...

Further, hedge funds are not subject to the numerous regulations that apply to mutual funds for the protection of investors, such as those requiring a certain degree of liquidity, the ability to redeem mutual fund shares at any time, the protection against conflicts of interests, assurance of fairness in the pricing of fund shares, disclosure regulation, the limitation in the use of leverage, etc.... The recent SEC financial disclosure requirements are really light-handed regulations used to assuage public concerns over financial markets and have had little impact on hedge fund investment.⁴⁵

The fundamental transformation of the commodity market and the change in the nature of trading have led to a disconnect between the analysis of micro movements of trading (hours and days) and the long term movements.

The CFTC found that such extreme changes in price volatility were not evident in the data. However, the volatility of time-series data need not exhibit any clustering or

⁴³ Nelson C. Schwartz, “Asleep as the Spigot,” *New York Times*, July 6, 2008, Business Section, p. 7.

⁴⁴ Goldman Sachs, Global: Energy: Oil, \$100 Oil Reality, part 2: Has the Super-Spike End Game Begun?, May 5, 2008; Morgan Stanley, Commodity Shipping: Current Crude Oil Shipping Patterns Suggest \$150/bbl WTI by July 4th, June 5, 2008.

⁴⁵ Peter Fusaro and Gary Vasey, “Hedge funds Change Energy Trading,” *International Research Center for Energy and Economic Development*, Occasional Paper No. 39, 2005.

significant changes for the market to be influenced by the trading behaviors of a large group of participants. Shifting aggregate expectations due to relatively tight short-term fundamentals and changing composition of market participants are not aspects the CFTC normally examines, and these factors are indeed essential to the proper analysis of the question of the role of speculators in price formation. Thus, it can be argued that the models employed were not adequate to answer the types of questions being asked.⁴⁶

However, knowing whether price changes lead or lag positions changes over short horizons, (a few days) is of limited value for assessing the price pressure effects of flows into commodity derivatives markets. Of more relevance is whether flows affect returns and risk premiums over weeks or months. The imputed flows of funds into index positions... suggest that such intermediate-terms price-pressures effects may well have been present.⁴⁷

The Proper Function of Commodity Markets and Normal Speculation

Thus, it is important to understand the purpose of commodity markets and the difference between normal speculation and excessive speculation caused by the "financialization" of commodity markets. The original purpose of commodity market was to smooth the operation of physical commodity markets. For decades the commodity markets allowed the buyers and seller to hedge risk and plan their business operations by contracting for the delivery of future supplies of the goods on which they depend for their living. Financialization of commodity markets turned these commodities into asset classes that were not traded for physical delivery. They were bought (and frequently held) for pure financial gain. A barrel of oil might be traded 10, 20 or even 30 times before it was delivered, and it never was delivered to the speculators, who came to hold three-quarters or more of the contracts.

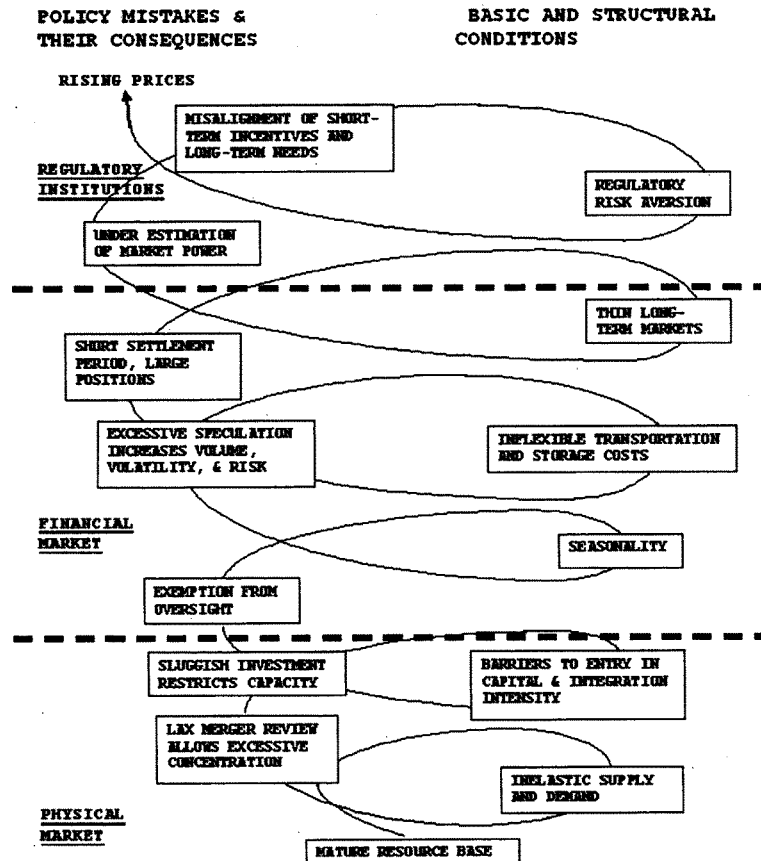
As the risk and volatility increased with financialization, the markets became severed from their underlying function. When this relationship is disrupted because of inadequate regulation, excessive speculation undermines the ability of the market to provide its vital functions for the real economy – driving prices too high, but simultaneously reducing, not increasing supply, creating volatility that makes it more difficult, not easier, to plan production. Risk and volatility became so great that many physical traders were forced out of the market.

The financialization of energy commodities wreaks havoc on household budgets and the economy because of the interaction between basic conditions in energy markets and the powerful and perverse effects of financialization. Exhibit V-1 summarizes an

⁴⁶ Kenneth B. Medlock and Amy Myers Jaffee, "Who is in the Oil Futures Market and How Has it Changed?" (James A Baker III Institute for Public Policy, Rice University, August 26, 2009), p. 14.

⁴⁷ Kenneth J. Singleton, Investor Flow and the 2008 Boom/Bust in Oil Prices, March 23, 2011.

EXHIBIT V-1: PHYSICAL, FINANCIAL AND REGULATORY FACTORS IN THE ENERGY PRICE SPIRAL



Source: Mark Cooper, "The Failure of Federal Authorities to Protect American Energy Consumers from Market Power and Other Abusive Practices," *Loyola Consumer Law Review*, 19:4 (2007), p. 318.

explanation of the interconnected role of speculation in commodity markets and market fundamentals in the price spiral.⁴⁴

At the bottom of the spiral are the physical market characteristics that define the basic nature of the commodity. At the right side of the spiral are the structural conditions that affect price in the long term. On the left side of the spiral are the policy decisions and behaviors that affect price in the short term. The key role of the financial and commodity markets and the escalation of volume, volatility and price are clear. Demand and supply are relatively inelastic in the short and mid-term, while transportation of these commodities is difficult and costly, making them vulnerable to manipulation and excessive speculation.

Financialization allows banks and hedge funds with deep pockets and market leverage to exploit these underlying market conditions. The market participants benefit by exploiting asymmetric information. They have perverse incentives to drive prices up by straddling positions in different markets, hyping high prices in public and attracting more money into the market in private. They have strong conflicts of interest in straddling positions and playing different roles in many markets. When regulators relaxed the prudential regulation that restrained the exploitive behavior of speculators and invited new institutions to enter with different purposes and goals, the function of the commodity markets was undermined. Exemptions from oversight and repeal of restrictions allowed money to flow in and excessive speculation quickly took hold.

The role of the big, deregulated banks is pervasive in the process of financialization as described above. They led the charge into the markets, posted eye-popping profits, backed hedge funds, straddled asset classes and hyped up price increases. The opportunity to straddle a variety of markets can also be exploited by the new players. They can take positions in lightly regulated exchanges and unregulated over-the-counter markets, directly hold physical assets, and participate as large players in equity markets.⁴⁵ Chasing high profits in the energy sector in markets that lack transparency increases risk, which demands higher returns. "What is readily apparent from all of this activity is that the fund community now sees the energy complex fundamentals trending to higher prices and that it offers them an attractive sector in which to inflate sagging returns for investors."⁴⁶

⁴⁴ The role of speculation has been recognized by academic analysts looking at the 2008 bubble, although there remain uncertainties about the precise size of its role. Marco Lombardi and Ine Van Rovy, *Destabilizing Speculation in the Oil Market*, (January 11, 2011), find the role of speculation in the price decline to be three times as large as in the increase. Across the entire cycle, it accounted for about a quarter of the price movement. Hamilton (2009) argues that oil price increases have their effect, regardless of the cause of the price increase, and concedes that "speculative investing in oil futures contracts may have contributed (p.39)." Hamilton notes that the underlying factors that create the conditions for speculation as a cause of the price spike are the same conditions as those necessary for supply and demand as causes. He notes (pp. 22-23) that the price pattern could have induced the owners of oil to keep it in the ground and they readily admit as much and act in this way. Thus, speculation becomes a cause of the supply demand balance. We believe that the movement of prices and trading since 2008 strengthen the case for a larger role of speculation in contemporary oil price setting and weaken the case for movements in fundamentals as the cause of the wild price gyrations.

⁴⁵ Fusaro, Peter, and Gary Vasey, "A Major Structural Shift in Energy – But Where are the Majors?," p. 2.

⁴⁶ Fusaro, and Vasey, "Why Have They Appeared Now?," p. 2.

This prediction of increasing profits made in October 2004 proved quite correct. The bonus pool at Goldman Sachs, one of the key members of the "triangle of trading," has raised some eyebrows.

The bonus pool, as we've heard ad nauseam, is overflowing with some \$11 billion. Mr. Paulson, the chairman and chief executive, alone took home 437 million, or about 800 times the median household income in the United States. Well done. The question is whether all of this is sustainable – and, of course, whether the bank hasn't turned into a huge hedge fund.³¹

Goldman Sachs was in the thick of the extremely lucrative speculation once again in 2010-2011. When its own model concluded that speculation had increased the price of crude by as much as \$27/bbl, they advised their clients who they had brought into the market to push the price up a few month earlier to get out with a 25% return in a mere five months.

Specifically, Goldman Sachs warned clients on Monday to lock-in trading profits before oil and other markets reverse, with the bank's estimates suggesting speculators are boosting crude prices as much as \$27 a barrel. Oil prices promptly dropped 3 percent as speculators anticipated Goldman's clients would liquidate positions. Goldman's advice came after US oil futures have risen some 20 percent this year and the bank was advising clients they should close their CCCP basket positions, taking profits on a trade that has returned 25 percent since first recommended in December.³²

OPEC

Having made the case for a complex relationship between market fundamentals and excessive speculation in which trading is the primary factor in the bubble and burst cycle, we would be remiss if we did not also note that OPEC plays a role in the overall process. Whenever the bubble inflates, OPEC ministers insist that it is not their fault and blame speculators.³³ At one level, our analysis exonerates them from blame. At another level, they bear a great deal of responsibility.

OPEC is a rent seeking cartel that attempts to manage the price by setting supply quotas among its members. There is a great debate about how effective they are at this, but the more important point is that OPEC members, who possess the lowest cost sources of crude oil, have systematically underinvested in development of supplies.³⁴ They distort the supply curve, driving the world to develop more expensive resources long before they would have to if the market were not distorted by the cartel behavior. With nearly 50-year reserve to consumption ratio, in spite of the withholding of supply by OPEC, it is reasonable to assume that the escalation in the price path would be much less steep absent the cartel

³¹ Sorkin, Andrew Ross, "Cheer to Deals that Fizzed (or Fizzled)," *New York Times*, January 1, 2006.

³² Stuart Burns, Goldman Sachs Calls the Top in Oil and Metals: Clients Advised to Close Their Positions, April 14, 2011;

³³ Michael Greenberger, "The Relationship of Unregulated Excessive Speculation to Oil Market Volatility," *International Energy Forum*, January 5, 2010.

³⁴ Bureau of Economics, *Gasoline Price Changes and the Petroleum Industry: An Update*, FTC Staff Study, September 2011, p. 14.

behavior. It is also entirely possible that an orderly market would produce a much less erratic path of supply development and be less vulnerable to manipulation and excessive speculation.

POLICY IMPLICATIONS OF THE ANALYSIS

Ironically, when it is clear that the market fundamentals argument cannot explain price movements, some of its adherents invoke the problem of market psychology as the explanation. The reality of the market no longer matters; it is only the perception of the participants that matters.

Everyone in the oil market is attuned to every little twitch that has the potential to damp supply or increase demand. That's why, for instance, when Libya announced on Thursday that it might cut oil production, oil jumped more than \$5. Meanwhile, when Brazil discovers a huge new oil field, the market shrugs. That is not speculation at work – its market psychology. There's a big difference. If there is a bubble, that's what is causing it.³³

Our July 2009 testimony to the Senate Permanent Subcommittee on Investigations Committee on Homeland Security and Government Affairs concluded with the following advice and irrational psychology.

In the end, if it is just psychology, we would urge policy makers to ask themselves whether they are obligated to let the psychos run wild in a market as vital as oil. We submit that you are not. If the traders in this market have become irrationally attuned to "every little twitch" that might increase prices, but disregard facts that might lower prices, it is hard to conclude that the market is functioning properly. The psychos need a little sedation to restore balance to their perspective. Prudential regulation has the benefit of both preventing excessive speculation and sedating the psychos, not to mention allowing the physical traders to reenter the market and use its price discovery and risk management functions.³⁴

The need to restore effective prudential regulation in commodity markets is just as great today, if not greater given the demonstration that the bubble and burst cycle has repeated itself and the vulnerable state of the economy.

Recognizing that excessive speculation exists and imposes huge costs on consumers and the economy is the first step in solving the problem. It creates the predicate for vigorous new policies to reduce excessive speculation.

It was foolish to believe that self-regulation would prevent excessive speculation and two speculative bubbles in less than half a decade make it clear that self-regulation has not and will not work.

³³ Joe Nocera, "Easy Target, But Not the Right One," *New York Times*, June 28, 2008, p. B8.

³⁴ "Statement of Mark Cooper on Excessive Speculation in Commodity Market and the Collapse of Market Fundamentalism," Permanent Subcommittee on Investigations Committee on Homeland Security and Government Affairs, Hearing on Excessive Speculation in the Wheat Market, United States Senate, July 21, 2009. P. 12.

Coordination across agencies both domestically and internationally is critically important to driving excessive speculation out of national and international markets, but the U.S. cannot wait for others to act. The U.S. is the largest single market for many of these commodities. The U.S. accounts for one quarter of the daily global oil consumption. If we do not lead, there will be no one to follow.

In 2008 we suggested a lengthy set of policies that are needed to address the severe problem of excessive speculation. These policies address all of the problems listed in the financial side of the price spiral analysis in Exhibit V-1⁷.

Chase out bad actors: All traders must register and be certified (for honesty and competence, like bankers and brokers). All trading must be reported across all transactions

Eliminate the funny money: Raise margin requirements. Increase capital reserve requirements,

Reduce the ability to push prices up: Lower position limits and tie limits and margin policies to needs of physical, traders. Lengthen settlement windows. Ban conflicts of interest (analyst's reports that enrich analyst's portfolios)

Restore the proper functioning of commodity markets and their regulators: Enforce meaningful speculative limits, Do honest analysis (classify traders correctly). Close the loopholes (foreign boards of Trade exemptions, the Enron and swaps). Create minimum criminal penalties for violation of commodity laws

Redirect investment to productive long-term uses: Put a tax on short-term capital gains. Move pension funds out of speculation, Ban institutional index funds.

Position limits, which are at the head of the list of policies the CFTC is now working on, are one of the tools in the arsenal, but they have to be meaningful and they alone will not be enough.

Interestingly, in evaluating the position limits proposal circulated by the CFTC in the summer,⁷ a financial services consulting firm estimated that the CFTC proposal would reduce open positions by between zero and eight percent. Based on the relationship between trading and price, it would take a 25 percent reduction of open interests to eliminate the speculative excess from the price. At the high end of the estimate, eight percent would be an important step forward. Obviously, zero would be unacceptable. Position limits are not the only policy instrument to deal with excessive speculation, but they are an important instrument to control excessive speculation. The CFTC has yet to adopt the rules and any weakening of this modest first step would be a mistake.

⁷ Keefe, Bruyette & Woods, *Exchange Order Execution*, September 6, 2011.

RESPONSE FOR THE RECORD
provided by
THE HONORABLE GARY GENSLER
Chairman
Commodity Futures Trading Commission

Mutual Fund Participation in commodity markets

With regard to legislation to amend the Internal Revenue Code and the degree to which mutual funds can commit invested funds to trading in commodities, the Commission can't predict the degree to which speculative investment would rise. Data published weekly by the Commission in its Disaggregated Commitment of Trader (COT) Reports shows the degree to which managed money – a category that includes mutual funds – already trades in CFTC-regulated designated contract markets. The February 28, 2012, COT report shows that in the NYMEX light sweet crude oil futures and options contracts, which has a high level of open interest, the managed money category accounted for about 25% of the long open interest and about 15% of the short open interest. It is clear that, on any given day, financial actors such as mutual funds are part of the pricing that we see in energy, agricultural and other physical commodity contracts. The CFTC aggressively pursues its role to make sure that the market is free of fraud, manipulation and other abuses. CFTC action to finalize its position limits rule is an example.

The Commission recently took other action relevant to mutual fund participation in futures markets. Prior to regulatory amendments made in 2003, Commission rules permitted an entity's exclusion from designation as a Commodity Pool Operator (CPO) only if its uses of commodity futures for non-hedging purposes were limited to five percent of its portfolio. In 2003, the Commission removed the trading threshold for exclusion from the definition of CPO for registered investment companies, provided they continued to be registered with the Securities and Exchange Commission. In 2006, the Internal Revenue Service began issuing a series of Private Letter Rulings (PLRs) to different investment companies granting them relief from the 10% investment limitation under Subchapter M of the Internal Revenue Code provided that they used wholly owned foreign subsidiaries to conduct their trading. Due to the interaction between these PLRs and certain other provisions of the Investment Company Act of 1940, most registered investment companies using controlled foreign corporations can invest 25% of their portfolio in derivatives. Commission staff is aware of at least 23 registered investment companies that self-identify as offering managed futures strategies.

On February 9, 2012, the Commission finalized changes to its regulations which, among other things, reinstated the pre-2003 5% trading threshold. Any registered investment company exceeding that threshold will be required to be listed with the Commission and its advisor registered as a CPO. Therefore, a registered investment company with more than a de minimis exposure to derivatives will be subject to Commission oversight. Additionally, the Commission recently rescinded the exemption from CPO registration in section 4.13(a)(4) of the Commission's regulations, which will result in controlled foreign corporations being required to be listed with the Commission and subject to its oversight as well. Therefore, any registered investment company holding significant derivatives positions and any controlled foreign corporation will be subject to Commission oversight.

Permanent Subcommittee on Investigations

EXHIBIT #12

RESPONSES TO SUPPLEMENTAL QUESTIONS FOR THE RECORD
from
SENATOR TOM COBURN
to
GARY GENSLER
Chairman
Commodity Futures Trading Commission

PERMANENT SUBCOMMITTEE ON INVESTIGATIONS
Hearing On
"Excessive Speculation and Compliance with the Dodd-Frank Act"
November 3, 2011

1. In total, how many new rules and regulations will be required by Dodd-Frank?
 - a. How many of those will be written by the CFTC?
 - b. How many rules have been drafted so far and how many are still to come?
 - c. How many total pages of new rules will the CFTC write for Dodd-Frank? How many has it written to date?

Response: The Commission has identified 32 areas where the CFTC is responsible for rule writing under the Dodd-Frank Act. In implementation of the Act, the Commission has issued 54 proposed and 28 final rulemakings. We have approximately 20 more final rules to go. The rule text portions of the Commission final rule releases take up approximately 150 pages of the Federal Register. In many cases, these rulemakings restate existing provisions and the Commission has not precisely determined the number of pages that are new.

2. You have repeatedly said that Congress in the Dodd-Frank bill required the CFTC to impose position limits. That is an issue some people are still debating, hinging on the "as appropriate" language. What is your interpretation of the "as appropriate" language?
Did the Commission consider any alternatives, like position accountability, instead of limits?

Response: The Commission described that phrase in its final rulemaking release. When considered in the context of the position limits provisions as a whole, it is read as directing the Commission to exercise its discretion in determining the extent of the limits that Congress required the Commission to impose.

3. You said, "the CFTC does not set or regulate prices ... " But, isn't the purpose of position limits to keep prices from either going too high or experiencing too much volatility?
Isn't this a form of price regulation? If no, how do you differentiate between price regulation and the impact position limits are supposed to have?

Response: The Commodity Exchange Act includes the finding that excessive speculation causing sudden or unreasonable fluctuations or unwarranted changes in the price of a commodity is an undue and unnecessary burden on interstate commerce. The Act directs that the Commission set position limits at levels that would serve to the maximum extent

Permanent Subcommittee on Investigations EXHIBIT #13
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possible to diminish, or prevent excessive speculation; deter and prevent market manipulation, squeezes, and corners; ensure sufficient market liquidity for bona fide hedgers; and ensure that the price discovery function of the underlying market is not disrupted.

4. How did the Commission arrive at the position limits set in the rule?
 - a. Will that analysis be made public?
 - b. Will you conduct a similar analysis every two years when you adjust the limits?
 - c. How did the Commission arrive at the decision to adjust position limits as needed every two years?
 - d. Did the Commission consider possible adverse effects on the liquidity and price discovery functions of affected markets?

Response: The CFTC considered substantial public comment in determining to adopt the formula for the spot-month limits at 25 percent of the deliverable supply. The 25 percent limitation is also consistent with the Commission's existing acceptable principles for compliance with Core Principle 5. The formula for the non-spot-month position limits is based on total open interest for all Referenced Contracts in a commodity. The formula provides for limits equal to: 10 percent of the open interest for the first 25,000 contracts and 2.5 percent of the open interest thereafter. In developing the final rulemaking, the Commission benefitted from thousands of public comments.

In its adoption of position limits, the Commission recognized the concerns raised by commenters regarding the necessity and desirability of periodically updating deliverable supply calculations. Accordingly, the Commission determined to update spot-month limits every two years for energy and metal Referenced Contracts, and to stagger the dates on which estimates of deliverable supply shall be submitted by designated contract markets (DCMs) in order to mitigate the costs of compliance for DCMs.

5. What parts of the position limits rule present the greatest possibility for legal challenge and how has the CFTC prepared to meet those challenges?

How do you respond to the strong concerns of those that this rule will not stand up in court?

Response: The Commission's final rule has been challenged and the case is pending.

6. How will the Commission define "identical trading strategies" for purposes of aggregation? How will the Commission gain access to a market participants' trading strategies to determine whether a participant is attempting to evade position limits through taking positions utilizing "identical trading strategies"?

Response: The Commission adopted the identical trading strategies aggregation provision to prevent circumvention of the aggregation requirements. In absence of such aggregation requirements, a trader could, for example, acquire a large long-only position in a given

commodity through positions in multiple pools without exceeding the applicable position limits.

7. Are you concerned that U.S. market participants will take their business to other exchanges because of this rule?

a. Do you have a sense as to whether other market authorities will adopt a similar position limits regime?

b. How did that factor into the CFTC's decision to move forward with its proposal?

c. The final rule mentions two studies conducted in 1994 and 1999 to determine the competitive effect on U.S. contract markets when there is lighter regulation in markets abroad. Can you please walk me through these studies and their results, and explain how these studies that are over a decade old are relevant to the markets as they are structured now?

Response: The Commission's final rule implements the Congressional directive in the Dodd-Frank Act to establish position limits for derivatives on certain commodities. The Commission is actively consulting and coordinating with international regulators to promote robust and consistent standards and avoid conflicting requirements in swaps oversight. The Commission participates in numerous international working groups regarding swaps, including the International Organization of Securities Commissions Task Force on OTC Derivatives, which the CFTC co-chairs.

Congress mandated the 1994 study under 1992 amendments to the Commodity Exchange Act. It analyzed the growth of futures trading in non-U.S. markets and the relative decline in the global market share of U.S. exchanges. The study found no evidence that disparities in the regulatory frameworks of various jurisdictions, including particular disparities in procedures for listing new contracts, were a major factor explaining the success of various exchanges in the global market.

In 1999, the Commission updated the 1994 study to review foreign and domestic futures and options trading activity over the period 1994-1999. The findings in these studies were considered in the course of the Commission's rulemaking, along with the thousands of comments provided by the public.

8. The CFTC just finalized a rule establishing the requirements applicable to clearinghouses that would set a minimum capital requirement for clearinghouse members at \$50 million, which is much lower than the amount currently required by clearinghouses. It is my understanding that this \$50 million threshold was criticized as being too low by both members of the commission and the industry. It is also my understanding that one of the firms pushing for the lower capital requirement was MF Global, the derivatives dealer which filed for bankruptcy protection earlier this week. Can you please explain how you arrived at the \$50 million number and whether you did any sort of economic analysis to determine whether this number makes sense from a risk management perspective?

Response: The rulemaking implements the Dodd-Frank Act's requirement for open access to derivative clearing organizations (DCOs). This rule benefitted from substantial public comment and analysis from numerous individuals and organizations. The participant eligibility requirements promote fair and open access to clearing. In addressing how a futures commission merchant can become a member of a DCO, the rule promotes more

inclusiveness, while allowing the DCO to scale a member's participation and risk based upon its capital. This improves competition that will benefit end-users of swaps, while protecting a DCO's ability to manage risk. Under staff guidance applicable to the rulemaking, the Office of the Chief Economist is represented on the rule-writing team and appropriate methodologies are employed in the rule's cost benefit discussion.

RESPONSES TO SUPPLEMENTAL QUESTION FOR THE RECORD
from
SENATOR TOM COBURN
to
PAUL CICIO
President
Industrial Energy Consumers of America

PERMANENT SUBCOMMITTEE ON INVESTIGATIONS
Hearing On
"Excessive Speculation and Compliance with the Dodd-Frank Act"
November 3, 2011

1. Your testimony states that "in 1998, physical hedgers represented 77 percent of the market, "but that today it is closer to 31 percent-essentially flipping from 2/3 to 1/3. This statistic is widely used, but where did you get it?

a. *Do you have any evidence that the statistic is accurate?*

The specific numbers have been used for some time by a lot of the industry. We did not generate this data. However, what we can say is that the IECA Board of Directors is largely the people in charge of buying energy for their companies, including natural gas. It is their direct observation that these numbers are about right.

b. *How do you define your terms? Is it possible to completely separate bona-fide hedgers from speculators? If so, what is the precise difference?*

Bona-fide hedgers either consume or produce the physical commodity. Speculators do not.

c. *Even if it's accurate, what does this say about the impact of speculation in commodity markets?*

The answer starts with the fundamental fact of what makes the futures market different than other markets. The futures market was created to serve one function and one function only – to determine price discover based on the "supply and demand" of the underlying physical commodity and allow those that consume or produce the physical product to complete their transactions. The volume of physical product consumed each month is finite. The speculator is needed to provide liquidity for transactions to occur to service that volume. When the finite commodity volume of deals is serviced, most of the other transactions are simply trading to make bets – to gamble on the market that can move the price up or down and cause price volatility. Their trades are to simply make a profit by creating volatility and we end up paying for it. Volatility increases our transaction costs and can drive the price either up or down – often, irrespective of supply and demand.

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2. Do you believe that federal regulatory costs are a factor in commodity prices?

- a. For example, do you believe that Federal and State regulations about blending impact the price of gasoline?*

Yes, there are additional costs to physically blend, store and ship multiple blends of fuels that would not otherwise exist without blending regulations.

- b. Do you believe the price of corn was affected by federal policies on ethanol?*

Yes. Mandates for ethanol demand in fuels and subsidies drive additional demand for corn based ethanol above what would otherwise have occurred putting upward pressure on the price of corn.

- c. How do these factors compare with impact of speculation?*

Price movement because of speculation is driven purely by profit motive while price movement due to regulation is driven by policy with a purpose. They cannot be compared.

3. What would you say to the concern that banning commodity index funds will encourage investors seeking commodity exposure to go into the physical market?

It is not clear what is meant by "physical market" (i.e.) encourage them to purchase physical product (or) trading futures directly versus through an ETF.

Banning commodity index funds will not force the majority of investors to trade futures on their own (trade futures for their own account). It will encourage them to buy the "companies" who produce the commodities. In the energy product area, banning energy ETFs will result in retail investors owning shares of Exxon, Chesapeake, and Devon Energy etc. The typical ETF investor will not buy the physical product. Only large banks and trading houses have the capacity to buy/sell and or store the physical product.

Isn't that even more likely to increase volatility for consumers?

No. It would reduce volatility.

- 4. You said position limits are essential to combating excessive speculation. How do you respond to the fact that many of the nine commodities with position limits saw repeated record prices recently?**

We do not monitor commodities other than natural gas so I cannot comment directly. However, common sense says that record prices could have been caused by the underlying demand exceeding supply. In that case, the relative price should go up irrespective of speculative position limits.

Importantly, the concept of position limits is not to reduce the price movements due to fundamental changes to the supply or demand of the commodity. If there is more demand than supply of the commodity, the price should go up. The case for setting speculative position limits is to ensure that the price movements are not caused by aggressive speculation.

It is also possible that the position limits were too large and did not reduce or limit the impact of excessive speculator volumes.

- 5. Your testimony talks about the direct implication of commodity prices to real people who need to feed their families and heat their homes. In your analysis, did you consider worldwide demand for these commodities, and its impact on these prices?**

My testimony addressed natural gas. Natural gas is not exported and the price is "not" set or influenced by international demand.

- a. Between 2005 and 2007 China's oil consumption went up 5.1 percent annually, according to the Federal Reserve Bank of Dallas. Do you believe this has an impact on the price of oil in the United States?*

Underlying growing demand for the physical product relative to supply puts upward pressure on price.

- b. Are you concerned that U. S. market participants will choose to leave the U. S. because of the position limits being imposed by the CFTC?*

No. Bona-fide hedgers would not leave. As for speculators, there are inherent advantages of operating from the U.S. This is not to say that some would choose to leave.

6. In your testimony you express concerns about speculators trading with other speculators. Can you first define what exactly you mean by "non-commercial" trading?

Noncommercial entities are not commercial consumers and producers of the underlying commodity.

7. You say that because in the last four years index funds held long position 83% of the time that this "confirms that index funds put upward pressure on prices." How is this so?

No matter what entity you are, if you consistently are long, that is, always buying versus selling – puts upward pressure on price. Remember, we are dealing with a commodity that has a finite volume. If only ten apples are available in the market and ETFs keep placing orders to buy apples, then the price will rise.

An ETF like UNG, the United States Natural Gas Fund always buy. The only time they sell is to sell the current month only to go "long" in the next month. The only time there is an actual "sell" of futures positions is when a customer liquidates their shares of the ETF.

Do you think that the balance should instead be 50-50?

Banning ETFs is the only solution.

Remember, the problem with ETFs is that their goal is to satisfy a retail investor's strategy of "asset diversification." This goal is completely inconsistent with the fundamentals as to why the futures market was created. The futures market was not set up to satisfy asset allocation for retail consumers! It was created to serve consumers and producers of a commodity and determine the price of the commodity. Those who participate in an ETF for asset allocation buy the commodity through an ETF and do not care what the underlying supply or demand is - nor the price they pay for the commodity. This is contrary to the futures market and how it works. Consumers and producers of the commodity "do" care about price determination that reflects supply and demand.

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RESPONSES TO SUPPLEMENTAL QUESTION FOR THE RECORD

from
SENATOR TOM COBURN
 to
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1. You have singled out commodity index funds as the source of volatility and upward price pressure, but in the first quarter of this year during the price run-up in oil markets, the single largest passive investor in those markets, the US Oil fund, actually shrank in size. How do you explain this?

Just to be sure that my position is clear, my testimony was that commodity index funds structurally create upward price pressures and that these pressures ultimately give way to a substantial correction. I do not assert that this bias is the sole source of volatility and upward price pressure – the law of supply and demand was not "repealed." In other words, I do not believe, and our work does not indicate, that commodity index funds are "the" source, in the event that I was not clear on this point.

This pressure creates a "boom/bust" cycle that constitutes long-wave volatility. This is because of a chronic and fundamentally unsound contango price curve. This is not strictly a function of volume, though volume does have an effect. It may well be (and our work suggests) that the forcefulness of the contango bias is more a function of the point in time during the cycle.

Further, volume is also affected by the allocation between futures and physical market hedges used by the sponsors. If more futures are used as hedges in a given roll, the direct price pressure on the out month rolled into is greater. This would mitigate the affect of fund outflows during a given period.

The other by-product of the contango is that investors experience losses on the roll ("selling" low and "buying" high) in the boom cycle when an actual contango exists. This is less problematic for institutional investors who hold commodity index swaps as a long-term structural hedge in their portfolio. It is more of a problem for investors who simply want to "play" in commodity prices and see the balance of their investment deteriorate. The most likely conclusion is that the US Oil Fund suffered losses in the run up and investors opted out. This is not inconsistent with the structural contango that we found or the conclusion that it contributes to price run-ups and boom/bust cycles. And, importantly, please be aware that we never suggested that supply and demand are not crucial to price; we believe that the commodity index fund-influenced contango causes a

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boom/bust wave around the ideal fundamental price line that tends to create longer duration high prices with rapid and intense corrections.

2. You testified that banks don't care about price, but with respect to oil and oil products, it is consumers who are not very sensitive to price changes, especially in the short run. For example, during the oil run-up from 2007 to mid 2008, when crude oil jumped from \$57 to \$143 per barrel, there was no decline in consumption, and inventories were depleted. What are we to make of this?

There is no doubt that consumers behavior is relatively price inelastic. Nonetheless, commodity index fund sponsors, upon whom the price consequences of a contango price curve do not exist, are clearly indifferent to higher futures prices (that is why they are called "passiv"). In fact, to the extent that they hold physical positions, they would be benefited by a non-fundamentally sound contango price curve, so long as they anticipate the burst of the bubble and liquidate or hedge their physical positions. It is by no means out of the question that a sophisticated sponsor would perceive this benefit and have access to information regarding the cycle to act accordingly.

The price inelasticity of demand actually creates an environment in which a non-fundamentally sound price curve will be a direct cost on consumers. They pay the cost and are resistant to adjusting behavior.

3. Other commodities like coal, tallow, and cobalt had similar price patterns to oil at the same time, and there are no futures markets for those. Doesn't that suggest it may have been market fundamentals driving the price spike rather than speculators?

Again, the premise is that the trading activity of commodity index fund sponsors biases an upward slope in the curve, not that it is the sole driver of price. Certainly, fundamental factors in all of these markets could be in concert. However, an upward sloping curve in a commodity such as crude oil is interpreted by the market that prices are likely to rise. This would undoubtedly influence prices for other commodities that embed basic energy costs. Further, alternate sources of energy, such as coal, would experience a more direct price effect. While the drivers of price are complex and inter-related, we measured the bias toward contango that is clearly present and has a significant effect.

4. Have you ever seen a time when excessive speculation caused prices to go too low?

There are different forms of excessive speculation. Commodity index fund speculation is structurally biased toward increased prices because its primary driver is invalid information. The correction in a bust cycle is a return to fundamental values, but price momentum could very well cause the correction to overshoot fundamentally sound values for a period. But it would be brief because the bust is driven, at least in part, by a discounting of the trading activity of the sponsors once the price-curve spread is so high that it is no longer credible.

Other excessive speculation, primarily the traders drawn to the market by the distortions generated by commodity index funds, create shorter term volatility. In this case, prices may be "too high" or "too low" compared with a fundamentally sound ideal. However, volatility, by itself, exacts a cost on hedgers. For instance, initial margin at clearinghouses goes up and the cash liquidity risk borne by hedgers increases. This cost must be recovered in prices, so short-term volatility on the downside (as well as the upside) actually puts upward pressure on prices in the intermediate term.

5. Do you believe speculation is a problem when it drives prices down? Or do you believe it is only a problem when prices are going up?

See the response to question 4.

6. In 2008, the Interagency Task Force on Commodity Markets issued an Interim Report on Crude Oil. The Task force found that the activity of speculators has not resulted in systematic changes in price. It said "on the contrary, most speculative traders typically alter their positions following price changes, showing that they are responding to new information - just as one would expect in an efficiently operating market." How do you respond to this report?

I believe that they were not measuring the correct things. Non-commodity index fund traders undoubtedly respond to information. My testimony is that the activity of commodity index fund sponsor trading creates an information flow that, because of its disconnection from fundamentals (that is to say, it is passive), is misleading. Speculators behave rationally for the most part. It's just that the rational behavior of commodity index fund sponsors is driven by motivations that are different from other market participants. Those other market participants infer rationality based on their own motivating factors, or at a minimum cannot precisely measure the motives of the sponsors and distinguish their trading behavior from trading activity based on fundamentals. The report failed to consider the possibility that the information flows were corrupted.

It should be noted that this logic is not a radical notion. Noise trading, which is unsophisticated and uninformed trading, is known to have a direct impact on sophisticated traders and ultimately price. My point is that commodity index fund sponsor trading similarly affects price. It is not uninformed. But it is motivated by factors that are not fundamentally market price driven and this is impossible to discern and measure. So the principle is in parallel.

7. You said that those who disagree with you are only "self-interested entities seeking to continue their speculative activities...regardless of how much harm they cause." Please explain what you mean by this point.

I did not intend to suggest that every individual that disagrees with me is driven by venality and insensitive to harm inflicted on others. Nonetheless, the positions on this question are, I believe, heavily biased by self-interests. The sponsors make money from

the fees (and maybe even more from trading against the curve-influenced boom/bust cycle). They also are highly sensitive to the possibility that they may have (perhaps even inadvertently) caused higher prices to be paid by consumers of energy and food on a worldwide basis, especially given the public's opinions growing out of the financial crisis. Infrastructure providers, such as exchanges and clearinghouses, charge fees based on volume. They appear to be biased because lowered trading volume if the roll no longer occurs each month would affect their profitability. Finally, many academics are heavily invested in the concept that markets are inherently efficient. This means that information is efficiently and widely shared and that anomalies are arbitrated out. My testimony challenges that concept. Adapting to that has consequences that are, naturally resisted. (It also may be the case that some academics have a financial interest in supporting the positions preferred by financial market participants, but I have no knowledge of this.)

