

Testimony of

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Mr. Chairman and Members of the Committee, thank you for the opportunity to testify today on the topic of “Ending Excessive Speculation in Commodity Markets.” I testified in front of this committee on May 20th of this year on this important issue and I welcome the opportunity to return and discuss legislative options.¹ In that testimony I shared many observations and statistics related to the general phenomenon of Index Speculation in the commodities futures markets. Before we discuss legislative options, I would like to build on my previous testimony and look specifically at the damage that Index Speculation does to the price discovery function in the agricultural and energy futures markets.

When I use the term Index Speculator, I am referring to Institutional Investors such as Corporate and Government Pension Funds, Sovereign Wealth Funds, University Endowments and others who allocate capital to the 25 key commodities that compose the Standard & Poors - Goldman Sachs Commodity Index (S&P-GSCI)² and/or the Dow Jones - AIG Commodity Index (DJ-AIG).³

In the last five years, Institutional Investors have adopted the mistaken belief that commodities futures are an investable asset class, similar to capital market investments. They have failed to grasp the essential differences between the commodities futures markets and the capital markets, and do not appear to understand that investing in inventories is vastly different from investing in the means of production.⁴

Commodities futures markets exist solely for the benefit of bona fide physical hedgers, the producers and consumers of actual physical commodities.⁵ These markets do not exist for the

¹ http://hsgac.senate.gov/public/_files/052008Masters.pdf

² http://www2.standardandpoors.com/portal/site/sp/en/us/page.topic/indices_gsci/2,3,4,0,0,0,0,0,0,1,1,0,0,0,0,0.html

³ <http://www.djindexes.com/mdsidx/index.cfm?event=showAigIntro>

⁴ “Put simply, a capital asset is part of a system that has some consistent, expected output that exceeds the owners’ consumption needs. It is a component of the means of production. The designation is dependent on the use of the asset, not on its type. My automobile is a consumption good, inappropriate as a store of value for me. The fleet of automobiles owned by a car rental company is a capital asset, designed to produce a constant return over the useful life. Beer is a consumption good for most of us, a capital asset when stored in a brewery or a bar. Capital assets should contribute to a constant, positive return through their part in the output of a business. Money directed toward these assets by shareholders, lenders, sole proprietors and any other participants can be said to be invested. Capital assets can become speculative media rather than investment outlets when they are held in a form in which the only expected return would come from a change in price rather than the generation of an output. Speculative assets promise no output beyond a prospective change in price. . . . Central to the question is whether or not commodity indices, meant to track the price changes in a fairly broad but largely energy related list of commodities are an investment medium that might reasonably constitute an asset class in the manner of common stocks, rental properties, bonds, private businesses or any groups of capital assets from which the owners can expect some positive business output over time. The clear answer is ‘no.’” excerpted from pre-publication copy of “The Commodity Question,” Michael Aronstein, Marketfield Asset Management, New York, NY.

⁵ “The fundamental purpose of the measure is to insure fair practice and honest dealing on the commodity exchanges and to provide a measure of control over those forms of speculative activity which too often demoralize the markets to the injury of producers and consumers and the exchanges themselves.” Report No. 421, U.S. House of Representatives 74th Congress, Accompanying the Commodity Exchange Act, March 18, 1935.

purpose of speculation.⁶ The commodities futures markets provide bona fide physical hedgers with two vital functions: one, a means for price discovery, and two, a means to offset price risk.⁷

Congress clearly understood and appreciated the value of these two vital functions back in 1936 when it passed the Commodity Exchange Act.⁸ The Commodity Exchange Act was designed to protect these functions by establishing speculative position limits, thereby preventing what it terms “excessive speculation.”⁹ While the Commodity Exchange Act does not define this term, it is clear that Congress recognized that unlimited speculation posed a threat to the commodities futures markets and their two vital functions.¹⁰

⁶ Some limited speculation in the commodities futures markets provides beneficial liquidity to the primary constituency (bona fide physical hedgers).

⁷ "An Important Mission in the Ever-Changing World of Finance," About The CFTC, <http://www.cftc.gov/aboutthecftc/index.htm>

⁸ United States Code Title 7, Chapter 1, Section 5(a) Findings http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=browse_usc&docid=Cite:+7USC5

⁹ The commodities futures markets are completely free markets for bona fide physical hedgers - they face no restrictions.

¹⁰ “It should be our national policy to restrict, as far as possible, the use of these exchanges for purely speculative operations.” President Franklin D. Roosevelt message to Congress February 9, 1934
“The bill authorizes the Commission . . . to fix limitations upon purely speculative trades and commitments. Hedging transactions are expressly exempted. That this power of the Commission will be exercised judiciously and for the purposes merely of preventing overspeculation and a type of ‘racketeering’ by a few large professional traders, may be assumed as a matter of course.” Report No. 421, U.S. House of Representatives 74th Congress, Accompanying the Commodity Exchange Act, March 18, 1935. Also see previous footnote 6.

HOW THE PRICE DISCOVERY FUNCTION WORKS IN THE AGRICULTURAL AND ENERGY MARKETS

Because commodities are bulky and costly to transport, spot markets for commodities are geographically dispersed. Many decades ago, local markets relied almost exclusively on local supply and demand to determine prices, with the result being that there were sometimes great differences between prices in various regional spot markets.

This began to change in the 1980s, when spot market participants in the agricultural and energy markets moved to embrace centralized futures markets as the best indicator of overall supply and demand conditions across all spot markets.¹¹ Because of the benefits of price discovery and risk hedging that the futures markets provide to physical commodity producers and consumers, today those participants have agreed to price nearly all spot market transactions at the futures price plus or minus a “local basis” or “differential.”¹²

The CFTC describes it this way: “In many physical commodities (especially agricultural commodities), cash market participants base spot and forward prices on the futures prices that are “discovered” in the competitive, open auction market of a futures exchange.”¹³ Platts, which is the leading pricing service for the energy industry, describes it this way: “In the spot market, therefore, negotiations for physical oils will typically use NYMEX as a reference point, with bids/offers and deals expressed as a differential to the futures price. Using these differentials, Platts makes daily and in some cases intra-day assessments of the price for various physical grades of crude oil, which may be referenced in other spot, term or derivatives deals.”¹⁴

¹¹ “The Structure of Global Oil Markets—A Backgrounder,” Platts, A Division of McGraw Hill Companies, July 2007, page 5. <http://www.platts.com/Resources/whitepapers/index.xml>. Additionally Conversation with Tom Buis, President of National Farmers Union, June 10, 2008

¹² Not all spot commodities are priced this way. This method is used mostly in agriculture for wheat, corn and soybeans, and in energy for WTI crude oil, heating oil, gasoline and natural gas. The basis (in agricultural markets), or differential (in energy markets), is an adjustment to the futures price based on local supply and demand conditions.

¹³ “The Economic Purpose of Futures Markets and How They Work - Price Discovery or Price Basing,” Commodities Futures Trading Commission Website, <http://www.cftc.gov/educationcenter/economicpurpose.html>

¹⁴ “Platts Oil Pricing and Market-on-Close Methodology Explained - A Backgrounder,” Platts, A Division of McGraw Hill Companies, July 2007, page 3. <http://www.platts.com/Resources/whitepapers/index.xml>

As an example, a wheat farmer delivering his crops to the local grain elevator is going to be paid the CBOT futures price plus or minus the local basis spread. A New England Heating Oil distributor buying heating oil from the local wholesaler is going to be paying the NYMEX futures price plus or minus a local differential. That means that when the futures price rises by \$1, if the local basis/differential does not change, then the spot price will also rise by \$1, typically the same day.¹⁵

In the present system, price changes for key agricultural and energy commodities originate in the futures markets and then are transmitted directly to the spot markets. For these commodities, what happens in the futures markets does not stay in the futures markets, but is felt almost immediately in the spot markets.

Physical commodity producers and consumers trust and rely upon the price discovery function of the commodities futures markets to accurately reflect the overall level of supply and demand, pricing their spot market transactions directly off the applicable futures price.¹⁶ For many years, spot market traders have trusted the veracity of futures prices, focusing instead almost exclusively on the local basis / differential in their respective markets.¹⁷

Unfortunately, this has changed in the last few years. This trust has been betrayed, and many physical commodity market participants are now losing faith in the futures price as a benchmark for their transactions.¹⁸

¹⁵ Any classic finance textbook would tell you that futures prices are a derivative of spot prices but we can see here that in fact the opposite is true. Capital markets participants are taught that (1) spot prices are exclusively a function of supply and demand in the spot market (2) futures prices are equal to spot prices plus the cost of carry minus the convenience yield (3) futures prices can only impact spot prices if they impact the supply or demand for that commodity in the spot markets and (4) futures prices must converge to spot prices at expiration. The only one of these statements that is true for these particular commodities futures is that futures and spot prices must converge. But that is only half true, because spot prices can rise to meet futures prices; futures prices do not always have to fall. This whole issue highlights imputed biases that capital markets investors have when it comes to the commodities futures markets.

¹⁶ Other non-exchange traded commodities also price off futures contracts that they closely resemble or with which they have an economic relationship. "Many non-traded commodities price according to the nearest exchange-traded benchmarks - for example, coal to oil, fertilisers to corn and soya - and therefore tend to move in the same direction." GaveKal Research Report, May 27, 2008. This comment was issued in response to people claiming that Index Speculators cannot be driving futures prices because non-exchange traded commodities have risen in price. <http://ftalphaville.ft.com/blog/2008/05/27/13338/commodities-spiral-are-speculators-to-blame/> also see <http://gavekal.com/forum3/default.aspx?f=2&m=2848>

¹⁷ I have had numerous conversations with spot market traders of physical crude and crude products as well as participants in the grains markets. I would encourage Congress to reach out to participants in these spot markets in order to understand how the pricing mechanisms work. I can supply an extensive list of contacts to assist in this effort if needed.

¹⁸ One needs to look no further for a sampling of physical commodity producers and consumers questioning the price discovery process than the Agricultural Forum that the CFTC hosted on April 22, 2008 - <http://www.cftc.gov/newsroom/cftcevents/2008/oeaevent042208.html>

INDEX SPECULATORS HAVE DRIVEN FUTURES AND SPOT PRICES HIGHER

It is important to remember there is only one thing that causes prices to rise in futures markets: buy orders. When a trader sends a buy order to the exchange floor or presses the “buy” key on their trading terminal, if he or she is attempting to buy more contracts than are currently offered for sale at the market price, then the market price will rise.¹⁹ As a hypothetical example, if there are 50 WTI Crude Oil contracts offered for sale at \$135.10 and another 50 WTI Crude Oil contracts offered for sale at \$135.15 then a buy order of 100 contracts will result in the price moving up from \$135.10 to \$135.15.

Please note that *who* initiates a buy order and *why* they initiate it are irrelevant when it comes to explaining an order’s impact on market prices. Almost all trading is anonymous and a trader’s underlying motivation is generally not known to his fellow traders. A 100 contract buy order from a bona fide physical hedger locking in input costs will have the exact same price impact as a 100 contract buy order from an Institutional Investor trying to allocate into commodity futures. 100 contracts is 100 contracts and demand is demand, regardless of who is initiating the buy orders and why they are initiating them.²⁰

Table One shows that Index Speculators have bought more commodities futures contracts in the last five years than any other group of market participants.²¹ If Index Speculators have been the largest buyer of futures contracts, is it not reasonable to assume that they have had the largest impact on futures prices?

¹⁹ Some commentators have observed that for every buyer there is a seller, implying somehow that prices will not move because one cancels out the other. If that were the case, then prices would never move. As it stands, every transaction ever recorded in history necessarily included both a buyer and a seller. In January of 2000 the price of Yahoo common stock traded above \$120 per share. In October of 2001 the price of Yahoo common stock traded below \$10 per share. In every one of these transactions there was a buyer and a seller.

²⁰ Comments by regulators that speculators do not move prices, are price-takers not price-makers, et cetera, are patently absurd. If speculators cannot move prices, why do we have any speculative position limits? Why do we have a regulator? It begs the question why a regulator would be determined to convince the public that the group they are supposed to regulate poses no threat to the marketplace.

²¹ The figures in Tables One, Two and Three do NOT include single commodity swaps that speculators use to access the futures markets through the “swaps” loophole. We have seen unofficial figures that lead us to believe that a large fraction of commercial open interest in the NYMEX WTI crude oil contract actually represents speculative swap positions. Although NYMEX has these exact numbers, they have presently not released them to the public.

TABLE ONE ²⁴	2003 LONG OPEN INTEREST			2008 LONG OPEN INTEREST			PURCHASES LAST 5 YEARS		
	PHYSICAL HEDGER	TRADITIONAL SPECULATOR	INDEX SPECULATOR	PHYSICAL HEDGER	TRADITIONAL SPECULATOR	INDEX SPECULATOR	PHYSICAL HEDGER	TRADITIONAL SPECULATOR	INDEX SPECULATOR
COCOA	71,300	5,673	2,710	50,243	72,866	29,527	-21,056	67,193	26,817
COFFEE	38,378	12,197	5,671	41,159	56,866	63,133	2,781	44,669	57,463
CORN	227,612	54,123	51,139	505,627	300,017	441,197	278,016	245,894	390,057
COTTON	52,529	23,633	9,518	91,820	77,132	114,804	39,291	53,499	105,286
SOYBEAN OIL	76,717	33,449	3,272	104,064	48,619	72,287	27,348	15,169	69,015
SOYBEANS	98,696	58,567	13,733	141,375	132,849	194,391	42,679	74,282	180,658
SUGAR	95,610	31,143	45,931	359,427	180,670	411,510	263,817	149,527	365,579
WHEAT	24,846	25,698	33,960	58,484	66,958	218,191	33,639	41,260	184,231
WHEAT KC	32,759	4,955	10,526	35,629	31,201	30,299	2,870	26,246	19,773
FEEDER CATTLE	3,864	5,238	2,641	5,117	16,208	9,279	1,253	10,969	6,637
LEAN HOGS	5,316	7,377	15,517	29,366	33,374	105,228	24,049	25,997	89,711
LIVE CATTLE	19,820	40,864	20,021	27,898	51,798	135,451	8,078	10,934	115,429
WTI CRUDE OIL	433,028	56,629	108,599	1,161,063	203,280	606,176	728,035	146,651	497,577
HEATING OIL	69,363	14,063	26,217	65,851	27,972	83,008	-3,512	13,909	56,791
GASOLINE	44,252	20,698	25,555	83,826	41,534	78,692	39,574	20,836	53,137
NATURAL GAS	397,488	21,734	29,774	480,964	77,462	214,641	83,476	55,728	184,867
TOTAL	1,691,579	416,042	404,785	3,241,915	1,418,805	2,807,813	1,550,337	1,002,764	2,403,029

Figures derived from data from Goldman Sachs, Dow Jones, Bloomberg, CFTC Commitments of Traders report and the CFTC CIT Supplement. Non-Directional Spreads and Non-Report (Unclassified) Positions are not shown. Traditional Speculators accessing the futures market through the "swaps loophole" are still classified as Physical Hedgers because the CFTC does not distinguish.

Below is a small sample of what Wall Street analysts have had to say about Institutional Investors driving up commodities futures prices:

“A Tidal Wave of Fund Flow - Despite the economic gloom many commodity prices hit new highs in recent weeks, driven largely by investment inflows.”²²

Citigroup - April 7, 2008

“Without question increased fund flow into commodities has boosted prices.”²³

*Goldman Sachs*²⁴ - May 5, 2008

“We have argued recently that some of the price buoyancy during Q1 reflected financial flows and investments in oil and other commodities. . . . Our study indicated that for every \$100 million in new inflows, WTI prices increase by 1.6%. . . . Our conclusion for this study is that we are seeing the classic ingredients of an asset bubble.”²⁵

Lehman Brothers - May 29, 2008

“The entry of new financial or speculative investors into global commodities markets is fueling the dramatic run-up in prices”²⁶

Greenwich Associates - May 2008

It is clear to Wall Street from their vantage point that Institutional Investors pouring billions of dollars into the commodities futures markets have greatly influenced prices. The reality is that the effect of Index Speculators has been so great that they have actually altered the price discovery dynamics in today’s futures markets.

²² “Great Bulks of Fire IV,” Citi Commodities Strategy, Alan Heap and Alex Tonks, April 7, 2008, page 1.

²³ \$100 oil reality, part 2: Has the super-spike end game begun?,” Goldman Sachs Global Investment Research, Arjun N. Murthi, Brian Singer, et al. May 5, 2008. page 12.

²⁴ Goldman Sachs, together with Morgan Stanley, are the two largest purveyors of commodity index swaps followed by J.P. Morgan and Barclays. Source: “The Global Commodities Boom,” Greenwich Associates, Andrew Awad, Woody Canaday, et al., May 2008, page 1.

²⁵ “Oil Dot-com,” Lehman Brothers Energy Special Report, Edward Morse, Michael Waldron, et. al., May 29, 2008, page 3.

²⁶ “Financial Investors Fueling Commodities Boom,” Greenwich Associates, Andrew Awad, Woody Canaday, et al., May 2008, page 1.

INDEX SPECULATORS DAMAGE THE PRICE DISCOVERY FUNCTION OF THE COMMODITIES FUTURES MARKETS

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

In contrast, Index Speculators invest in a broad basket of commodities and therefore do not express a view on any single commodity. Their reasons for entering into their positions vary widely. Perhaps their investment committee recently voted to allocate millions of dollars to commodities. Or if they manage a commodity index mutual fund or ETF they might have received cash inflows from investors. Perhaps they are seeking to hedge against inflation or to make a bet against the U.S. dollar.²⁷ What is clear is that the vast majority of Index Speculators do not trade based on the underlying supply and demand fundamentals of the individual physical commodities. Therefore, their trading decisions damage the price discovery function of the commodities futures markets.

If a pension fund decides to allocate \$100 million to a commodities futures strategy that replicates the S&P GSCI, the \$40 million that consequently flows into WTI Crude Oil has nothing to do with the actual supply or demand for crude oil in the real world. Every single WTI futures contract that is traded for any reason other than the supply and demand of physical crude oil is a contract that weakens the price discovery function of the markets.

In crude oil, Index Speculator demand for paper barrels²⁸ has little or nothing to do with the demand for physical barrels. Yet under the current pricing system, the paper barrel price sets the real world price for physical barrels.

²⁷ Some Wall Street commentators would argue that the level of the U.S. Dollar vis a vis other currencies is a fundamental factor in supply and demand. However, any effect the dollar has on supply and demand will show up in actual supply and demand figures and will be reflected in the hedging activities of physical commodity producers and consumers. Investors' myopic preoccupation with commodity prices relative to currency levels stems from their macroeconomic views rather than from any firsthand experience observing actual changes in real world supply and demand due to these factors.

²⁸ It is critical to note that Index Speculators never actually take possession of physical commodities, and they do not have to in order to drive up prices. They impact the price at the time that they buy their initial futures contracts. Then when their contracts approach the delivery month, they simply exchange their existing contracts for other contracts with expiration dates that are further in the future. Because futures are a zero sum game, there is someone on the other side of the Index Speculators position that generally is just as motivated to close out their position. Since over 90% of all positions get closed out, the futures exchanges are set up to facilitate what is called "rolling," which involves a specific kind of trade called a "spread trade." As part of their roll trade, Index Speculators close out one futures contract which simply "extinguishes" it; they then open another new contract with a later delivery month. Because they always defer delivery, Index Speculators never take possession of physical inventories.

Contrary to what some on Wall Street would have you believe, it is physical commodity producers and consumers who make commodities futures markets “efficient.”²⁹ The commodities futures demand of Index Speculators for “investment” reasons has little or nothing to do with the supply and demand of the actual commodities and grossly distorts the price discovery function. Institutional Investor participation actually makes the commodities futures markets less “efficient” from a pricing standpoint.

By virtue of their investment strategy, Index Speculators collectively do great damage to the price discovery function of the commodities futures markets.

²⁹ The Efficient Markets Hypothesis (EMH) is a capital markets theory that underlies the key rationale for passive indexing. It says that all publicly available information concerning a company’s future cash flows is already reflected in a company’s stock price so one cannot consistently make money by analyzing publicly available information. It incorporates the Capital Asset Pricing Model (CAPM) which says that all securities can be valued as the net present value of future cash flows. A big part of CAPM is determining the appropriate discount rate utilizing the Beta of the security with the market. EMH and CAPM both tie into Modern Portfolio Theory that talks about the ideal composition of portfolios. Given that commodities have no future cash flows and a beta of 1 with themselves (oil is part of the oil market) it looks rather foolish to try to apply capital markets concepts to the commodities futures markets.

INDEX SPECULATORS' PRESENCE BREEDS EXCESSIVE SPECULATION AND RADICALLY RESHAPES MARKET DYNAMICS

Traditional Speculators³⁰, unlike Index Speculators, are not committed to any particular trading strategy. Their motivation is simply to profit from the direction of prices, whether that is up or down.

Table Two shows that in 1998, average long positions in the commodities futures markets were comprised of about 79% bona fide physical hedgers, 14% Traditional Speculators and 7% Index Speculators. Because speculators at the time were outnumbered 4 to 1 by physical hedgers, the speculators knew that futures prices would move based on what physical hedgers did. Because physical hedgers based their trading decisions strictly on supply and demand fundamentals, Traditional Speculators did the same. For this reason, commodities futures markets effectively reflected the supply and demand realities in the underlying physical commodity market and were very efficient at price discovery.³¹

TABLE TWO
Commodities Futures Markets
Percentage Of Open Interest²⁴

1998	LONG / DEMAND SIDE		
	Physical Hedger	Traditional Speculator	Index Speculator
COCOA	89%	9%	2%
COFFEE	81%	18%	2%
CORN	87%	9%	4%
COTTON	84%	14%	2%
SOYBEAN OIL	73%	27%	0%
SOYBEANS	87%	11%	2%
SUGAR	87%	9%	3%
WHEAT	68%	21%	11%
WHEAT KC	86%	5%	8%
FEED CATTLE	52%	37%	10%
LEAN HOGS	57%	28%	16%
LIVE CATTLE	68%	24%	9%
WTI CRUDE OIL	84%	4%	12%
HEATING OIL	88%	2%	10%
GASOLINE	80%	4%	16%
NATURAL GAS	90%	3%	7%
AVERAGE	79%	14%	7%

Source: CFTC Commitments of Traders reports, and estimates derived from CFTC CIT Supplement.

TABLE THREE
Commodities Futures Markets
Percentage Of Open Interest²⁴

2008	LONG / DEMAND SIDE		
	Physical Hedger	Traditional Speculator	Index Speculator
COCOA	33%	48%	19%
COFFEE	26%	35%	39%
CORN	41%	24%	35%
COTTON	32%	27%	41%
SOYBEAN OIL	46%	22%	32%
SOYBEANS	30%	28%	42%
SUGAR	38%	19%	43%
WHEAT	17%	20%	64%
WHEAT KC	37%	32%	31%
FEED CATTLE	17%	53%	30%
LEAN HOGS	18%	20%	63%
LIVE CATTLE	13%	24%	63%
WTI CRUDE OIL	59%	10%	31%
HEATING OIL	37%	16%	47%
GASOLINE	41%	20%	39%
NATURAL GAS	62%	10%	28%
AVERAGE	34%	26%	40%

Source: CFTC Commitments of Traders reports, and estimates derived from CFTC CIT Supplement

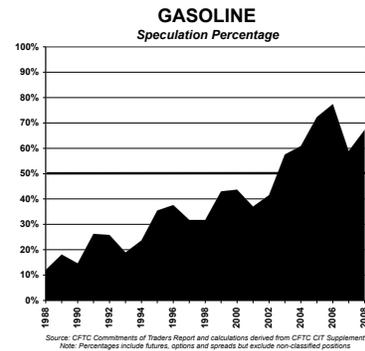
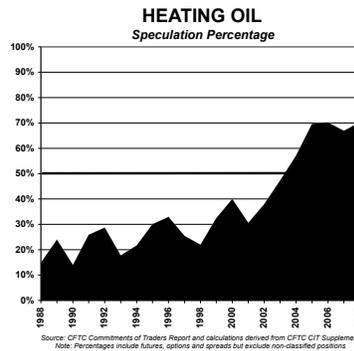
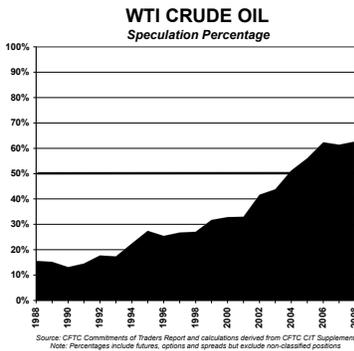
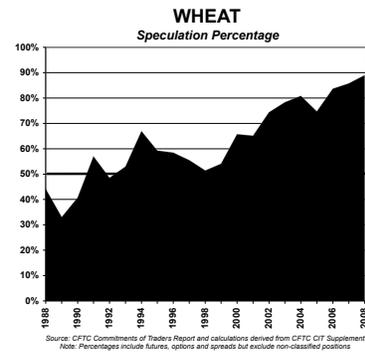
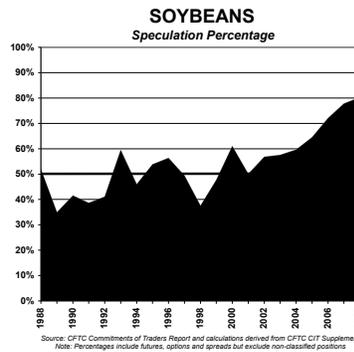
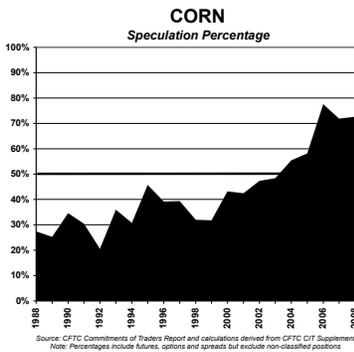
³⁰ A Traditional Speculator follows an active trading strategy of buying and selling. They have always been present in the commodities futures markets and do not have the detrimental characteristics of Index Speculators that I outlined in my May 20th Testimony http://hsgac.senate.gov/public/_files/052008Masters.pdf

³¹ At this time, liquidity in the futures markets was more than sufficient; market participants were not complaining about a lack of liquidity. The people who most want to increase speculative volume in the name of increased liquidity are the same people who get paid on a per contract basis, namely the exchanges.

Ten years later, the markets look dramatically different. Today, on the long side of the market, the dominant position of bona fide physical hedgers has been usurped by Index Speculators. Table Three shows that Index Speculators now average 40% of the long open interest, followed by bona fide physical hedgers at 34% and Traditional Speculators at 26%. This means that speculators today outnumber bona fide physical hedgers by a 2 to 1 ratio!

Index Speculators have been consistently buying billions of dollars worth of futures contracts at an increasing rate over the last 5 years. This accelerating buying pressure has contributed to an upward price trend for commodities futures. The strong price performance of commodities has, in turn, attracted an increasing number of additional speculators, including active participants like Hedge Funds. The influx of these additional speculators into the commodities futures markets further amplifies price increases. The resulting speculative feedback loop contributes to increased volatility and accelerating price moves.

The charts below show this phenomenal increase in speculation in recent years as more and more speculators have entered the commodities futures markets.



Traditional Speculators that were active in the markets prior to the rise of the Index Speculators have had to adapt their trading strategies to this new dynamic. Those Traditional Speculators that continued to trade purely on supply and demand fundamentals have not survived. Those Traditional Speculators that did adapt and thrive under this new dynamic have adopted trading strategies that take into account the behavior of these new entrants into the commodities futures markets.

Because the commodities futures markets are now dominated by speculators, of which the Index Speculator is the most influential type, prices in these markets move for reasons that increasingly have little to do with specific commodity supply and demand fundamentals. Today the level of the U.S. dollar, the allocation decisions of Pension Funds or the amount of investor inflows into commodity index ETFs, ETNs and mutual funds can have a much bigger impact on commodity futures prices than the fundamental conditions in the underlying physical markets. All of the discussion today about WTI crude oil being a hedge against a weakening U.S. dollar is prima facie evidence that capital markets investors now dominate the WTI crude oil markets. Bona fide physical hedgers as a group have increasingly lost their ability to influence prices through their hedging decisions.

Because of this disassociation between futures prices and the supply and demand realities in the physical markets, the futures markets are no longer able to serve the only constituency they were ever intended to serve: bona fide physical hedgers. Many bona fide physical hedgers, now greatly outnumbered and having to transact in a market that is mainly driven by the activities of large institutional speculators, are questioning the value of the futures markets for hedging purposes. If this trend continues, we can expect to see many physical commodity producers and consumers abandon the futures markets entirely as a vehicle for hedging purposes and price discovery. At that point, the futures markets' destruction from excessive speculation will be complete.

RESTORING THE PRICE DISCOVERY FUNCTION OF THE COMMODITIES FUTURES MARKETS

The commodities futures markets today are clearly experiencing the detrimental effects of excessive speculation. The time for studies is well past. Studies should be attempted prior to the adoption of new financial techniques, like the FDA does with new medicines, not after approval has been granted. “First do no harm...”, as the beginning of the Hippocratic Oath reads, is a concept that market regulators should take to heart.

I have read the discussion drafts introduced by Senators Lieberman and Collins on June 18th and believe they represent a substantial step in the right direction. I note that your three proposed pieces of legislation correspond generally to the first three steps of the four steps that I am outlining here today. To the extent that they differ please accept these differences as my suggestions on how to improve upon the proposals. Now, let me outline for you the steps I believe are needed to protect and strengthen the critical price discovery function of our commodities futures markets.

STEP ONE: ESTABLISH LIMITS THAT APPLY TO EVERY MARKET PARTICIPANT

As a first step, I recommend that Congress convene a panel composed exclusively of physical commodity producers and consumers for every commodity. This panel will set reasonable speculative position limits in the spot month as well as in all other individual months, and as an aggregate across all months. For commodities where real limits have been replaced by “accountability” limits, real limits must be re-established.³²

The commodities futures markets exist solely for the benefit of bona fide physical hedgers, so they are best qualified to set the limits. These physical market participants understand the benefits of liquidity and will do nothing to jeopardize their ability to hedge. The key here is that reasonable speculative limits allow the commodities futures markets to function properly.

As part of this first step, speculative position limits must apply to every market participant (exempting bona fide physical hedgers) whether they access the futures markets directly or trade in the over-the-counter markets through swaps and other derivatives. This means effectively closing the swaps loophole and ensuring that position limits “look through” the swap transaction to the ultimate counterparty. It is essential that swaps dealers report all their positions to the CFTC so that positions can be aggregated at the control entity level for purposes of applying position limits.

³² In 1998, the CFTC codified an exemption for commodities that trade in “high volume and liquid markets” that allowed exchanges to replace speculative position limits with “position accountability limits” which do not actually limit the size of positions. Speculative position limits were still required in the spot month. So effectively this means there are no hard and fast limits for NYMEX WTI crude oil futures except in the spot month. <http://www.cftc.gov/foia/fedreg98/foi980717a.htm>

One potential avenue for ensuring that speculative limits apply in the over the counter markets would be to require that all OTC transactions clear through the appropriate futures exchange. This would have the added benefit of strengthening the current system and making it more transparent.

Additionally, it is imperative that measures be taken to ensure that speculative position limits apply to the proprietary trading desks of Wall Street Banks. Also, if a financial institution owns a physical commodity business, then they can only take exempt positions commensurate with the size of their actual physical business. Beyond that, they must be subject to the speculative position limits.

STEP TWO: PLACE AN OVERALL LIMIT ON EXCESSIVE SPECULATION FOR EACH COMMODITY

As a second step, Congress should instruct the panel of physical commodity producers and consumers to determine, based on a percentage of open interest, what constitutes “excessive speculation.” As an example, physical crude oil producers and consumers may decide that the crude oil futures markets should never be more than 35% speculative (not including spreads) on a percentage of open interest basis. These are their markets, so they should be empowered to define numerically what constitutes excessive speculation.

Next, the CFTC should be instructed to establish “circuit breakers” (a concept familiar to equity market participants) that adjust individual speculative position limits downward in order to prevent any commodity futures markets from reaching the overall limit established by the panel. These adjustments to individual limits should happen in a gradual fashion and be based on data that is averaged over time in order to minimize the impact on the markets. A speculator whose existing position exceeds the newly established limit by virtue of the downward adjustment in limits would not be required to sell; they would simply be unable to add to their position.

Building on our earlier crude oil example, the CFTC could publish a sliding scale from 25% to 35% of speculative open interest that pares back the individual position limits from 100% to 20% of their normal size. So if the established aggregate speculative position limit was normally 20,000 contracts at an overall speculative percentage of 25% or less, then if overall speculation reaches 30% perhaps the individual position limit would adjust downward to 12,000 contracts.³³

³³ If position limits range between 20,000 contracts (100%) and 4,000 contracts (20%) based on an overall speculative percentage of 25% to 35% then at 30%, the midpoint of the range, speculative position limits would equal 12,000 contracts which is halfway between 20,000 and 4,000. These figures are used purely for illustrative purposes and do not reflect levels that we recommend.

STEP THREE: PROHIBIT COMMODITY INDEX REPLICATION STRATEGIES

The third step is to eliminate the practice of investing through passive commodity index replication. Index Speculators have no sensitivity to supply and demand in the individual commodities because of the nature of passive indexing. The practice should be prohibited because of the damage that it does to the price discovery function. Congress should use any and all available means to do so. One potential avenue might be ERISA.³⁴

Another avenue might be found in the Commodities Exchange Act which states, when discussing speculative position limits, 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 positions were held by, or the trading were done by, a single person.”³⁵ Since, Index Speculators are all acting in express agreement by following the exact same index trading methodology, they should all be collectively subject to the speculative position limits of a single speculator. If this provision of the CEA were enforced, then the amount of money allocated to index replication would have to drop from the current level of \$260 billion to the limits of a single speculator, approximately \$4 billion.

STEP FOUR: INVESTIGATE PHYSICAL HOARDING OF COMMODITIES BY INVESTORS

Congress should actively investigate the practice of investors buying physical commodity inventories. It has come to my attention that some Wall Street Banks are offering commodity swaps based on actual physical commodities.³⁶ This is a distressing development because it means that investors are directly competing with American corporations for natural resources and thereby competing with American consumers.

³⁴ Pension fund trustees under the Prudent Man Rule have a fiduciary duty to avoid purely speculative “investments” (such as futures contracts). Under the Prudent Investor Rule, no class of “investments” is excluded if it makes sense from a portfolio perspective, but speculating is still not sanctioned by the rule.

³⁵ U.S. Code, Title 7, Chapter 1, Section 6a, http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=browse_usc&docid=Cite:+7USC6a

³⁶ “CS Commodities: Group Update And Key Commodity Themes For 2008,” Credit Suisse International, Alex Toone (Head of Sales) see also “Trade Idea: Fixed Rate Swap On Iron Ore,” Credit Suisse International, May 23, 2008

DO NOT BE SWAYED BY EMPTY THREATS OF OFFSHORE MIGRATION

Before I conclude, let me say that many of the people who are profiting from the practices outlined in my testimony will try to scare you into believing that futures trading in U.S. commodities will simply move offshore. This is an empty threat.

First of all, any futures contract that calls for physical delivery inside the United States is automatically subject to CFTC regulation.³⁷ Any futures contract that cash settles against a U.S. contract with physical delivery provisions is also automatically subject to CFTC regulation unless specifically exempted.³⁸ If not exempted, then no person inside the United States may lawfully trade that contract.³⁹ So for instance, 60% of the volume of the cash-settled WTI crude oil contract on the Intercontinental Exchange (ICE) is traded by U.S. entities.⁴⁰ If the CFTC had not exempted the ICE from regulation then those U.S. entities would not be able to trade that contract and it would have been very difficult for the contract to get off the ground.

In order for any futures contract to be successful it must reach a “critical mass” of volume.⁴¹ Market participants always prefer the contract that has the most liquidity. The United States is the largest consumer of energy in the world and the largest producer of food in the world. Every U.S.-based physical commodity producer and consumer will favor a futures contract with physical delivery provisions inside the United States. This will be the contract that they choose as their benchmark for spot market transactions, which will only encourage non-U.S. physical market participants to choose this contract as well. This ensures the critical mass of liquidity necessary for the futures contract to flourish.

Re-establishing speculative position limits will significantly reduce the speculative volume on commodities futures exchanges. But, the majority of speculators likely will remain well within the speculative position limits and will not be affected. Therefore they will have no incentive to shift their trading to non-regulated exchanges.

Proper enforcement of speculative position limits and the elimination of any hedge exemptions for arbitrage transactions between U.S. regulated and non-U.S. regulated exchanges will mean that prices on offshore exchanges are de-linked from prices on U.S. exchanges. If an offshore exchange (1) cannot offer a physical delivery provision within the U.S., (2) cannot attract

³⁷ Section 4.05[2] “Derivatives Regulation,” Philip McBride Johnson and Thomas Lee Hazen, Aspen Press, 2004, pages 977-980

³⁸ Section 4.05[6] “Derivatives Regulation,” Philip McBride Johnson and Thomas Lee Hazen, Aspen Press, 2004, pages 983-986. See also Testimony of Michael Greenberger - June 3, 2008: http://commerce.senate.gov/public/_files/IMGJune3Testimony0.pdf

³⁹ *ibid*

⁴⁰ Conversations with House Energy Committee Staff

⁴¹ “Financial Futures and Options,” Todd E. Petzel, Quorum Books, New York, 1989, page 4.

physical commodity producers and consumers and (3) its prices cannot be arbitrated, then the prices of these offshore futures contracts will bear no relationship to the true prices found on U.S. regulated exchanges.

The implementation of the solutions outlined in this testimony will greatly increase the confidence of market participants around the world that our futures contracts' prices are an accurate reflection of true supply and demand fundamentals. This will lead to greater participation and therefore further volume.

FINAL THOUGHTS

Institutional Investors from the capital markets have hijacked the commodities futures markets. "Passive indexing," "long only," "buy and hold," and "long term," are all capital market investment concepts that are completely at odds with the commodities futures market. These investors have been beguiled into believing that commodities futures are an asset class just like stocks or bonds. Commodities futures markets are not capital markets.

Wall Street is very good at inventing and promoting novel investment strategies because of the lucrative rewards which can follow. Unfortunately, Wall Street is not good at foreseeing the long-term consequences of the instruments that they create. We have to look no further than the recent subprime debacle, which has now grown into a worldwide financial crisis, to see where unbridled financial innovation can lead.

Can we trust that large institutions investing in an "asset class" for the first time fully understand all of the potential ramifications of their actions? What is the cost to society when an investment decision, embraced en masse by Institutional Investors, drives futures prices and spot prices higher and ultimately cripples the price discovery function of the commodities futures markets?

What is the point of an investment practice that drives up food and energy prices and therefore contributes to higher measures of inflation?

This concludes my testimony.