Testimony of
The Commodity Markets Council
On Financial Speculation in Commodity Markets: Are Institutional Investors and Hedge Funds Contributing To Food and Energy Price Inflation?

Before the Committee on Homeland Security and Governmental Affairs
U.S. Senate

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Mr. Chairman and Members of the Committee:

Good morning. My name is Thomas Erickson and I am the chairman of the Commodity Markets Council (CMC). I also serve as a vice president of government and industry affairs with Bunge.

Mr. Chairman and Ranking Member Collins, the issues you plan to address today are very important and I would like to thank you for hosting this hearing and for inviting CMC to participate.

CMC is a trade association that represents commodity futures exchanges, regional boards of trade, and numerous industry counterparts in the agriculture and energy businesses, including domestic and multinational commodity merchandisers, processors, millers, refiners, commercial and merchant energy companies, precious and base metal trading firms, and bioenergy producers; US and internationally-based futures commission merchants; food and beverage manufacturers; major transportation companies; and financial institutions.

Representing the complete spectrum of commercial uses of the agricultural and energy futures markets, the activities of our members range from grain and energy hedging by local country grain elevators to highly sophisticated, high-volume hedging activities supporting domestic and international grain and other agricultural product merchandising, exporting, and processing operations. The businesses of all our non-exchange member firms depend upon the efficient and competitive functioning of the risk management products traded on U.S. futures exchanges.

Examining The Role Of Institutional Investors And Hedge Funds In Commodity Markets

CMC views the investment activity of institutional investors and index funds as legitimate "financial hedging," but we recognize that it is passive in nature and not responsive to price levels or supply and demand fundamentals. In 2005 and 2006, CMC worked closely with the Commissioners and staff of the Commodity Futures Trading Commission (CFTC) to bring about a better industry understanding of the nature of index fund activity in futures markets. The result of this collaborative effort was the CFTC's release of a new Commitment Of Traders (COT) Supplemental report showing index fund financial hedges as a separate and distinct category.

We believe the COT Supplemental Report provides much needed transparency to the market about the size and behavior of such investors. Despite being a relatively young report, it is already one of our industry's most essential tools for analyzing markets.

Although some organizations believe that the activities of large institutional investors in futures markets pose a threat, CMC believes that this is not necessarily the case. CMC recognizes that passive investment in the commodity markets may have had some price impact, but current evidence shows that market fundamentals generally support the current price levels seen in the futures markets.

The CFTC recently indicated that it will take a "go-slow" approach in expanding exemptions for this new class of investors. CMC supports this regulatory approach because it will allow the Commission and market users more time to thoroughly evaluate the potential this passively invested money may have on commodity markets. Given the many concerns in the commercial marketplace about convergence, CMC believes it is critical for market participants to have a clear idea and understanding of this new type of investor. It is important to note that this type of investment is new and different, but not necessarily bad.

Equally important is the distinction between passive investment and price-responsive investment. Typically index funds and institutional investors engage in passive investments. They take a position and hold it until a determined time. They do not change their position based on market movements. On the other hand, hedge funds tend to be more responsive to market signals and act as a traditional speculator. As such, hedge funds are subject to speculative limits which are appropriate.

In the last decade, futures markets, especially in the enumerated agricultural commodities, have grown immensely because of the relevance of their products to the commercial hedging, financial hedging, and general international and domestic trading communities – including hedge funds, index funds, and institutional investors. This increase in volume boosts liquidity, aids in price discovery, and enhances market efficiency.

Futures markets today reflect global economics and trends, not speculative buying power. Speculative activity in futures markets may influence day to day prices, but it is powerless in the face of larger, fundamental forces. If prices begin to retreat tomorrow, speculative activity will follow that retreat, not cause it.

Policy Recommendations To Consider

To address the concerns surrounding this new investor in commodity markets, CMC recommends:

1. Monitor Index Fund Positions. To maintain competitive markets, exchanges and the CFTC should continue to monitor index fund participation and be prepared, if necessary, to examine the structure of the hedge exemptions granted to the funds.

   In the agriculture futures markets, volume grew immensely in the last decade and the increased liquidity benefited all market participants. Fund investment contributed to this prosperity, and CMC believes that the CFTC and lawmakers should move slowly when adopting measures that will discourage such participation in the markets.

2. Continued Product Innovation. As the markets evolve and learn to adapt to the changing supply and demand dynamics, CMC would support legislation and regulations that allow exchanges to continue to innovate and create new products to manage risks.

3. CFTC Study Of Alpha Trading. CMC also recommends that the CFTC initiate a study of the trend toward "alpha" or "enhanced return" trading by index and hedge funds. Because this type of investment is price-responsive and not passively managed, CMC believes it is speculative in nature and should be reported as such on the CFTC COT Supplemental Report.

Margin Requirements

With crude oil prices moving higher and higher, CMC shares the concerns of many lawmakers. We are confident in the ability of CFTC professional staff to monitor and evaluate trading in energy markets, as well as their conclusions about the impact of speculation on prices in the energy futures markets.

CMC is concerned about a provision in the Consumer-First Energy Act of 2008 that would require the CFTC to set a "substantial increase in margin levels for crude oil." It appears the intent of the provision would be to lower prices; however, we believe that increased margin requirements would force many market participants off-exchange and into less transparent markets.

A margin payment, also called a performance bond, is the amount of money or collateral deposited by either a customer with a broker, a broker with a clearing member, or a clearing member with a clearing organization. A margin payment does not serve as a partial payment on a purchase, but rather serves to manage counter-party risk and ensure the financial integrity of the markets. Raising margin requirements will not reduce volatility or manage prices. It will increase the cost of futures transactions and potentially push speculative liquidity from the regulated exchange marketplace.

CMC Grain Futures Performance Task Force

With unprecedented challenges facing the US grain markets, CMC brought together exchanges and exchange-users to discuss futures market performance. The Task Force reviewed many market-related issues with the participants and the role of institutional investors and hedge funds was a significant point of discussion.

As CMC is still working to finalize our findings report, I can provide a general overview based on the dialogue the Task Force panel had with the participants. CMC will make the full report available to you as soon as it is complete.

The overriding concern expressed by participants is the financial impact of high commodity prices and increased price volatility – not futures market performance. Most market participants agree that current supply and demand fundamentals support high commodity prices. They do not believe that institutional investors or hedge funds are pushing price levels higher. Specifically, participants identified the following as the primary reasons for current price levels:

1. Strong economic growth in developing countries such as China and India resulting in increased demand for commodities.

2. Increased demand for commodities used for biofuel production and government mandates on biofuel use that result in inelastic demand for grains and vegetable oils.

3. Reduced yields in major producing regions due to weather events that are resulting in historically low world grain stocks-to-use ratios.

4. Export restrictions imposed by other nations.

5. A weakening U.S. dollar.

Meanwhile many grain and oilseed handlers face greater financial scrutiny as the sub-prime mortgage problems increase the pressure on lenders. This tighter credit creates an increased need for more consistent convergence between cash and futures markets.

Consistent convergence was the primary topic regarding technical futures market performance. While most participants agree that basis weakens in high price environments relative to more normal market conditions as grain and oilseed handlers' increased risk is incorporated in lower cash grain bids, participants still expect consistent basis strengthening as futures markets approach expiration. Some Task Force participants have disagreed on why convergence has been inconsistent – citing either insufficient storage charges on futures market receipts and certificates; index fund and/or speculative activity in the market; or the multitude of external shocks hitting the market. Most of those interviewed by the Task Force urged Exchanges to not make drastic changes until the markets adjust to this new operating environment.

The panel discussed a number of proposals that might improve convergence, but no broad consensus emerged from the process. Nonetheless, the largest number of participants generally supported increasing storage rates. Participants also supported seeking CFTC approval to clear OTC grain swaps.

In conclusion, we are in complicated times with supply and demand fundamentals shifting. CMC believes that markets are generally the most efficient filters of information and given time to respond, market participants will adapt.

Mr. Chairman, we compliment you and Ms. Collins for your efforts and we look forward to working with you. Thank you.