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 purchases 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.