TESTIMONY OF CHAIRMAN GARY GENSLER

COMMODITY FUTURES TRADING COMMISSION

BEFORE THE

U.S. SENATE PERMANENT SUBCOMMITTEE ON INVESTIGATIONS

JULY 21, 2008

Chairman Levin, Ranking Member Coburn, Members of the Subcommittee, thank you for the invitation to testify before the Permanent Subcommittee on Investigations regarding the wheat market.

This Subcommittee's report, *Excessive Speculation in the Wheat Market*, is a timely and significant contribution to discussions regarding the potential effects of index trading in the wheat market and other commodity futures markets. As the Commission continues our own analysis and appropriate regulatory responses, the report's recommendations will be carefully considered.

The continued lack of convergence in important segments of the wheat market has significantly diminished the usefulness of the wheat futures market for commercial hedgers. The reduced ability of these firms to hedge their price risks increases the cost of doing business. Ultimately, it is the American consumer who will bear the burden of these increased costs. Core to the Commodity Futures Trading Commission's (CFTC) mission is to ensure fair and orderly markets that enable commodity users to discover and hedge price risks. At the heart of this is the convergence of cash and futures prices. My firm belief is that we must aggressively use all existing authorities to fulfill this mission.

My testimony today will cover four areas:

- First, a review of the conditions in the wheat futures market;
- Second, some key regulatory initiatives the CFTC is undertaking within our current authorities;
- Third, a brief discussion of the need for broad regulation of the over-the counter (OTC) derivatives markets; and
- Fourth, specific responses to the Subcommittee's recommendations.

The Wheat Futures Market

I would like to start with a review of the lack of convergence in the wheat futures market. I also will touch upon possible factors leading to this lack of convergence and recent steps taken by the futures exchanges to try and address the problem.

Lack of Convergence. Hedging in the futures markets only works to the extent that the price of the commodity in the cash market and the price of the commodity in the futures market converge as a futures contract expires. If the cash and futures prices do not come together in a predictable manner upon expiration of the futures contract, then the effectiveness of the hedge is significantly reduced.

As this Subcommittee's report documents, over the past several years, the futures price and the cash price for soft red winter wheat have often failed to reach convergence. The average difference between the Chicago Board of Trade (CBOT) wheat futures price at contract expiration and Toledo cash wheat prices rose from an average of about 5 cents per bushel in 2005 to 47 cents in 2006, narrowed to 24 cents in 2007, but widened again appreciably to $1.07 in 2008.

So far this year, the average difference between the cash and futures prices at contract expiration has improved modestly. Contract changes designed by the Chicago Board of Trade (CBOT) to address convergence began with this July's contract. Even so, the final July Toledo difference was still 83 cents. This continued lack of convergence is unacceptable. Several market participants have stated that the problem is so severe that they could not use the CBOT wheat futures contract for hedging and they have preferred to bear whatever risks the cash market presented.

Possible Factors Contributing to Lack of Convergence. Many factors are cited as having contributed to the lack convergence in the soft winter wheat markets, ranging from contract design, changing market conditions, to natural disasters such as flooding. I would like to focus on three factors believed by many market participants to be involved. First, the relative sizes and scale of the participants in the wheat market. Secondly, the design of the wheat futures contract. Third, the large "carry," or additional price paid for successive futures contracts. There is much debate and controversy about the importance of each of these factors. Amongst market participants and observers, there is not even agreement as to whether each of these factors constitutes a cause or an effect of the convergence problem.

Factor # 1: The relative sizes and scale of market participants. The soft red winter wheat futures market is one of three wheat futures markets in the United States. Hard red winter wheat futures contracts are traded on the Kansas City Board of Trade and hard red spring wheat futures contracts are traded on the Minneapolis Grain Exchange. Although it is the smallest of the three major wheat crops, constituting only about 20% of total U.S. wheat production, the CBOT's soft red winter wheat futures contract is the primary futures contract used to hedge wheat in the U.S. and globally. US soft red winter wheat, with a $1.4 billion annual crop, constitutes just 2 % of global wheat production over the last several years. Despite its relatively small production base, the total open interest in the CBOT wheat contract is typically several times larger than the open interest for wheat contracts on the other exchanges.

Because the CBOT contract is so widely used, it is considered the global benchmark for the price of wheat. For this reason, many of the commodity indexes have chosen to peg their indexes to the value of the CBOT contract. Investors in these indexes now constitute a particularly large share of the wheat market. Over the past five years index traders have represented between 30 and 55 percent of the total long open interest in the CBOT wheat futures market.

As a result, the CBOT wheat futures contract must shoulder a large amount of index trading relative to the actual amount of the commodity produced and traded under the contract. For example, in mid-2008 commodity index traders held futures contracts representing the purchase of approximately 1 billion bushels of wheat. The size of the entire US soft red winter wheat crop for 2007-08 was about 360 million bushels. Thus, index investors, through futures contracts, were invested in the equivalent of three years of production of soft red winter wheat.

There are large amounts of index trading in other commodity futures markets as well. Yet, in these other markets, the index investments may not have been as large in relation to annual commodity production and hedging. These other markets, though experiencing challenges, have not experienced the same extent of convergence problems as the wheat futures market.

Factor #2: Contract design. Second, the limited capacity for delivery of wheat under the CBOT contract may have contributed to the lack of convergence. As with other commodity futures contracts only facilities in specific locations and approved by the CBOT may make delivery under the wheat futures contract. This restriction has been considered necessary for grain and other physical commodity futures contracts to ensure that persons committed to making delivery under a contract actually have the ability to do so. Until recently, there were only two warehouses in Chicago, six in Toledo, and three in St. Louis that were approved to make delivery under the CBOT wheat futures contract. These warehouses are operated by five firms, and as wheat merchandising shifted, became less centrally located to the cash market for soft red winter wheat.

Further contributing to the delivery constraints is that there is no mechanism to force the holders of shipping certificates for grain to redeem them for physical grain. As long as it is profitable for warehouses and holders of shipping certificates to keep the grain off the market rather than place it into the stream of commerce they will do so, and convergence will be harmed.

Factor #3: Large carry. The price spreads between futures contracts in the CBOT wheat market (i.e., the “carry”) have been large. This phenomenon, usually associated with ample physical supplies, has prevailed since last summer’s harvest. As a result, it has been profitable for traders to keep grain in storage, as prices for out dated futures are greater than near dated futures. When the carry is equal to the full cost of financing, insurance, and storage, it is said that a market is in “full carry”. Periods of full carry can expose weaknesses in the delivery mechanism of a contract. Traders seeking to take advantage of full carry markets can, at times, overwhelm the capacity of grain delivery facilities. Grain delivery operators normally try to engage in arbitrage transactions between the cash and futures markets that helps bring about convergence. Over the past few years, the lack of convergence has been most pronounced when the carry has been large. Convergence has occurred when the carry has been small. Observers are divided about whether the large carry has been a cause of the lack of convergence, or a symptom of it.

Recent Changes to Contract. The Chicago Mercantile Exchange (CME) has recently implemented several changes in the wheat futures contract in an effort to improve convergence for the CBOT wheat contract. Several other measures have been discussed as well. The Commission is monitoring the CBOT wheat contract to determine whether the changes to date have been effective, and we are considering what additional measures should be adopted. In addition, the CFTC's Agriculture Advisory Committee and its Subcommittee on Convergence is examining the convergence problem and monitoring the performance of the contract. They will provide recommendations to the Commission as to the effectiveness of the recent changes and whether additional measures should be adopted.

In December 2008, the Commission approved rule changes to the CBOT soft red wheat contract that added several new delivery points. Beginning with the July 2009 contract, total delivery capacity has more than doubled to 167 million bushels of wheat (equivalent to more than 33,000 futures contracts). Eleven firms are now eligible to participate in the delivery process, with additional delivery locations in Northwest Ohio and along the Ohio and Missouri rivers.

The CBOT also has increased the storage fees applicable to delivery certificates for the wheat futures contract, on a seasonal basis. Raising the cost of storage lessens the financial incentive for traders to take delivery under a future contract, and should help convergence. A third rule change, effective for the September 2009 contract, reduces the amount of vomitoxin (a grain toxin) permissible in wheat delivered under the contract. This change will increase the conformance of the futures contract to commercial standards, thereby improving the consistency between the grain in the cash market and that which is deliverable under the futures contract.

With these changes, however, we saw only small numbers of deliveries at the new locations and still a significant lack of convergence as the July contract expired. We will watch closely for the full effects of the changes in the September delivery period.

Other Possible Contract Changes. A variety of other recommendations have been made by market participants. These include:

- Changing the primary delivery location of the contract to the Gulf of Mexico;
- "Compelled load-out," which could require persons holding shipping certificates to redeem them for physical grain; and
- Adding a new contract which is "cash-settled."

The Gulf of Mexico has been suggested as the primary futures delivery location because the majority (70%) of wheat exports leave the U.S. from the Gulf of Mexico. Much of the wheat in the cash market is priced in relation to the price of wheat exported from the Gulf.

Compelled load out would force traders to promptly put wheat delivered under a futures contract into the cash market. Proponents of this measure believe it would reduce the financial incentives to stand for delivery and would likely improve convergence

Under cash-settlement, physical delivery of the commodity is neither required nor an option at contract expiration. Instead, the final settlement of the futures contract is determined by taking an average of many cash prices at many locations, possibly over more than a single day. Although there are many examples of successful cash-settled contracts in financial products, some in physical commodities, and a few in agricultural products, many market participants have expressed reluctance to trading a cash-settled wheat futures contract because of difficulties related to unique aspects of the physical wheat markets. However, because cash settlement would eliminate the convergence problem, I have asked the CME to consider whether cash settlement may be a feasible answer to convergence problems in the wheat market.

CFTC Initiatives

Upon becoming the Chairman of the CFTC, I instructed Commission staff to present all available regulatory options to carry out our duties and fulfill our mission. My firm belief is that we must aggressively use all existing authorities to ensure market integrity and efficiency.

Position limits. As part of this effort, the Commission will be holding public hearings to examine the imposition of Federal position limits in futures markets for physical commodities, in particular energy commodities. The Commodity Exchange Act (CEA) states that the CFTC shall impose limits on trading and positions as necessary to eliminate, diminish, or prevent the undue burdens on interstate commerce that may result from excessive speculation. The CFTC currently sets, and ensures adherence to, position limits with respect to certain agriculture products. This is not the case for energy markets. This difference in regulatory approach deserves thoughtful review.

The CEA provides for exemptions from position limits for "bona fide hedging transactions or positions." The CFTC is currently reviewing the manner in which these exemptions have been implemented. Our hearings, starting July 28, will further inform the Commission as to on whether the "bona fide" hedge exemption should continue to apply to persons using the futures markets to hedge risks other than risks arising from the actual use of a commodity.

Improving Transparency. The Commission also has announced initiatives to improve the transparency of our markets. We will be providing additional data in our weekly Commitment of Traders (COT) reports.

We will create new categories of traders in the COT report to reflect the aggregate positions of swap dealers and of professionally managed market positions, such as hedge funds. Also, for the first time we will be including in our COT reports data from both the ICE Futures

Europe exchange in London and on contracts determined to perform a significant price discovery function under the provisions in the 2008 Farm Bill.

In addition, the Commission, through our special call authority, will continue to collect and report data from swaps dealers and index investors. Last September, the CFTC published a Report on Swap Dealers and Index Traders. The CFTC will improve the quality of the data included in the report, and release aggregate data on commodity index investment on a quarterly basis. We hope to eventually be able to provide this data on a monthly basis. We look forward to public comment on these recent transparency initiatives.

Regulation of OTC Derivatives Market

I believe Congress should enact broad reforms to regulate the over-the-counter (OTC) derivative markets. Such reforms must comprehensively regulate both derivatives dealers and the markets in which derivatives trade.

The current financial crisis has taught us that the derivatives trading of a single firm can threaten the entire financial system and that all such firms should be subject to robust Federal regulation. It is only by fully regulating the institutions that trade or hold themselves out to the public as derivatives dealers that we can effectively oversee derivatives markets. Derivatives dealers should be subject to capital requirements, robust margining requirements, business conduct rules, and reporting and recordkeeping requirements.

Additional safety and transparency should be provided by regulating the derivative market functions as well. We should require that all derivatives that can be moved into central clearing be required to be cleared through regulated central clearing houses and brought onto regulated exchanges or regulated transparent electronic trading systems.

Critical to this reform is for the CFTC to have the ability to impose position limits, including aggregate limits, on all persons trading OTC derivatives that perform or affect a significant price discovery function with respect to regulated markets that the CFTC oversees. Such position limit authority should clearly empower the CFTC to establish aggregate position limits across markets in order to ensure that traders are not able to avoid position limits in a market by moving to a related exchange or market, including international markets.

The CFTC has been working closely with the Treasury Department, the Securities and Exchange Commission, and other Federal agencies on developing draft legislation to achieve these goals. I look forward to continuing to work with the Congress as it considers these proposals.

<u>Response to PSI Recommendations</u>

I would like to now turn to the specific recommendations of the Subcommittee for improving the performance of the wheat market and other commodity markets.

Recommendation #1: Phase out existing wheat waivers for index traders.

The Subcommittee's wheat report found that index traders were one of the primary causes for the large price spreads that inhibited convergence. CFTC regulations currently limit speculative traders to 5,000 wheat futures contracts in any one month, and 6,500 wheat contracts for all months combined. The CFTC has granted a number of specific exemptions from these position limits to swap dealers who are purchasing futures contracts to hedge their positions arising from the sale of index-related swaps to third parties. The CFTC also has granted "no action" letters to two other traders selling index-related products that allow them to hold positions at levels above the standard speculative position limits. The report recommended that the CFTC limit the positions of index traders to the standard speculative position limits for wheat futures.

The CFTC is seriously considering this recommendation and will examine it in its upcoming hearings. The CFTC has received many comments in response to recently issued concept release regarding whether a separate risk management exemption for persons hedging purely financial risks is appropriate. We are evaluating the comments received from the concept release.

Recommendation #2: Take further action if necessary.

Based on the performance of the wheat contract during the expiration of the July futures contract, we are not yet satisfied that the changes made to the contract are sufficient. The CFTC will continue to closely monitor the performance of the wheat futures contract. We will consider further actions that are necessary, to ensure that the wheat futures market performs its function of providing for reliable price discovery and risk management.

Recommendation #3: Analyze other agricultural commodities.

There also have been convergence problems in the corn and soybean markets, but the problems in these markets have not been as severe or persistent as the problems in the wheat market. There have been several issues in the cotton market as well. The Commission will continue to monitor all agricultural futures markets for problems. The improvements to our COT reports that I described earlier should facilitate our efforts in this area and help provide the type of analysis recommended by the Subcommittee.

Recommendation #4: Strengthen data collection for non-agricultural commodities.

As I have outlined, we are also making several improvements to the transparency of our markets, including the extent to which index traders have positions. As part of these improvements, we will be collecting and providing more data to the public about the nature of the trading in all of our commodity markets.

Conclusion

Over the past several years there has been unprecedented volatility in the commodity markets. It is not the job of the CFTC to determine whether prices are too high or too low. It is the job of the CFTC to ensure that all of our commodity futures markets are free from fraud, manipulation, and excessive speculation. It is our job to ensure that these markets can fulfill the basic purpose for which they were established—to provide the producers, users, and consumers of a commodity with a means to manage the price risks arising from the production, use, or consumption of the commodity. I believe the CFTC must use all of its statutory authorities to fulfill this responsibility. I look forward to continuing to work with the Members of this Subcommittee on these important issues.