

Testimony of Wallace C. Turbeville, Derivatives Specialist, Better Markets, Inc.

Permanent Subcommittee on Investigations

November 3, 2011

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

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

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

SUMMARY

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

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

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

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

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

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

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

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

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

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

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

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

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

DISCUSSION

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

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

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

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

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

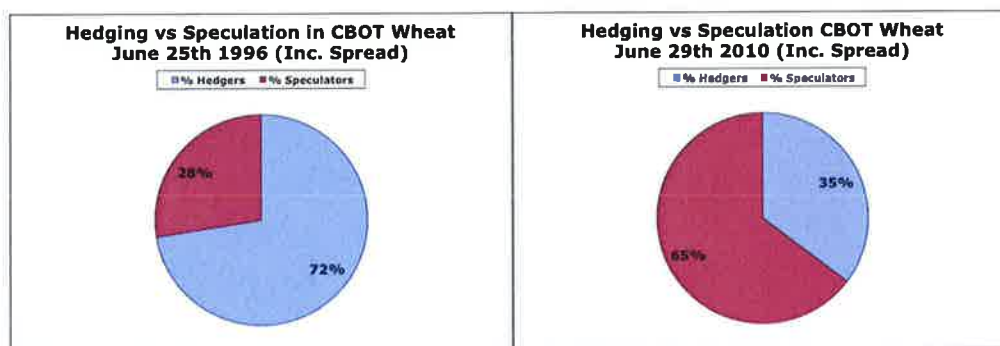
² Cartea, A. and Penalva, J., “Where is the Value in High Frequency Trading,” Universidad Carlos II de Madrid, November 2, 2010; Better Markets, Inc., Comment Letter to the CFTC. Core Principles and Other Requirements for Designated Contract Markets, February 22, 2010, *available at* <http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=27994&SearchText=b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

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

Speculation in commodity markets has dramatically increased and is excessive

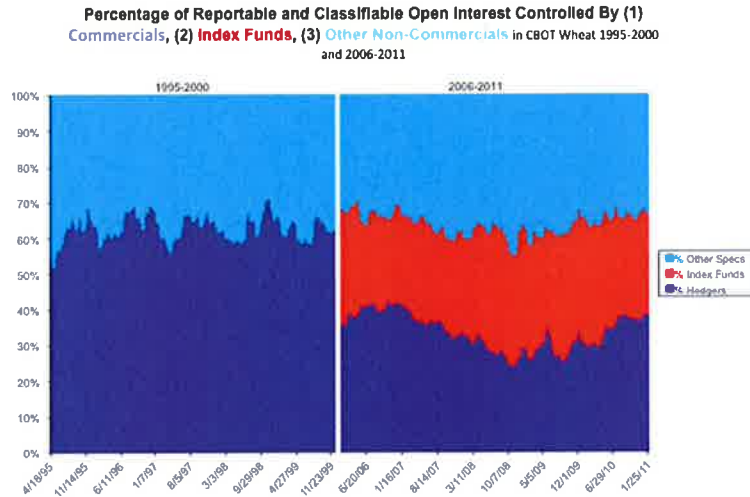
The facts demonstrate that, today, financial speculators have overwhelmed the commodity markets and also driven out many legitimate commercial physical hedgers. Historically, when commodity markets have worked well (i.e., when there is sufficient liquidity and meaningful price discovery for all physical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

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



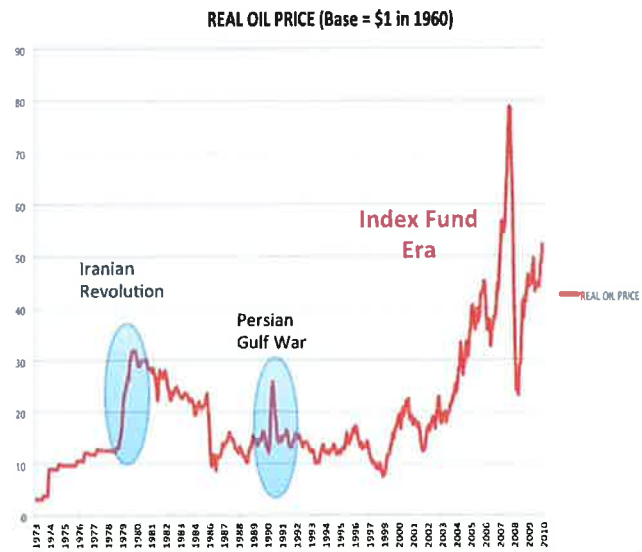
The diagrams above illustrate how the Speculation/Hedging ratios have reversed using the example of CBOT Wheat. (Full size copies of all diagrams are included at the end of this testimony.)

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



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

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

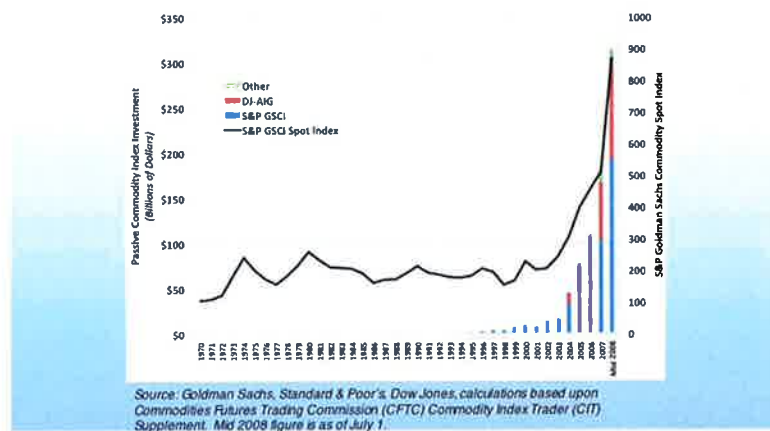


The diagram above illustrates that the volatility and price levels seen since the advent of excessive speculation are unprecedented, here using the example of NYMEX WTI Crude Oil. Note the past effects of significant world events compared to the index fund era today.

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

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

Passive Commodity Index Investment



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

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

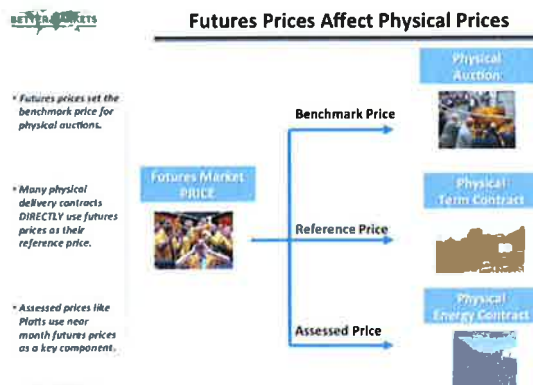
³ See, for example, Javier Blas, “Commodity Indices: Rollover Practice Hits Investors,” Financial Times, November 1, 2009, available at <http://www.ft.com/intl/cms/s/0/453764e8-c586-11de-9b3b-00144feab49a.html#axzz1cMIFQSMR>; and Tang, K. (Princeton University) and Xiong, W. (Renmin University) (2010):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

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

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

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

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



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

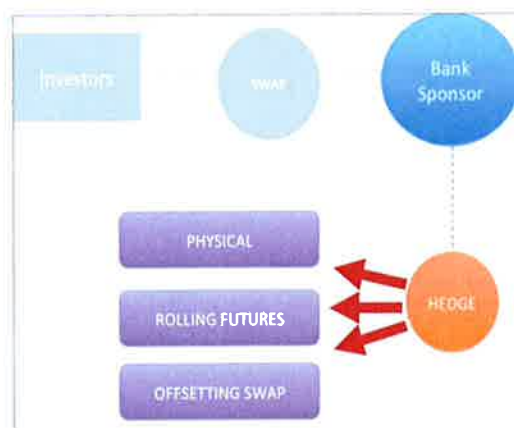
⁴ Fundamental forces refer to the price effects of supply and demand in the context of production and transportation costs and elasticity of demand.

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

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

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

Commodity Index Fund Structure



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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Excessive Speculation

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

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

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

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

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

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

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

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

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

Commodity Index Limits

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

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

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

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

Abandonment of Class Limits

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

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

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

Calculation Periods

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

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

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

Definition of “Referenced Paired Futures Contract, Option Contract, Swap or Swaption”

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

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

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

CONCLUSION

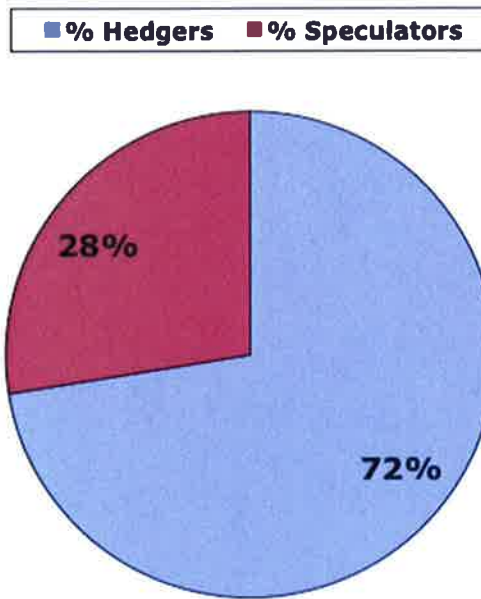
In conclusion:

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

Thank you for your consideration of these very important matters.

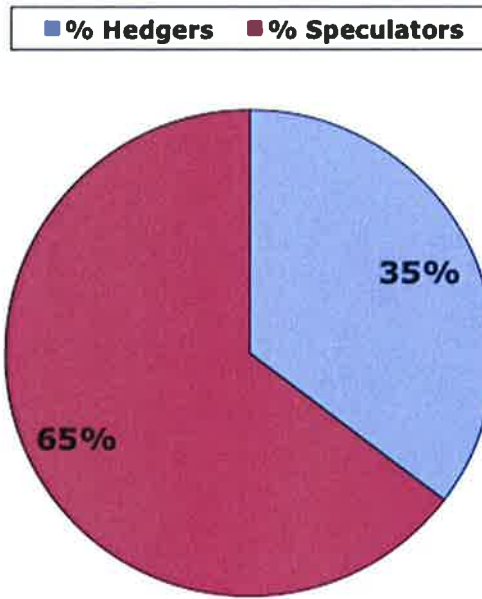
[Full-Sized Version of All Charts Attached]

Hedging vs Speculation in CBOT Wheat June 25th 1996 (Inc. Spread)



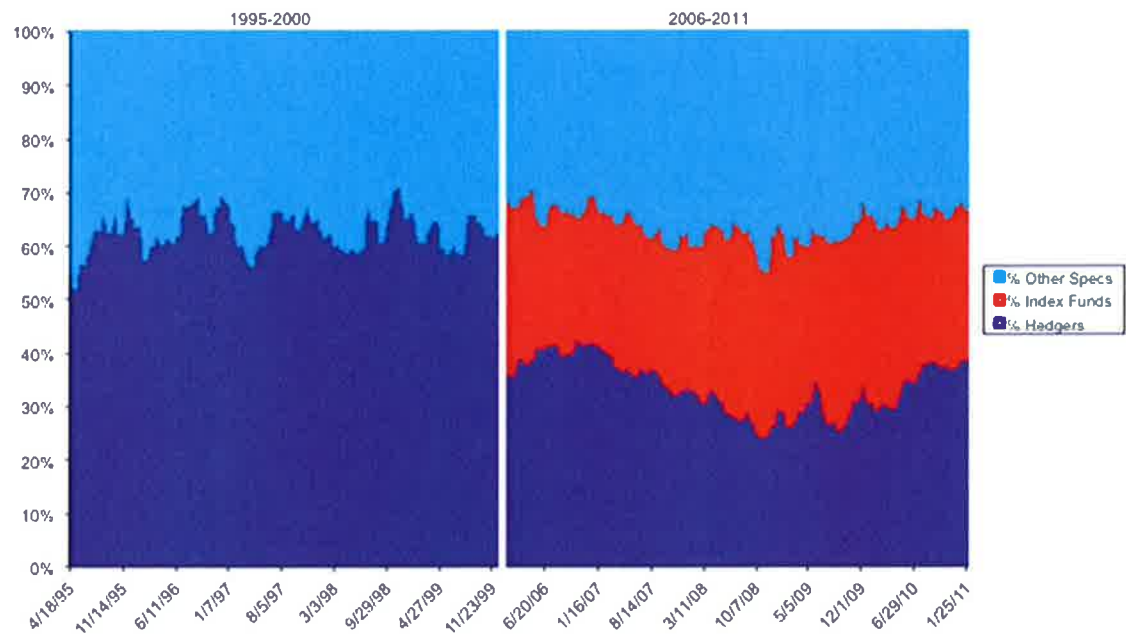
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Hedging vs Speculation CBOT Wheat June 29th 2010 (Inc. Spread)

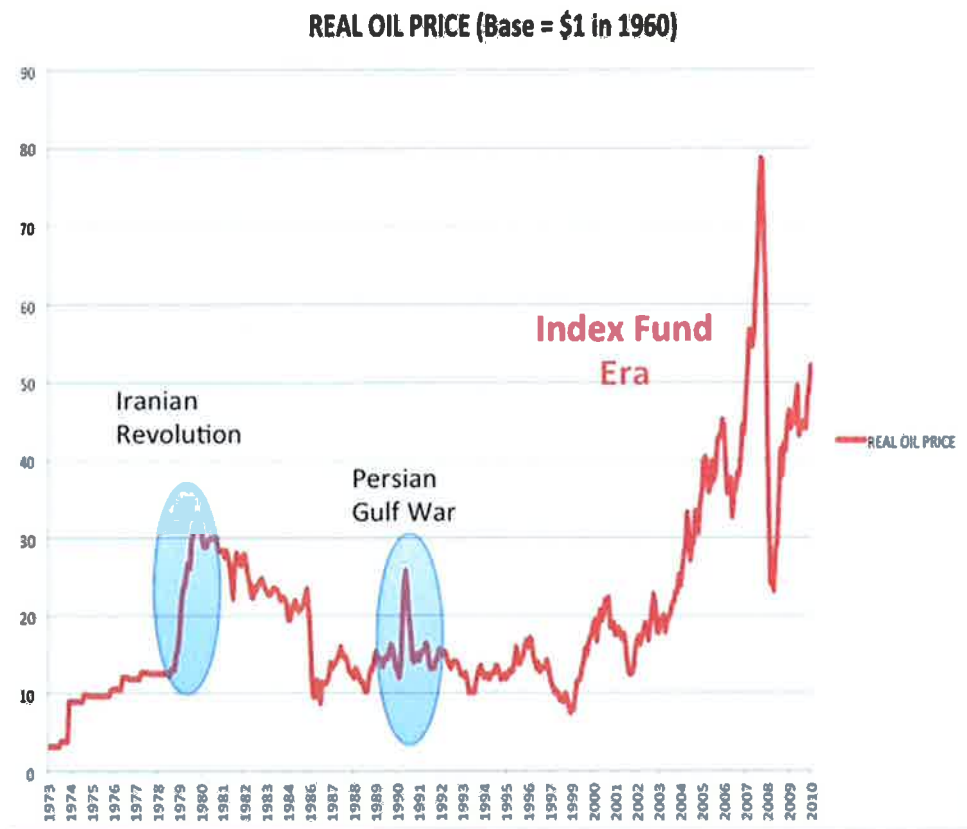


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**Percentage of Reportable and Classifiable Open Interest Controlled By (1)
 Commercials, (2) **Index Funds**, (3) **Other Non-Commercials** in CBOT Wheat 1995-2000
 and 2006-2011**

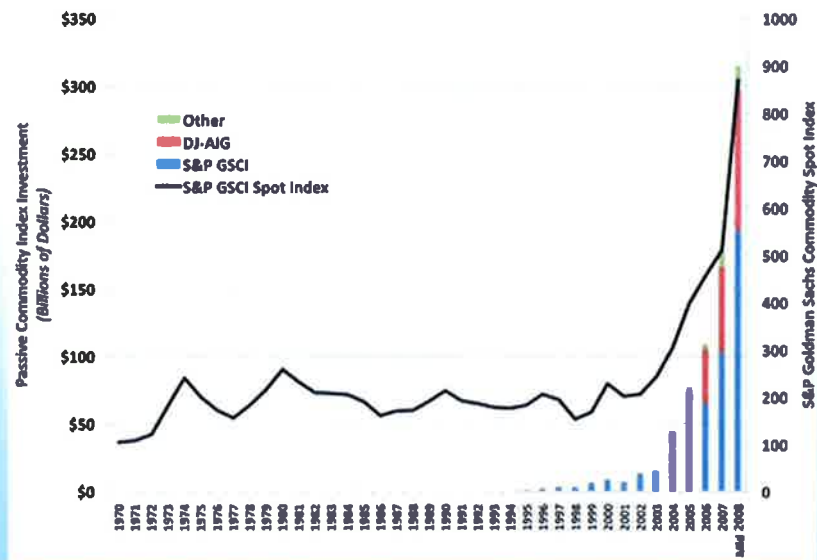


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Passive Commodity Index Investment

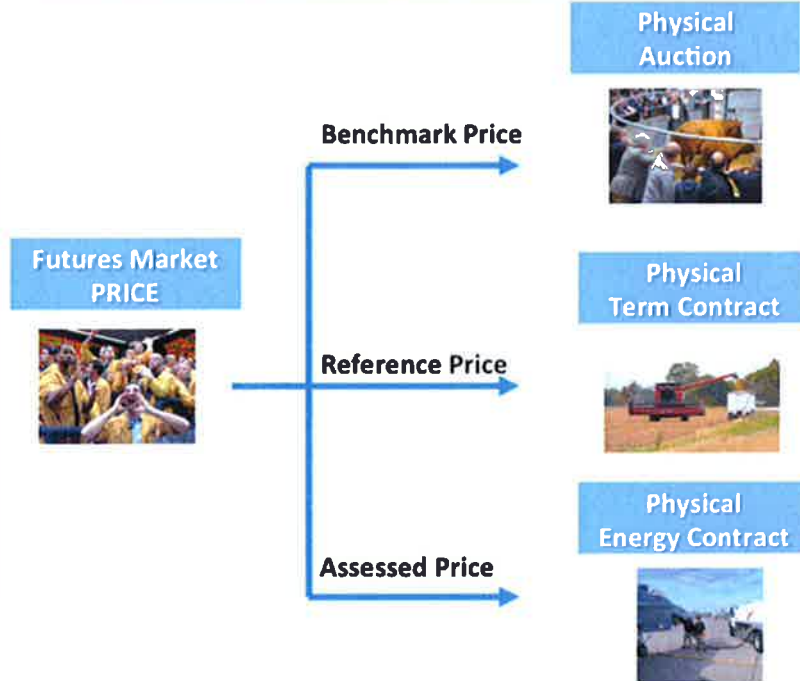


Source: Goldman Sachs, Standard & Poor's, Dow Jones, calculations based upon Commodities Futures Trading Commission (CFTC) Commodity Index Trader (CIT) Supplement. Mid 2008 figure is as of July 1.

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Futures Prices Affect Physical Prices

- *Futures prices set the benchmark price for physical auctions.*
- *Many physical delivery contracts DIRECTLY use futures prices as their reference price.*
- *Assessed prices like Platts use near month futures prices as a key component.*



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United States Senate

COMMITTEE ON
HOMELAND SECURITY AND GOVERNMENTAL AFFAIRS

WASHINGTON, DC 20510-6250

September 22, 2011

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

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

Dear Mr. Turbeville:

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

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

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

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

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

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

Sincerely, *



Tom Coburn
Ranking Minority Member
Permanent Subcommittee on Investigations



Carl Levin
Chairman
Permanent Subcommittee on Investigations