

**Testimony Of
The Commodity Markets Council**

**On
Legislation Amending the Commodity Exchange Act**

**Before the
Committee on Agriculture
U.S. House of Representatives**

July 10, 2008

Mr. Chairman and Members of the Committee:

Good morning. My name is Christine Cochran and I am the vice-president of government relations for the Commodity Markets Council (CMC).

Mr. Chairman and Ranking Member Goodlatte, the issues you plan to address in this series of hearings are very important to the industry I represent. I would like to thank you for hosting them 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.

The passage of the Commodity Futures Modernization Act of 2000 (CFMA) shifted the regulatory philosophy from prescriptive regulations to core principles. This shift explicitly recognized the success of the self-regulatory organization model and entrusted U.S. exchanges with broad authority to offer products and services to expand their businesses, attract customers, and compete domestically and globally. Since that time, U.S. futures exchanges have grown rapidly and the community of exchange users have benefited tremendously. U.S. capital markets are also an important beneficiary of this dynamic growth. The success of the U.S. futures business has helped sustain the U.S. as the centerpiece of global risk management.

CMC strongly supports your efforts and those of the Commodity Futures Trading Commission (CFTC or Commission) to seek greater visibility into the commodity markets, especially in the energy markets. We believe that improved transparency for both market regulators and participants is the first step to maintaining responsible commodity markets and we have confidence in the CFTC's ability to gather and analyze such data. With greater visibility into the market, we also believe that the CFTC will be able to provide more accurate and useful information about all classes of market participants. For example, in

2006, CMC led the industry effort and worked with the CFTC to increase transparency on index traders in the grain markets through the Commitment Of Traders (COT) Supplemental Report. Based on data collected by the CFTC, the Commission created a report that has already become one of the grain industry's most essential tools for analyzing markets. We believe that applying the same principle to other commodity markets will significantly benefit everyone – including market regulators, traditional market users, and the general public.

The businesses of all CMC members depend on market integrity and we strongly support the CFTC's efforts to investigate and prosecute market manipulation. Ferreting out market participants that attempt to inappropriately influence the market is critical to protecting customers and keeping the trust of the trading public. Simultaneously, we need to ensure that US markets continue to serve as global benchmarks and continue to provide efficient price discovery.

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. By showing index fund financial hedges as a separate and distinct category, the COT Supplemental Report, a pilot program, helped deepen the grain industry's understanding of the nature of index fund activity in futures markets. The report shows the size and behavior of such investors and provides a degree of transparency in the grain market that is not provided in other commodity markets. Some believe that the activities of large institutional investors in futures markets are the reason for current price levels; however, based on the information currently available, CMC does not believe that this is the case.

As an advocate for open competitive markets, we do not support drastic proposals that ban any group of legitimate investors from participating in commodity markets. At the same time, CMC wants to emphasize that we in no way support or condone manipulative behavior. Increasing the information sent to the CFTC will assist the Commission in identifying, investigating, and possibly prosecuting market manipulators. Additionally, reporting index trader position on the COT report in all appropriate commodity markets could help market participants better understand the role these investors may play in the market.

CMC also encourages you to weigh the possibility that banning or severely restricting institutional investors and hedge fund will not accomplish the intended purpose. The money will not disappear; instead, it may move off-exchange and take with it valuable market liquidity and transparency. It is important to be informed, thoughtful, and prudent as you evaluate restrictions on a class of market participants.

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. The additional transparency that we are calling for would provide the tools necessary for market participants to evaluate the impact of this new class of investor.

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. Meanwhile, hedge funds tend to be more responsive to market signals and act as a traditional fundamental trader. As such, hedge funds are subject to position 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 for all market participants.

Futures markets today reflect global economics and trends, not speculative buying power. Based on the information currently available to us, CMC believes speculative activity in futures markets may influence day-to-day prices, as it always has. On the other hand, it is the fundamental forces of supply and demand that create and sustain the price levels we see in the markets.

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. 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.

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.

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.

At the same time, the increased pressure in the credit markets is increasing the need for consistent convergence.

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.

The Role of Swaps In Commodity Markets

CMC supports the efforts of the Commission to gather more information regarding swaps transactions and would support greater transparency of such transactions. However, we also believe that swaps contracts provide a legitimate and important commercial service.

A swaps contract is between two private parties, so it can provide a highly customized service that cannot be obtained in on-exchange contracts. For example, a commercial company may seek to secure a hedging position that extends over a five year period, but on-exchange futures contracts are not available that far out. In the over-the-counter market, the company can enter into a swaps agreement with another willing party for the desired terms. This arrangement meets the hedging needs of the commercial company seeking the position. It also creates risk exposure for the counterparty, which is often managed over time on-exchange.

Aggregating Speculative Position Limits

Aggregating speculative position limits could cause serious harm for existing markets by grouping contracts that serve distinct purposes and by severing liquidity between markets.

It is critical that any policy seeking to aggregate speculative position limits accounts for the difference between existing contracts. Wheat is traded on the Chicago Board of Trade, Kansas City Board of Trade, and Minneapolis Grain Exchange; however, each wheat contract is distinct and provides a unique risk management solution. For example, a company hedging soft red winter wheat flour on the Chicago Board of Trade is hedging ingredients in pastries, cakes, and pie-crusts; a company hedging hard red winter wheat on the Kansas City Board of Trade is hedging ingredients in bread; and a company hedging hard red spring wheat flour on the Minneapolis Grain Exchange is hedging ingredients in bagels and some pastas.

Another possible consequence from aggregating speculative position limits is the division of the liquidity that currently exists between exchanges. If position limits in similar contracts are aggregated and subjected to existing speculative position limits, then firms, including commercial firms, may be forced to either reduce their positions in each individual market or move their positions to one market. This shifting of positions could severely reduce liquidity on existing exchanges and negatively impact all market participants.

Some proposals currently being considered would apply aggregate speculative position limits for on-exchange products and OTC products. Given the customized nature of over-the-counter commodity contracts, our members, who are active in both markets, we would appreciate caution when examining such a proposal.

Margin Requirements

CMC is concerned about calls to require the CFTC to set substantially higher margin levels in the energy markets. It appears the intent of such proposals would be to lower prices; however, we believe that increased margin requirements would undermine a proven model and could 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. Moreover, the system for setting margins, which can change frequently, is a finely-tuned, mathematical model that has a remarkably low default rate. Raising margin requirements will not reduce volatility or manage prices. It will increase the cost of futures transactions and potentially push liquidity from the regulated exchange marketplace.

In conclusion, CMC believes the commodity industry is in a volatile period due to supply and demand fundamentals experiencing new thresholds. Our system of open and competitive markets coupled with proper government oversight positions market participants to read, understand, and respond to market signals efficiently. Before any drastic changes are considered, we strongly urge you seek additional transparency and evaluation. More information will help regulators, traditional market participants, and the general public understand the impact this new class of investor is having on the market.

Mr. Chairman, we compliment you and Mr. Goodlatte for your efforts and we look forward to working with you and answering any questions that you may have. Thank you.