

**Post-Hearing Questions for the Record
Submitted to Thomas J. Erickson
From Senator Susan M. Collins**

**“Financial Speculation in Commodity Markets: Are Institutional Investors and Hedge Funds Contributing to Food and Energy Price Inflation?”
May 20, 2008**

- 1. Mr. Erickson, you say there is an important distinction to be made for reporting and other regulatory requirements between hedge funds and index funds. Could you elaborate?**

CMC views the investment activity of institutional investors, hedge funds, and index funds as legitimate financial hedging. However, we believe, there is a distinction between investment that is passive in nature and not responsive to price levels and “alpha” or “enhanced return” trading by some index and hedge funds.

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. Hedge funds tend to be more responsive to market signals and act as a traditional speculator. As such, hedge funds are subject to speculative limits which we believe is appropriate.

Alpha trading, which is an investment strategy that some hedge funds and index funds engage in, is price-responsive and not passively managed. CMC believes this kind of investment is speculative and should be regulated as such by the Commodity Futures Trading Commission (CFTC).

- 2. Mr. Erickson, you say that even if financially driven speculation does affect day-to-day pricing in the futures markets, “it is powerless in the face of larger, fundamental forces”? Is that a realistic description of events, considering the size and sophistication of some of these institutions?**

With the evidence we have today, we believe that it is a realistic description. 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.

It also means that our futures markets today reflect global economics and trends – not speculative buying power. The depth of these markets means that speculative activity may influence day-to-day prices, but it is powerless in the face of larger, fundamental forces. As we have seen this month, if prices begin to retreat, speculative activity follows that retreat. It did not cause it.

- 3. Some in the Senate (Democrat’s energy package) have proposed increasing the margin requirement for trading on futures markets. Do you support or oppose this proposal, and why?**

CMC believes that margin requirements should be set by exchange-owned or independent clearinghouses. CMC shares the concerns of many lawmakers about the impact escalating commodity prices will have on all Americans. It appears the intent of such proposals is to lower prices; however, we believe that increased margin requirements could have the opposite effect. It

could force market participants off-exchange and into less transparent markets.

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

In the current system, clearinghouses set margin requirements. They are responsible for the financial integrity of their clearing firms and customers, and preservation of the exchange's reputation. They know their markets, firms and customers, and they interact with and monitor each market minute-to-minute.

With decades of experience, they have great expertise to assess market risk, firm risk posed to the clearing house relative to each firm's financial resources, and total risk underwritten by the mutual risk pool of the clearing house itself. They also developed and utilize highly sophisticated risk assessment capabilities and software specifically designed for real-time risk evaluation. These systems have been tested by markets even more stressful than what we are currently experience and they have withstood those tests without failure.

The CFTC audits clearinghouses regularly to assess the health and sufficiency of these capabilities and CMC is confident in the ability of CFTC professional staff to monitor and evaluate trading in all commodity markets.

For our markets to operate effectively, margin levels must be set with care and appropriate understanding of consequences. It would be easy to impose high margins with the intent of dealing with a specific risk or problem, and unwittingly trigger the negative consequence of diminished liquidity and participation. Loss of liquidity can easily exacerbate exactly the risk being targeted with high margins. The best decisions about margin levels are made on the spot by people closest to the situation.