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Testimony

Written Testimony of Acting Chairman Walter Lukken Before the House Committee on Agriculture

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Chairman Etheridge, Ranking Member Goodlatte, and other distinguished Members, thank you for inviting me to testify before this Committee about the Commodity Futures Trading Commission's (CFTC or Commission) review of recent trading activity in the futures markets.

One of the core missions of the CFTC is protecting the sanctity, effectiveness and efficiency of the central price discovery process on futures exchanges. If prices are not reflecting fundamental factors of supply and demand, the futures markets are not functioning properly and all Americans suffer. Recent record prices in energy and agricultural commodities have underscored this point. If there is a lack of confidence in the validity of the price of a commodity, commercial participants will be less likely to manage risk in the futures markets. Furthermore, those involved with commercial merchandising of a physical commodity, such as a utility or grain elevator, will be hesitant to forward contract with customers if there is doubt about the basis of a price discovered on the futures markets. This is why the CFTC's core mission of protecting the central price discovery process is so important.

With the growth of electronic trading, globalization and financial innovation, we have witnessed the development of satellite financial markets that complement and compete with the centralized and regulated futures markets in the United States. During the last year, the CFTC has systematically been reviewing these developments to determine whether these satellite markets are having an impact on the centralized price discovery process and to make regulatory adjustments as needed.

Last summer the CFTC began with an examination of Exempt Commercial Markets (ECMs)—those less-regulated electronic trading platforms that allow institutions to trade certain over-the-counter swap contracts. After holding a hearing on the matter, the CFTC provided a report and recommendations to this Committee that grants additional authorities to the agency when products on these exchanges begin to serve as significant price discovery contracts that may be linked to the regulated marketplace. I want to thank this Committee for including those recommendations as part of the recently-enacted Farm Bill, which we are in the midst of implementing.

Linkages between markets are not purely a domestic occurrence but also exist across international borders. In May and June, the CFTC announced certain modifications to its Foreign Board of Trade

(FBOT) policy that imposes conditions on the process that allows FBOTs to directly access U.S. participants. The conditions include position and accountability limits on any contract whose price is linked to the price of a U.S. contract traded on an exchange. The CFTC also announced it is enhancing its ongoing information sharing by requiring daily large trader reports on these linked contracts. These improvements were necessary due to the possibility that these linked markets could influence prices on the centralized futures market in the United States.

For both ECMs and FBOTs, this combination of enhanced information data and additional market controls will help the CFTC in its surveillance of its regulated domestic exchanges when these satellite markets have the ability to impact the price discovery process.

Today's hearing is meant to review the role of swap dealers and index traders and whether their connection to the futures markets is having an impact on the price of commodities. There is public and Congressional concern about the amount of index money flowing into the commodity markets and whether this passive investment is impacting the price discovery process that consumers and producers rely on. In May, the CFTC announced that it would use its special call authority to gather more detailed data from swap dealers on the amount of index trading occurring in the OTC markets and to examine whether index traders are being properly classified for regulatory and reporting purposes.

The CFTC staff in this report has collected and compiled substantial information on index funds and other transactions that are being conducted through swap dealers. I committed to Congress that we would provide this report no later than September 15. Given this Committee's hearing and interest in the report, I am pleased to present the CFTC's staff report with Commission recommendations. Although this has proven to be a huge undertaking for our staff and the agency, it is a critical endeavor to ensure that our markets are functioning properly.

CFTC Report on Swap Dealer and Index Trader Activity

This staff report represents a survey of swap dealers and commodity index funds to better characterize their activity and understand their potential to influence the futures markets. This type of a compelled survey relating to off-exchange activity is unprecedented, but the growth and evolution in futures market participation and growing public concern regarding off-exchange activity supported the need for this extraordinary regulatory inquiry.

In June 2008, Commission staff initiated a special call to futures traders, which included 43 request letters issued to 32 entities and their sub-entities. These entities include swap dealers engaged in commodity index business, other large swap dealers, and commodity index funds. The special call required all entities to provide data relating to their total activity in the futures and OTC markets, and to categorize the activities of their customers for month-end dates beginning December 31, 2007 through June 30, 2008, and continuing thereafter.

The scope of the survey attempts to answer the following questions:

- How much total commodity index trading is occurring in both the OTC and on-exchange markets?
- How much commodity index trading is occurring by specific commodity in both the OTC and on-exchange markets?
- What are the major types of index investors?

- What types of clients utilize swap dealers to trade OTC commodity transactions?
- To what extent would the swap clients have exceeded position limits or accountability levels had their OTC swap positions been taken on exchange?

The preliminary survey results represent the best data currently available to the staff and the results present the best available snapshot of swap dealers and commodity index traders for the relevant time period. However, as a result of the survey limitations, there may be a margin of error in the precision of the data, which will improve as the staff continues to work with the relevant firms and to further review and refine the data. As entities continue to provide monthly data to the Commission in response to their ongoing obligation to comply with the special call, Commission staff will continue to examine the data, refine the specific requests, and further develop the analysis.

Findings:

In analyzing the total OTC and on-exchange positions for index trading, the report focuses on three quarterly snapshots – December 31, 2007, March 31, 2008, and June 30, 2008 and has thus far revealed the following data:

- Total Net Commodity Index Investments: The estimated aggregate net amount of all commodity index trading (combined OTC and on-exchange activity) on June 30, 2008 was $200 billion, of which $161 billion was tied to commodities traded on U.S. markets regulated by the CFTC. Of the $161 billion combined total, a significant amount of the OTC portion of that total likely is never brought to the U.S. futures markets.

- Net Notional Index Values vs. Total Notional Market Values: For comparison purposes, the total notional value on June 30, 2008 of all futures and options open contracts for the 33 U.S. exchange-traded markets that are included in major commodity indexes was $945 billion – the $161 billion net notional index value was approximately 17 percent of this total.

    - The total notional value of futures and options open contracts on June 30, 2008 for NYMEX crude oil was $405 billion – the $51 billion net notional index value was approximately 13 percent of this total.
    - The total notional value of futures and options open contracts on June 30, 2008 for CBOT wheat was $19 billion – the $9 billion net notional index value was approximately 47 percent of this total.
    - The total notional value of futures and options open contracts on June 30, 2008 for CBOT corn was $74 billion - the $13 billion net notional index value was approximately 18 percent of this total.
    - The total notional value of futures and options open contracts on June 30, 2008 for ICE-Futures cotton was $13 billion – the $3 billion net notional index value was approximately 23 percent of this total.

- Crude Oil Index Activity: While oil prices rose during the period December 31, 2007 to June 30, 2008, the activity of commodity index traders during this period reflected a net decline of swap contracts as measured in standardized futures equivalents.

    - During this period, the net notional amount of commodity index investment related to NYMEX crude oil rose from about $39 billion to $51 billion—an increase of more than 30 percent. This rise in notional value, however, appears to have resulted entirely from the increase in the price of oil, which rose from approximately $96 per barrel to $140 per barrel—an increase of 46 percent.

  - Measured in standardized futures contract equivalents, the aggregate long positions of commodity index participants in NYMEX crude oil declined by approximately 45,000 contracts during this 6 month period - from approximately 408,000 contracts on December 31, 2007 to approximately 363,000 contracts on June 30, 2008. This amounts to approximately an 11 percent decline.

- Types of Index Investors: Of the total net notional value of funds invested in commodity indexes on June 30, 2008, approximately 24 percent was held by "Index Funds," 42 percent by "Institutional Investors," 9 percent by "Sovereign Wealth Funds," and 25 percent by "Other" traders.

- Clients Exceeding Position Limits or Accountability Levels: On June 30, 2008, of the 550 clients identified in the more than 30 markets analyzed, the survey data shows 18 noncommercial traders in 13 markets who appeared to have an aggregate (all on-exchange futures positions plus all OTC equivalent futures combined) position that would have been above a speculative limit or an exchange accountability level if all the positions were on-exchange. These 18 noncommercial traders were responsible for 35 instances of either exceeding a speculative limit or an exchange accountability level through their aggregate on-exchange and OTC trading that day. Of these instances:

  - 8 were above the NYMEX accountability levels in the natural gas market;
  - 6 were above the NYMEX accountability levels in the crude oil market;
  - 6 were above the speculative limit on the CBOT wheat market;
  - 3 were above the speculative limit on the CBOT soybean market; and
  - 12 were in the remaining 9 markets.

These combined positions do not violate current law or regulations and the amounts by which each trader exceeded a limit or level were generally small. However, there are a few instances where a noncommercial client's combined on-exchange futures positions and OTC equivalent futures positions significantly exceeded a position limit or exchange accountability level.

In light of the preliminary data and findings set forth herein, the Commission believes that, at a minimum, certain constructive steps can and should be taken and presents the following preliminary recommendations, several of which may benefit from legislative codification. The Commission will consider whether further recommendations are necessary as this survey and analysis continues.

Preliminary Recommendations:

1. **Remove Swap Dealer from Commercial Category and Create New Swap Dealer Classification for Reporting Purposes:** In order to provide for increased transparency of the exchange traded futures and options markets, the Commission has instructed the staff to develop a proposal to enhance and improve the CFTC's weekly Commitments of Traders (COT) Report by including more

delineated trader classification categories beyond commercial and noncommercial, which may include at a minimum the addition of a separate category identifying the trading of swap dealers.

2. **Develop and Publish a New Periodic Supplemental Report on OTC Swap Dealer Activity:** In order to provide for increased transparency of OTC swap and commodity index activity, the Commission has instructed the staff to develop a proposal to collect and publish a periodic supplemental report on swap dealer activity. This report will provide a periodic "look through" from swap dealers to their clients and identify the types and amounts of trading occurring through these intermediaries, including index trading.

3. **Create a New CFTC Office of Data Collection with Enhanced Procedures and Staffing**: In order to enhance the agency's data collection and dissemination responsibilities, the Commission has instructed its staff to develop a proposal to create a new office within the Division of Market Oversight, whose sole mission is to collect, verify, audit, and publish all the agency's COT information. The Commission has also instructed the staff to review its policies and procedures regarding data collection and to develop recommendations for improvements.

4. **Develop "Long Form" Reporting for Certain Large Traders to More Accurately Assess Type of Trading Activity:** The Commission has instructed staff to develop a supplemental information form for certain large traders on regulated futures exchanges that would collect additional information regarding the underlying transactions of these traders so there is a more precise understanding of the type and amount of trading occurring on these regulated markets.

5. **Review Whether to Eliminate Bona Fide Hedge Exemptions for Swap Dealers and Create New Limited Risk Management Exemptions:** The Commission has instructed staff to develop an advanced notice of proposed rulemaking that would review whether to eliminate the bona fide hedge exemption for swap dealers and replace it with a limited risk management exemption that is conditioned upon, among other things: 1) an obligation to report to the CFTC and applicable self regulatory organizations when certain noncommercial swap clients reach a certain position level and/or 2) a certification that none of a swap dealer's noncommercial swap clients exceed specified position limits in related exchange-traded commodities.

6. **Additional Staffing and Resources:** The Commission believes that substantial additional resources will be required to successfully implement the above recommendations. The CFTC devoted more than 30 employees and 4000 staff hours to this survey, which the Commission is now recommending to produce on a periodic basis. Other new responsibilities will also require similar additional staff time and resources. Accordingly, the Commission respectfully recommends that Congress provide the Commission with funding adequate to meet its current mission, the expanded activities outlined herein, and any other additional responsibilities that Congress asks it to discharge.

7. **Encourage Clearing of OTC Transactions**: The Commission believes that market integrity, transparency and availability of information related to OTC derivatives are improved when these transactions are subject to centralized clearing. Accordingly, the Commission will continue to promote policies that enhance and facilitate clearing of OTC derivatives whenever possible.

8. **Review of Swap Dealer Commodity Research Independence**: Many commodity swap dealers are large financial institutions engaged in a range of related financial activity, including commodity market research. Questions have been raised as to whether swap dealer futures trading activity is

sufficiently independent of any related and published commodity market research. Accordingly, the Commission has instructed the staff to utilize existing authorities to conduct a review of the independence of swap dealers' futures trading activities from affiliated commodity research and report back to the Commission with any findings.

In sum, this special call data and analysis has given the CFTC a snapshot of the OTC market. While the report's findings are useful and instructive, the data collection and analysis need to continue if the agency is to get a clearer, moving picture of this vast marketplace. The Commission's recommendations include enhanced transparency, increased reporting and information, and an overall modernization of several rules, regulations and practices used to oversee the markets. These changes will improve controls while ensuring that our futures markets remain competitive, open, and on U.S. soil.

Conclusion

The CFTC must remain diligent in fulfilling its critical public mission, and I expect this fall will continue to be busy on that front. Next week, I will be attending a meeting of the Technical Committee of the International Organization of Securities Commissions (IOSCO), which is the international standard setter for securities and futures markets. During the formal meeting, I plan to discuss the recent volatility of the futures markets and whether the current international standards for derivatives markets are adequate or need further review in light of current market conditions. Separately, on the domestic front, the Interagency Task Force on Commodity Markets continues its work on a final report on commodity market conditions and will make public its findings as soon as possible.

It is also important to note that the legislative, regulatory, and policy developments outlined today occur in tandem with our robust enforcement program. That program continues to ferret out price manipulations or attempted manipulations of our nation's vital commodity markets.

I cannot close my testimony without directly addressing the agency's funding situation. As I have testified in recent months and weeks, the lack of appropriate and predictable funding over the course of many years has had a negative impact on our staffing situation, rendering it unsustainable for the long run. Nothing has brought this point to bear more than our work on the swaps report, to which the CFTC has devoted more than 30 employees and 4000 staff hours.

The agency is operating under a $111 million budget and at its lowest staffing levels in its history. And yet, we have been asked to do more and more with less. As Congress considers any new authorities and initiatives in order to respond to changing market conditions, it is imperative that Congress provide the CFTC with adequate funding for its current duties and additional funding for any new ones. Due to funding shortfalls, the agency cannot take on any additional responsibilities without making very difficult sacrifices in other mission-critical areas.

The CFTC is working hard to protect the public and the market users from manipulation, fraud, and abusive practices in order to ensure that the futures markets are working properly. Thank you for the opportunity to appear before you today on behalf of the CFTC. I would be happy to answer any questions you may have.