

SUMMARY OF MAJOR POINTS OF NYMEX TESTIMONY

- The Commodity Futures Modernization Act of 2000 significantly enhanced the competitiveness of U.S. markets by allowing them to adapt readily to changing market demand, and, for the most part, the value and success of the CFMA holds true today.
- However, it was impossible to know then what we know now about how some markets would develop.
- Complete transparency is fundamental for competitive markets.
- The same level of transparency and position size controls present on regulated U.S. futures markets should be the standard for foreign markets offering products with U.S. delivery points and for OTC contracts that serve a price discovery function.
- Additionally, a case has been made for disaggregation and delineation of positions held by swap dealers. This will provide important information to determine whether speculative position limits are being avoided by index funds and other institution investors and whether their activity is influencing market prices.
- Many factors are contributing to high energy prices. NYMEX continues to believe that market fundamentals are a significant factor that must not be discounted in this debate.
- Increasing margins to dampen speculative activity will not change the fundamentals and will inevitably drive business away from the highly regulated, transparent market. This will do more harm than good.

**Testimony of
Dr. James Newsome, President and CEO
New York Mercantile Exchange, Inc.
before the House Energy and Commerce
Subcommittee on Oversight and Investigations**

June 23, 2008

Mr. Chairman and Members of the Committee, my name is Jim Newsome and I am the President and Chief Executive Officer of the New York Mercantile Exchange, Inc. (NYMEX or Exchange). NYMEX is the world's largest forum for trading and clearing physical-commodity based futures contracts, including energy and metals products, and has been in the business for more than 135 years. NYMEX is a federally chartered marketplace, fully regulated by the Commodity Futures Trading Commission (CFTC or Commission) both as a "derivatives clearing organization" (DCO) and as a "designated contract market" (DCM), which is the highest and most comprehensive level of regulatory oversight to which a derivatives trading facility may be subject under current law and regulation.

On behalf of the Exchange, its Board of Directors and shareholders, I want to express our appreciation to the Committee for holding this hearing and addressing the issue of "Energy Speculation: Is Greater Regulation Necessary to Stop Price Manipulation?" The ever increasing cost of energy touches all aspects of our daily lives and today is quite possibly the most important issue facing global and domestic economies as well as U.S. consumers. Highlighting the urgency of the matter, no fewer than seven bills have been introduced in the House and Senate over the last few weeks on this very topic. We applaud the

Committee's decision to thoroughly evaluate the many facets of this topic by inviting a diverse group of panelists who can provide a broad array of opinions to the discussion.

BACKGROUND

The Commodity Futures Modernization Act of 2000 (CFMA) was the premier legislative vehicle that transformed the regulation of derivatives markets in two important ways. The CFMA: 1) established flexible core principles to allow regulated exchanges to compete effectively with the growing over-the-counter (OTC) markets and foreign markets and; 2) provided legal certainty to financial and energy swaps. The CFMA, as anticipated, ushered in a period of phenomenal growth in the derivatives markets and has proven to be the gold standard of U.S. financial policy. As Acting Chairman and then Chairman of the CFTC from 2001-2004, I was involved in the implementation phase of this landmark piece of legislation.

The CFMA significantly enhanced the competitiveness of U.S. markets by allowing them to adapt readily to changing market demand, and, for the most part, the value and success of the CFMA holds true today. However, no one had a crystal ball back then and it was impossible to know then what we know now about how some markets would develop. In at least two instances, markets have developed differently than anyone could have anticipated at the time.

First, an OTC natural gas contract began trading on an unregulated exempt commercial market (ECM) that mirrored the regulated exchange-traded natural gas futures contract and the two contracts became intricately linked.

Over time, the volume on the ECM contract grew substantially, and an arbitrage market developed between the two markets. Ultimately, the OTC contract began to serve a price discovery function. Thus, ECMs began to function more like a traditional exchange and market participants easily moved positions from the regulated exchange to the ECM to avoid regulatory requirements such as position limits, a strategy that contributed to the collapse of Amaranth. This scenario was investigated by the Senate Permanent Committee on Investigations chaired by Senator Carl Levin. (NYMEX cooperated in this investigation.) Ultimately, this situation was addressed effectively in an amendment to the recently adopted Farm Bill.

Second, non-U.S. exchanges (also referred to as foreign boards of trade (FBOT)), which were permitted by CFTC staff to offer their products to U.S. customers pursuant to CFTC no-action letters, began listing futures contracts with U.S. delivery points among their product slates. Historically, under the FBOT CFTC staff no-action process, such exchanges were permitted to offer direct electronic access to their markets to U.S. customers based on a determination by CFTC staff that the foreign regulatory regime governing the the FBOT was “comparable” to that of the CFTC.

Essentially, there is a system of mutual recognition among regulators around the world as a means to facilitate access to global markets. This approach worked effectively up until a FBOT listed the look-alike of the NYMEX West Texas Intermediate (WTI) Crude Oil Futures contract without the level of transparency and market surveillance controls such as positions limits that are

provided by U.S. markets under direct CFTC regulation. It was not anticipated that the no-action process would be used in this manner, which has effectively diminished the transparency to the CFTC of approximately one-third of the WTI crude oil market, and permitted an easy avenue to circumvent position limits designed to prevent excessive speculation.

FOREIGN BOARDS OF TRADE AND TRANSPARENCY

NYMEX has advocated for greater transparency of futures activity linked to U.S. exchanges occurring on markets regulated by foreign regulators for two years. Complete transparency to the CFTC should be a fundamental requirement for markets that are linked. In this connection, we have argued that FBOTs offering these linked products should be required by the CFTC to provide the same level and quality of data and at the same frequency that U.S. exchanges provide to the CFTC on a daily basis.

In addition, we believe that no action letters for FBOTs offering contracts with U.S. delivery points should be conditioned to impose position limits and/or accountability levels. This would be a positive step and would provide an effective mechanism to restrict speculative activity in those markets. This is particularly important when the contract trading on the FBOT is the WTI crude oil contract, which is a benchmark for crude oil pricing, and which can have a substantial impact on U.S. consumers and the U.S. economy. Indeed, we would support the imposition of position limits even for listed contracts that are financially settled. We applaud the CFTC's recently issued press release that

advised that the CFTC is now imposing position limits on ICE Futures Europe as a condition of the no-action relief.

In this regard, approximately one year ago, a new futures exchange, the Dubai Mercantile Exchange (DME), commenced operations in Dubai. NYMEX is a founder and has an ownership share in this venture and provides clearing services for the new exchange. The core or flagship crude oil futures contract is an Oman Sour Crude Oil futures contract. The DME initiative provides competition and greater transparency to crude oil trading in a critically important energy region. Although the DME does not yet list a WTI financial futures contract, the DME has received a no action letter from the CFTC staff for this contract and NYMEX received an amendment to its Clearing Order allowing our exchange to clear positions. The DME is currently finalizing a launch date for that contract. It is our understanding that, when a launch date is finalized on the DME WTI contract, DME will implement hard position limits that are comparable to NYMEX's own limits on our WTI crude oil futures contract. Also, as part of the NYMEX Clearing Order, large trader reporting to both the CFTC and NYMEX is required.

In a more recent initiative, NYMEX has entered into an alliance with a London-based clearinghouse, LCH.Clearnet Limited (LCH), under which LCH will provide clearing services for two new product slates to be launched later this summer either by NYMEX or by a NYMEX affiliate. These new product slates are intended to provide greater competition to other energy trading facilities that are active in this energy space. One product slate, focusing upon natural gas

and electricity contracts, will be listed by a division of NYMEX in the exempt commercial market tier. Applicable products in this category will comply fully with the requirements for significant price discovery contracts contained in the recently implemented CEA Reauthorization Farm Bill. The other product slate, focusing upon crude and crude products, will be listed for trading by a NYMEX affiliate based in London that will be regulated by the U.K. Financial Services Authority. While that affiliate will follow the path of other exchanges regulated by other regulators and will be applying for CFTC no-action relief, this affiliate will provide large trader reporting to the CFTC and also will impose hard position limits on any listed contracts with U.S. delivery points.

SPECULATION

Speculative activity on futures exchanges is managed by position limits. As stated in the CFTC's rules, position limits and accountability levels are required "to diminish potential problems arising from excessively large speculative positions." These limits effectively restrict the size of a position that market participants can carry at one time and are set at a level that greatly restricts the opportunity to engage in possible manipulative activity on NYMEX. For the NYMEX WTI crude oil contract, the position limit during the last three days of the expiring delivery month is 3000 contracts. Breaching the position limit can result in disciplinary action being taken by the Exchange.

Many believe that speculators, particularly index funds and other large institutional investors in our markets are responsible for the high price of crude oil. However, data analysis conducted by our Research Department confirms

that the percentage of open interest in NYMEX Crude Oil futures held by non-commercial participants relative to commercial participants actually decreased over the last year even at the same time that prices were increasing. In addition, non-commercials are relatively balanced between long (buy) and short (sell) open positions for NYMEX crude oil futures. Thus, non-commercial participants are not providing disproportionate pressure on the long (buy) side of the crude oil futures market. We also reviewed the percentage of open interest in the NYMEX Crude Oil futures contract held by non-commercial longs and shorts relative to that held by commercial longs and shorts from 2006 to the present. Commercial longs and shorts consistently have comprised between 60 and 70% of all open interest.

We have seen various representations made relative to participation by speculators in our markets that directly contradict our data. One such representation claims that 70% of our crude oil market is made up of speculators. That analysis incorrectly assumes that all swap dealers are non-commercials and that all of their customers who would be on the opposite side of any energy swaps that they might execute would also all be non-commercials. We know that this is simply not the case. However, this confusion clearly highlights the need for the CFTC large trader data to delineate for energy futures the degree of participation by non-commercials in the same manner that such data are now being delineated for agricultural contracts.

NYMEX also maintains a program that allows for certain market participants to apply for targeted exemptions from the position limits in place on

expiring contracts. However, such hedge exemptions are granted on a case-by-case basis following adequate demonstration of bona fide hedging activity involving the underlying physical cash commodity or involving related swap agreements. A company is not given an open-ended exemption, and the exemption does not allow unlimited positions. Instead, the extent of the hedge exemption is no more than what can be clearly documented in the company's active exposure (as defined by the CFTC) to the risk of price changes in the applicable product. In a number of instances, hedge applications are either reduced in number or are denied because of staff's overriding focus on maintaining the overall integrity of our markets.

A vast amount of attention is focused on speculative activity and what, if any, influence speculators are having on current market prices and volatility. In order to determine accurately whether speculative activity is influencing the market, the data must be complete and accurate. Recently, a potential gap was identified in the large trader data compiled by the CFTC in its Commitment of Trader's Report. Specifically, questions are being raised as to whether hedge exemptions for swap dealers are being used as a means of circumventing speculative position limits.

At this time, due to the manner in which the data are reported, it is not clear whether this is true or not. In response to these queries, the CFTC announced its intent to develop a proposal that would routinely require more detailed information from index traders and swaps dealers in the futures markets, and to review whether classification of these types of traders can be improved for

regulatory and reporting purposes. NYMEX believes that it will be useful to the development of thoughtful public policy for the CFTC to obtain more precise data so as to better assess the amount and impact of this type of trading in the markets.

MARKET FUNDAMENTALS

NYMEX strongly believes that greater transparency is needed and that data on participation of swap dealers and index funds must be improved in order to effectively monitor these markets and accurately assess what is or is not influencing the price. In addition, we continue to believe that market fundamentals are the most important factor in the current market. Currently, uncertainty in the global crude market regarding geopolitical issues, refinery shutdowns and increasing global demand, as well as devaluation of the U.S. dollar, are clearly having an impact on the assessment of market fundamentals. One may view such factors as contributing an uncertainty or risk premium to the usual analysis of supply and demand data. Indeed, such factors now may fairly be viewed as part of the new fundamentals of these commodities.

Other demand and supply fundamentals in the oil markets are factors in high oil prices. For example, global demand is exceeding supply by one million barrels per day. As a result, a market with highly inelastic demand will need to equilibrate through a substantive rise in price. The upward pressure has been there and, according to these projections, will continue to be there. If the major oil companies truly believed that current levels are artificially high and do not properly reflect market fundamentals, one would expect them to sell in order to

lock in the current high prices. Such selling of course then would have the effect of providing downward pressure on prices. However, such a response by the big oil companies has not been observed to date.

MARGINS

In futures markets, margins function as financial performance bonds and are employed to manage financial risk and to ensure financial integrity. A futures margin deposit has the economic function of ensuring the smooth and efficient functioning of futures markets and the financial integrity of transactions cleared by a futures clearinghouse. Margin levels are routinely adjusted in response to market volatility. Some have suggested that the answer to higher crude oil prices is to impose substantially greater margins on energy futures markets regulated by the CFTC. The theory is that higher margin levels will dampen speculative activity, and that less speculative liquidity will lower prices.

We believe that this approach is misguided. As noted above, the appropriate tool for controlling speculation is position limits. In addition, adjusting margin levels significantly upward will not change the underlying market fundamentals. Furthermore, given the reality of global competition in energy derivatives, increasing crude oil margins on futures markets regulated by the CFTC inevitably will force trading volume away from regulated and transparent U.S. exchanges into the unlit corners of unregulated OTC venues and also onto less regulated and more opaque overseas markets.

CONCLUSION

Complete transparency is fundamental for competitive markets. The same level of transparency and position size controls present on regulated U.S. futures markets should be the standard for foreign markets offering products with U.S. delivery points and for OTC contracts that serve a price discovery function. Additionally, a case has been made for disaggregation and delineation of positions held by swap dealers. This will provide important information to determine whether speculative position limits are being avoided by index funds and other institution investors and whether their activity is influencing market prices.

Many factors are contributing to high energy prices. NYMEX continues to believe that market fundamentals are a significant factor that must not be discounted in this debate. Increasing margins to dampen speculative activity will not change the fundamentals and will inevitably drive business away from the highly regulated, transparent market. This will do more harm than good.

I thank you for the opportunity to share the viewpoint of the New York Mercantile Exchange with you today. I will be happy to answer any questions that any Members of the Committee may have.