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Remarks

Panel Discussion: "Futures aiding and abetting commodity price instability"

Remarks of Commodity Futures Trading Commission (CFTC) Commissioner Michael V. Dunn before the Swiss Futures and Options Association's, Bürgenstock Meeting

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(As Prepared)

Introduction

Thank you. I am happy to be here to talk today. The sage American philosopher, baseball great Yogi Berra, once said, "It's tough to make predictions, especially about the future." I think we all recognize that futures markets are notoriously difficult to predict and understand.

Maybe that's why people are so suspicious whenever they see record prices in the futures markets, especially for commodities. As you all know, the prices for daily staples such as food and energy have risen to staggering levels, far above what anyone would have predicted just a few years ago.

These price increases are reaching into every corner of the global economy, and ordinary citizens everywhere are asking – no demanding - an explanation. And as you all know, some people simply don't believe that these prices are justified. They suspect that something has gone wrong with the functioning of the commodity futures markets, and they want it fixed yesterday.

Fundamentals or Speculation or Both?

There are two sides to this debate. One side says that fundamentals such as the weakening of the dollar, tight supplies, and increasing demand sufficiently explain the price increases. The other says the increases are driven by a tidal wave of speculative trading by banks, hedge funds and institutional investors. And some say that it is a combination of these driving prices.

We know from the data we collect from our market surveillance that there has been an increase in speculative activity in our markets. But it is not clear, at least not to me, what impact this is having on prices. Based upon our staff's surveillance and research, we can tell a pretty good story about why market fundamentals have been, at least partly, behind the price increases in agricultural and energy markets.

But, it is undeniable that there have been large flows of new investment into our markets.

Commodities appear have become an asset class in their own right. More and more investors, both retail and institutional, are allocating part of their portfolios to investments that are tied to the performance of commodity futures. The performance has been good, especially compared to the more traditional asset classes. They add diversification to investment portfolios, and they provide a hedge against inflation.

The real question here is scale. Each one of these investments might be relatively small, but what happens when the trickle becomes a flood? Essentially, the argument goes, instead of pricing just supply and demand factors, commodity markets have begun to price commodities' value as an asset class as well, creating a price distortion or possibly even a bubble.

So what is the answer? The answer is … we are not quite sure. Considering our current knowledge, I doubt it is possible to come up with a definitive answer one way or another at this time—markets and market behavior are simply too complex and our understanding is still evolving.

We continue to build upon our ongoing research, but, currently, I think decisions as to the role of speculators in futures markets reflect a good dose of professional judgment—the data cannot provide all the answers.

Bubble Policy

But let's suppose we go to the next step. Suppose that we could all agree that, yes, there is too much speculation in the market. What would we do next?

This is actually a larger question about the proper role of regulators in all markets. As many of you may be aware, there is a tremendous debate among financial regulators about whether something should have been done to prevent the bubble in housing prices. While I am no expert on housing markets, I think some of the issues that are being raised in that debate are worth considering in the commodity futures context.

If we believe the federal government should have a role in deflating bubbles, a government regulator first would have to satisfy itself that bubbles or price distortions exist and that they have substantial, negative, economic consequences. Then the regulator would have to identify the causes of that bubble or distortion and construct a market intervention that would address the problem and return prices to a level reflecting a fundamental value.

Even given everything we know about futures markets, I think we need a certain amount of humility about our ability to do that, and do it correctly without causing undesired collateral economic damage.

There are no generally accepted models that yield answers to the causes or solutions of commodity bubbles. In fact, you can find examples in history where interventions commonly thought, at the time, to be “bubble popping” actually ended up making a bubble worse.

In the field of toxicology, one of the mantras is, “the dose makes the poison.” Since virtually every substance has the propensity to be toxic at some dosage, a great deal of the science of toxicology is trying to find that lethal dose.

But, how does one do that in the futures markets? We all know that a healthy futures market has to have some level of speculation. Without speculation, futures markets just don’t work. How does one determine how much speculation is “just right” and how much is “toxic”?

The CFTC examines this on a daily basis, but we do it in a limited way. We look at whether current market conditions or market structures are leading to problems with price discovery or price distortions. Where we see problems, we intervene, working with the exchanges and traders to address those problems. Where we see fraud or manipulation, we bring enforcement cases.

But this type of monitoring focuses on the short term, trying to assess the day to day functioning of the market. Trying to evaluate the impact of speculative trading over longer periods of time presents a different kind of challenge—one that requires a regulator to make conclusions about the structure and the validity of prices and trends.

The CFTC is specifically mandated by Congress to take action to address “excessive speculation” affecting futures contract markets. In particular, the Commodity Exchange Act directs the CFTC to periodically review and set speculative position limits:

> “The Commission shall, from time to time, . . . by rule, regulation. order, proclaim and fix such limits on the amounts of trading which may be done or positions which may be held by any person . . . on or subject to the rules of any contract market or derivatives transaction execution facility as the Commission finds are necessary to diminish, eliminate, or prevent [excessive speculation].”

Given the high percentage of open interest attributable to speculative trading in some of our markets we have to be vigilant for potential problems, and we do review speculative positions limits, but these limits again are aimed at short term market function, particularly the month a contract expires.

In some of our markets, particularly agricultural markets, we have noted potential structural problems. These problems, such as lack of convergence, weak basis, and high margin requirements jeopardize the markets’ effectiveness as a risk management tool for the agricultural sector.

Some market participants believe that index trading is a significant cause of these problems in combination with other market factors. They believe that the nature of the physical supply of agricultural commodities means that index funds are causing an upward impact on prices either through high demand for long futures contracts or through impacts upon the cash markets.

We have to take these concerns seriously. There have, of course, been periodic problems with convergence and basis in the agricultural markets over the years. But, we can not rule out that that speculative trading, particularly the roll of index fund positions may be contributing to the problems we see today.

We are evaluating these concerns, and we have not come to any conclusions yet. Impacts on convergence and basis do not necessarily lead to the creation of a bubble, but they can clearly undermine the functioning and efficiency of futures markets.

Even in the agricultural area, where we have comprehensive data for virtually all segments of agricultural markets, it can be very difficult to draw definitive conclusions as to what is causing the problems we see. I think this highlights the difficulty of trying to intervene in this area.

One thing the CFTC has done is increasing the transparency of these markets by breaking out index trading positions in our agricultural markets when we publish our weekly Commitments of Traders reports. Starting last year, we added an additional supplement to our reports to identify positions held by index traders. This supplemental report has been very well received by market participants.

Even if we cannot draw firm conclusions, hopefully we can provide market information to market users that can help them draw their own conclusions about market structure.

Legislative Proposals

There are of course some solutions already on the table. As many of you know, the U.S. Congress has responded to high commodity prices with four general types of proposals for intervening in the futures markets and reducing or restraining the amount of speculation in energy and agricultural markets.

These four interventions are:

- Raising margin requirements for speculators
- Imposing stricter position limits
- Limiting speculative investment through defining acceptable hedging practices
- Requiring additional reporting for over-the-counter markets

These interventions would be substantial changes to U.S. futures regulatory system, and we are still evaluating them in response to questions from the U.S. Congress to assess what the impact of such policy changes might be.

These proposals are in a state of flux and I don’t want to make any premature judgments, but I can offer a general principle.

If, and I repeat, if, there is a component of current commodity prices, caused by speculative investment, that creates an undesirable value for commodities as an investment asset separate from their fundamental value, the key question is whether it is possible to manage speculative investment to keep prices closer to a commodities' fundamental value while preserving optimal liquidity levels to ensure that markets continue to function effectively.

As I mentioned before, the CFTC is charged by Congress to set speculative position limits to guard against negative impacts from excessive speculation.

But there could also be other causes that might lead to a divergence from fundamentals. Once we have a better understanding of the impacts of speculative trading upon the structure of energy and agricultural markets, it could be that we will identify specific problems that are amenable to targeted solutions. It is our hope that our ongoing research and input from market users will help us identify possible mechanisms through which problems may be occurring.

Congress is back in session this week and I expect there is a good chance we may see new versions of legislation introduced and possibly debated in Congress.

Commission Actions

As I mentioned before, there are some actions the Commission has already taken.

Improving transparency of index traders and swap dealers

To help answer questions regarding the amount of money from index trading flowing into the futures markets, the Commission voted to use its special call authority to gather more detailed data from swap dealers on the amount of index trading in the markets and to examine whether index traders are properly classified for regulatory and reporting purposes.

Staff is in the final process of reviewing the information that has been submitted by the swap dealers, and will provide a report to Congress by September 15 regarding the scope of commodity index trading in the futures markets and recommendations for improved practices and controls, should they be required.

Interagency Task Force (June 2008)

Acting Chairman Walt Lukken formed an Interagency Task Force on Commodity Markets (ITF) in June 2008. The task force draws on a broad range of government staff expertise on the fundamental factors and market forces affecting commodity markets. Chairman Lukken and the other agency heads involved intend that the ITF will aid public and regulatory understanding of the forces that are affecting the functioning of the commodity markets.

The Task Force is composed of staff members from the Departments of Agriculture, Energy and the Treasury, the Board of Governors of the Federal Reserve, the Federal Trade Commission, and the Securities and Exchange Commission.

In July 2008, the ITF published an interim report on the crude oil markets. This preliminary report concludes that fundamental supply and demand factors provide the best explanation for the increase in crude oil prices. The report found no statistical evidence that speculative trading was systematically driving oil prices, and highlighted several global trends in oil markets such as the significant increase in the rate of growth of the world economy, stagnant production of oil, geopolitical unrest in oil producing countries, and the weakening of the U.S. dollar.

The ITF will continue to develop its analysis of crude oil and expand its work to cover other commodities in the coming months. New data from the CFTC's special calls on the activities of commodity swap dealers and commodity index traders is expected to become available for review during this time. In addition, an examination of prices in other commodities is expected to further enhance the understanding of commodity markets. The ITF expects to issue its report later this month.

Foreign Board of Trade (FBOT) Revisions

Since 1996, the CFTC has permitted certain foreign exchanges direct access to US participants through a staff no-action process. Today, 18 foreign markets have received permission to provide direct access to US customers, based on a CFTC staff review of the FBOT and its home regulator, and conditioned on access books and records, submission to US jurisdiction and information sharing.

The Commission re-examined its FBOT policy in 2006 when Ice Futures Europe (ICE), a UK exchange, listed the West Texas Intermediate Crude (WTI) contract that settled off the New York Mercantile Exchange (NYMEX) settlement price for WTI, effectively creating one market. The listing of the ICE WTI contract was unique from a regulatory point of view because it was the first listing of an FBOT contract that used the settlement prices of an existing US exchange contract. After a public hearing and public comment period on the Commission's staff no-action process for FBOT, the Commission issued a Policy Statement reaffirming the FBOT no-action process.

However, the linkage of the ICE and NYMEX contracts caused the Commission and its surveillance staff to be concerned that regulators would not be able to observe the entirety of a trader's position in both markets.

Consequently, CFTC staff worked with its foreign counterpart, the UK Financial Services Agency (FSA), to share large trader data for these linked contracts to ensure that traders were not gaming one market to influence positions on the other market.

In late May of this year, CFTC staff announced that pursuant to the 2006 arrangement with the FSA, it was requesting large trader data from the ICE WTI contract and that the ICE WTI contact observe speculative limits similar to those applicable to the linked contracts traded on U.S. contract markets.

Under this revised request, the CFTC will obtain daily (as opposed to weekly), large trader data for the linked ICE crude oil contract and certain other information enhancements.

CFTC staff will now require that other foreign exchanges seeking direct access to provide the CFTC with comparable large trader data and impose comparable position and accountability limits for any products linked with US regulated futures contracts. In July, the CFTC staff amended the no-action relief granted to the Dubai Mercantile Exchange in May 2007 to apply these new conditions.

Aggressive Enforcement Policy

Since December 2002, the Commission has filed a total of 43 enforcement actions charging a total of 73 defendants with violations involving the energy markets. The CFTC has assessed almost half a billion dollars in civil monetary penalties. The CFTC has also worked cooperatively with the Department of Justice to bring 35 criminal actions involving energy market misconduct.

Most recently, in July of this year, the CFTC charged a Dutch trading firm, Optiver, and several of its employees, with manipulation and attempted manipulation of various energy contracts, including crude oil and gasoline. As with most of our manipulation cases, the Commission alleged in its complaint that the activity was meant to artificially move prices for short, discrete periods of time – in this case, temporarily moving prices up or down for several minutes over certain days in March 2007.

Regulatory Agenda

The CFTC is required by law to publish every six months an agenda of significant rules that the Commission expects to propose or promulgate over the next year. For each subject area listed on the agenda, the Commission provides the objectives and legal basis for the issues of the rule, and an approximate schedule for its completion by the Commission staff.

We welcome comments and suggestions for our regulatory agenda, as the agenda provides the best overview of the entire CFTC regulatory program and, hence, what the Commission's priorities should be over the coming months. The next regulatory agenda will come out in October and I am working to get the details published on the CFTC website.

Conclusion

I expect that interest in commodity markets is going to remain high. In addition to the focus on energy markets, I think there is going to be increased attention paid to issues that have been raised by participants in agricultural markets. We still have a great deal of work to do in understanding the evolving role of speculation in futures markets. I look forward to working with my fellow commissioners and our staff to do that, and welcome any other input from the public or industry. Thank you.