S. HRG. 110–731

ROLE, RESPONSIBILITIES, AND RESOURCE NEEDS OF THE COMMODITY FUTURES TRADING COMMISSION FOR OVERSIGHT OF ENERGY MARKET AND OIL FUTURES CONTRACTS

JOINT HEARING

BEFORE THE

COMMITTEE ON AGRICULTURE, NUTRITION, AND FORESTRY

AND THE

SUBCOMMITTEE ON FINANCIAL SERVICES AND GENERAL GOVERNMENT

OF THE

COMMITTEE ON APPROPRIATIONS UNITED STATES SENATE

ONE HUNDRED TENTH CONGRESS

SECOND SESSION

SPECIAL HEARING

JUNE 17, 2008—WASHINGTON, DC

Printed for the use of the Committee on Appropriations

Available via the World Wide Web: http://www.gpoaccess.gov/congress/index.html

U.S. GOVERNMENT PRINTING OFFICE

44–289 PDF WASHINGTON : 2009

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
Fax: (202) 512–2104 Mail: Stop IDCC, Washington, DC 20402–0001

COMMITTEE ON APPROPRIATIONS

ROBERT C. BYRD, West Virginia, *Chairman*

DANIEL K. INOUYE, Hawaii	THAD COCHRAN, Mississippi
PATRICK J. LEAHY, Vermont	TED STEVENS, Alaska
TOM HARKIN, Iowa	ARLEN SPECTER, Pennsylvania
BARBARA A. MIKULSKI, Maryland	PETE V. DOMENICI, New Mexico
HERB KOHL, Wisconsin	CHRISTOPHER S. BOND, Missouri
PATTY MURRAY, Washington	MITCH McCONNELL, Kentucky
BYRON L. DORGAN, North Dakota	RICHARD C. SHELBY, Alabama
DIANNE FEINSTEIN, California	JUDD GREGG, New Hampshire
RICHARD J. DURBIN, Illinois	ROBERT F. BENNETT, Utah
TIM JOHNSON, South Dakota	LARRY CRAIG, Idaho
MARY L. LANDRIEU, Louisiana	KAY BAILEY HUTCHISON, Texas
JACK REED, Rhode Island	SAM BROWNBACK, Kansas
FRANK R. LAUTENBERG, New Jersey	WAYNE ALLARD, Colorado
BEN NELSON, Nebraska	LAMAR ALEXANDER, Tennessee

CHARLES KIEFFER, *Staff Director*
BRUCE EVANS, *Minority Staff Director*

SUBCOMMITTEE ON FINANCIAL SERVICES AND GENERAL GOVERNMENT

RICHARD J. DURBIN, Illinois, *Chairman*

PATTY MURRAY, Washington	SAM BROWNBACK, Kansas
MARY L. LANDRIEU, Louisiana	CHRISTOPHER S. BOND, Missouri
FRANK R. LAUTENBERG, New Jersey	RICHARD C. SHELBY, Alabama
BEN NELSON, Nebraska	WAYNE ALLARD, Colorado
ROBERT C. BYRD, West Virginia *(ex officio)*	THAD COCHRAN, Mississippi *(ex officio)*

Professional Staff

MARIANNE UPTON
DIANA GOURLAY HAMILTON
MARY DIETRICH *(Minority)*
RACHEL JONES *(Minority)*
LASHAWNDA SMITH *(Minority)*

Administrative Support

ROBERT RICH

COMMITTEE ON AGRICULTURE, NUTRITION, AND FORESTRY

TOM HARKIN, Iowa, *Chairman*

PATRICK J. LEAHY, Vermont
KENT CONRAD, North Dakota
MAX BAUCUS, Montana
BLANCHE L. LINCOLN, Arkansas
DEBBIE A. STABENOW, Michigan
E. BENJAMIN NELSON, Nebraska
KEN SALAZAR, Colorado
SHERROD BROWN, Ohio
ROBERT P. CASEY, JR., Pennsylvania
AMY KLOBUCHAR, Minnesota

SAXBY CHAMBLISS, Georgia
RICHARD G. LUGAR, Indiana
THAD COCHRAN, Mississippi
MITCH McCONNELL, Kentucky
PAT ROBERTS, Kansas
LINDSEY GRAHAM, South Carolina
NORM COLEMAN, Minnesota
MICHAEL D. CRAPO, Idaho
JOHN THUNE, South Dakota
CHARLES E. GRASSLEY, Iowa

MARK HALVERSON, *Majority Staff Director*
JESSICA L. WILLIAMS, *Chief Clerk*
MARTHA SCOTT POINDEXTER, *Minority Staff Director*
VERNIE HUBERT, *Minority Chief Counsel*

CONTENTS

ROLE, RESPONSIBILITIES, AND RESOURCE NEEDS OF THE COMMODITY FUTURES TRADING COMMISSION FOR OVERSIGHT OF ENERGY MARKET AND OIL FUTURES CONTRACTS

TUESDAY, JUNE 17, 2008

U.S. SENATE, COMMITTEE ON APPROPRIATIONS, SUBCOMMITTEE ON FINANCIAL SERVICES AND GENERAL GOVERNMENT AND THE COMMITTEE ON AGRICULTURE, NUTRITION, AND FORESTRY,

Washington, DC.

The subcommittees met at 10:30 a.m., in room SD–192, Dirksen Senate Office Building, Hon. Richard J. Durbin (chairman) presiding.

Present: Senators Durbin, Murray, Ben Nelson, Brownback, Harkin, Dorgan, Lincoln, Salazar, Brown, Klobuchar, Chambliss, Lugar, Roberts, Crapo, and Thune.

OPENING STATEMENT OF SENATOR RICHARD J. DURBIN

Senator DURBIN. I am pleased to welcome you to this joint hearing of the Senate Financial Services and General Government Appropriations Subcommittee and the Senate Committee on Agriculture, Nutrition, and Forestry. I am pleased to share the leadership task today with my colleague and friend, Senator Tom Harkin, chairman of the Agriculture Committee, which has authorizing jurisdiction over the Commodity Futures Trading Commission (CFTC). I want to also welcome the ranking members, Senator Brownback from the appropriations side, Senator Chambliss from the authorizing side.

Together we want to examine the role and responsibilities of the Commodity Futures Trading Commission, looking at your oversight of energy markets and oil futures and consider whether the agency has the resources it needs to fulfill its mission.

I welcome my colleagues who have joined me on the dais from both committees in this rare, maybe unprecedented joint meeting. I am pleased to welcome Acting Chairman Walter Lukken of the CFTC. I also want to note that CFTC Commissioners Mike Dunn, Bart Chilton, and Jill Sommers are in attendance. I thank them all.

Our second panel will include Dr. Mark Rogers of the Consumer Federation of America, Terry Duffy of the CME Group in Chicago (CME), Dr. Jim Newsome of NYMEX, Charles Vice of ICE, the

Intercontinental Exchange, and Jim May of the Air Transport Association.

Just a moment of prefatory remarks. Senator Harkin and I—our hearts are back home, even though we are here today with this important topic, because of the suffering which is taking place in the Midwest with flood waters. As Tom and I were just noting, the disaster which hit Iowa is now headed downstream and many of us are going to be facing similar challenges, and our hearts and prayers go to all those who are suffering, being separated from their homes and businesses and communities. Our American family comes together when there are such natural disasters to help in these situations, and I am sure that the President and Congress will do no less because of this devastation in the middle west.

Less than 2 weeks ago, the price of a barrel of oil on the futures market reached $139. In 2 days—2 days—the price rose $16, more than 10 percent. Did I miss some war in the Middle East? Was there an oil supply disruption that occurred in that period of time? The answer is no.

Something is going on in the oil futures markets beyond the fundamentals of supply and demand. And with the economy in a tailspin and the average price for a gallon of gas over $4, it is absolutely critical that we meet and take a look at it.

But here is one thing. No one knows for sure what is going on here. That is why we are conducting this hearing. The regulator of the oil futures markets is the CFTC. Chairman Lukken, who we will hear from shortly, has stated on several occasions that the CFTC does not believe there is market manipulation. Well, that may be true, but maybe it is not. I honestly do not know if the CFTC has the resources or the data to be able to make any definitive judgment about this market. And if it is true that the market is not being manipulated, I think that there still could be excessive speculation that is driving up the price of oil beyond pure supply and demand.

Manipulating the price of a future is clearly illegal. Simply speculating on whether the price of a future is going up or down is normal. That is what traders do. But excessive speculation in which large positions are taken that divorce the overall price of the commodity from its natural price is problematic for consumers and businesses and is really threatening our economy.

In the case of oil, every American family and business is hurting from the rampant rise in prices in recent months. Is excessive speculation taking place? Why is the price of oil futures rising so quickly? There are too many questions to even answer in this joint hearing.

Is the fact that stock markets are not an appealing place to invest driving people into the energy futures markets?

Is it that investors are worried about inflation, using oil to hedge against the risk like they used to use gold?

Is it the hugely deflated dollar exchange rate that is behind this or new investment vehicles such as commodity index funds driving up futures prices or investment bank analysts issuing reports predicting huge increases in oil prices in part because the same banks will profit if that happens or regulatory differences between the CFTC, which oversees American trading, and the Financial Services Authority (FSA), which oversees British trading, allowing traders to hide manipulative crude oil positions from the CFTC?

Is it the lack of true oversight of these markets that has encouraged institutional traders to take speculative positions through overseas markets or over-the-counter (OTC) trades, positions they cannot take in other markets?

You know, the list of questions goes on and on. The answers are scarce.

Given the importance of the price of energy to families and businesses in Illinois and across the Nation, I think this is the reason why we are coming together and why we need to take this very seriously.

I have introduced a bill with 15 co-sponsors entitled "Increasing Transparency and Accountability in Oil Prices". This bill would provide more people and better technology to the CFTC to help them understand the situation. It would also give them far greater visibility to the traders and the transactions that are involved.

Specifically, it authorizes the CFTC to hire an additional 100 employees, FTEs, and expresses the sense of the Senate for the need of an emergency supplemental request from the President for this funding.

Second, it closes the London loophole by treating oil traders located in London as if they were trading in the United States for regulatory purposes. So the CFTC would have access to oil trades on all exchanges rather than just the trades that take place physically in our country.

Third, it requires more detailed reporting to the CFTC for index funds and swap dealers who typically take long positions that might drive up the price of oil.

Fourth, it moves the CFTC Inspector General out of the CFTC Chairman's Office to ensure objectivity.

And fifth, it calls for a Government Accountability Office study of the existing international regulatory regime that should be preventing excessive speculation and manipulation.

Many of these ideas are not new. Senators, our colleagues, have joined us in this inquiry before, and some will be here today. Senators Levin, Feinstein, Cantwell, and Dorgan have been very active, and of course, Chairman Bingaman and Chairman Harkin have been leaders on these issues as well.

The CFTC needs more cops on the beat. It needs more information. It needs more authority. If the run-up in crude oil prices is being driven by large trader banks, pension banks, and hedge funds, then speculators have more to do with high gasoline prices than Saudi sheikhs.

And I have to ask, how can we possibly believe the CFTC is policing market manipulation in the energy markets and consistently ignores some of the massive trades that are going on in overseas markets and on OTC markets? I mean, that clearly is part of the responsibility of making sure that these are honest, transparent markets and that we actually know what is happening.

There has been a lot of speculation about speculation and what impact it has on the price of oil. The honest answer is today, Chairman Lukken, you do not have enough information. Some of that information is not coming your way because you and your predecessors consciously said we do not want to know. It is a separate market that we are not going to regulate. I think the time has come for that information to be available to you and to the American people so that we can avoid any possibility of market manipulation.

PREPARED STATEMENT OF SENATOR THAD COCHRAN

Before you begin, Senator Harkin, the subcommittee has received a statement from Senator Thad Cochran that he would like to have included in the record.

[The statement follows:]

PREPARED STATEMENT OF SENATOR THAD COCHRAN

Mr. Chairman, I would like to begin by thanking Senator Durbin and Senator Harkin for holding this joint hearing of the committees of jurisdiction over the Commodity Futures Trading Commission.

The Commodity Futures Trading Commission has the important role of ensuring that commodity markets function in an efficient manner, consistent with applicable laws and regulations. It is important for Congress to understand that it is not the role of the Commission to implement regulations to force the price of commodities up or down. In addition, Congress must carefully review any additional regulations which may do economic harm by forcing investors to abandon regulated markets. Regulations should not eliminate the price discovery functions of the market or prevent individuals from lawfully hedging against market risk.

I am pleased that the Commodity Futures Trading Commission has announced new initiatives to address the concerns which have been raised by agriculture industries. I applaud Acting Commissioner Lukken's leadership for recently hosting a roundtable discussion with agriculture leaders from around the country to discuss the problems within the futures market and consider suggestions that would provide stability without altering an individual's ability to hedge against market risk.

It is important that Congress be fully informed about the resource needs of the Commodity Futures Trading Commission. As the volume of futures trading increases, it is understandable that the current resources of the Commission could be strained. I hope the administration will advise Congress if additional funding is required and submit a request for appropriations that are clearly required to carry out its responsibilities.

I thank the panelists for appearing before the committees today and I look forward to their testimony.

Senator DURBIN. Chairman Harkin.

STATEMENT OF SENATOR TOM HARKIN

Senator HARKIN. Thank you very much, Mr. Chairman. I am pleased to help co-chair this hearing with the Subcommittee on Financial Services and General Government, along with Senator Brownback and Senator Chambliss.

Again, just to repeat what you said, we are holding this hearing to address both the mission and the funding of the Commodity Futures Trading Commission. The CFTC has critical regulatory responsibility to protect the integrity, fairness, and transparency of our Nation's futures, options, and derivatives markets. A lot of times people wonder what these markets are all about. Well, they affect the life of every single American in this country on a daily basis. The prices that consumers pay for everything from gasoline to a loaf of bread are directly affected by the prices that are discovered on these markets. That is why it is so critical that these markets function without manipulation and without excessive speculation.

The CFTC must have the authority, the resources, and the resolve to ensure that the prices discovered by the commodity futures markets reflect the fundamentals of supply and demand. The CFTC has a critical responsibility to protect customers, market integrity, and the public while also promoting efficient and internationally competitive futures and derivatives markets.

With good reason, there has been a great deal of interest in restoring fuller CFTC authority to monitor and take appropriate regulatory action in the derivatives market in energy. The farm bill that was enacted last month includes important additional authority to monitor exempt commercial market trading of oil, natural gas, and other commodities for contracts that perform significant price discovery functions. So they have just gotten that, and I am going to be curious to find out how they are going to implement it.

In the last few weeks, the CFTC announced energy market initiatives to expand international surveillance of crude oil trading and agricultural market initiatives, to review the role of index trading and speculators in the agricultural commodities, to improve market transparency, and to take steps to ensure that farmers have the tools they need to manage the risk in these times of volatile markets. Now, again, these were just announced by the CFTC in the last couple of weeks.

Today we will hear from witnesses who will provide their insight and recommendations as to what further steps we need to take. And given the dramatic increases in prices that Senator Durbin just talked about, we cannot tarry much longer. The American Automobile Association (AAA) reports that gasoline prices have risen 30 percent in the last year. At the end of May, corn prices rose 54 percent from May of last year, and they are continuing to rise this month because of all the flooding and everything. It is essential that we determine what we can do to ensure that these markets function properly.

I have often said that when you come to oil and corn, demand is pretty inelastic. There is not much substitute out there. Well, I guess there is a substitute for oil and that is not to use so much of it. But when it comes to corn that you feed the hogs and cattle and poultry and everything else, there is really not much of a substitute there.

So we also have to ensure that the CFTC has the resources it needs. The volume of futures exchanges has grown exponentially. Staffing is down. Futures are traded every hour of every day, 7 days a week, in both the regulated exchanges and over-the-counter transactions. The CFTC must have the human and technological resources to stay abreast of the market activity.

You will remember I asked this question at the confirmation hearings about staffing and staffing requirements and resources that are needed. It just does not seem to me that with the huge growth that we have had, that you can do the same job as you did 20 years ago, 30 years. How long have I been here? Since 1975 when we started this outfit. With all of the exponential growth in all these markets worldwide, we did not have this 30 years ago. Yet, we have got less people working there now. Now, I know technology has helped a lot. You can do a lot more with technology than perhaps with personnel. I understand that. But I still have a nagging feeling that we do not have the resources at the Commodity Futures Trading Commission to really get a handle on this appropriately.

So, again, I thank you, Mr. Chairman, for calling this hearing. I know sometimes it gets esoteric, but having followed the CFTC all these years, I will say this. There is no entity right now in America more important to the consumers of this country and the essentials of what they need—and that is food and fuel—than the CFTC. Thank you very much, Mr. Chairman.

Senator DURBIN. Senator Brownback.

STATEMENT OF SENATOR SAM BROWNBACK

Senator BROWNBACK. Thank you very much, Mr. Chairman. I appreciate that you are holding this hearing, along with Chairman Harkin. I am pleased to be here. I am glad the acting chairman is here as well.

I would like to note at the outset that my colleague, Pat Roberts, is here on the dais with us. We have disasters going on in our State as well, as did Manhattan, Kansas and Chapman. We have had several tornadoes this past year and our thoughts and prayers go out to those communities.

Mr. Chairman, oil prices are too high. Gasoline prices are too high. America is far too dependent on foreign oil. We know all of that. We know we are too reliant on foreign oil, especially from unstable parts of the world. There is no question that Americans are suffering and family budgets are being squeezed tighter and tighter by rising gasoline and food prices.

Today, in conjunction with the Committee on Agriculture, our subcommittee will examine one aspect of this issue, namely the role of futures markets in generating higher and higher energy prices. I want to reiterate that this is only one aspect of this issue. I think it is a very important one. It is one I have spent quite a bit of time thinking about what all is taking place here and what we can do to have a positive impact on price reduction because it sure looks like to me there is a lot of speculation in these prices. I get this from just looking around, but also from a number of knowledgeable people saying that the fundamentals do not support these prices. Most of this speculation is expressed through the CFTC and actions and positions that people take.

There has been much written regarding the role that speculators and index funds have played in driving the price of petroleum products higher and higher.

I am pleased that we have witnesses from both the CME and NYMEX testifying before us today, along with the Acting Chairman of the Commodity Futures Trading Commission. I hope you can offer us your front-line assessment of what is happening in the futures market, what problems need to be addressed, and what we in Congress should be doing globally. This is a global issue and must be handled in a global context.

I have had a number of knowledgeable individuals suggest the commodity index funds have played a significant role in driving up energy prices specifically and all commodities generally.

On the other hand, I heard from economists who suggest we may be experiencing a bubble in commodity prices. They point out that unlike the stock market, futures markets are zero sum games. For every dollar a futures market participant makes, another market participant loses a dollar.

I noted at the outset of this hearing that commodity prices are one of the key aspects of the current problem, and that is why I am appreciative that we are holding this hearing today. We have got a good set of panels but before we move ahead I want to put a few other thoughts forward.

One is a bipartisan bill that a number of us are soon to introduce called the Open Fuels Standard Act that allows and would require that one-half of our new cars would be flex fuel by 2012 so that we are not held hostage to oil and so that we may have other options, whether it be ethanol or methanol. I believe we will have strong bipartisan effort so we can get off of the oil addiction and have some other options.

Another issue I think we must face is that we cannot continue to limit domestic development and exploration. We have done that. That has happened for years. It cannot be allowed to continue. It makes us more dependent upon foreign sources. These are supply and demand issues, and I think we have got to get at that.

And what I would hope, Mr. Chairman, in your position as the number two person in the United States Senate, that we would put these items together and we would look at those or maybe a couple of others and let us move something forward. There is nothing more important that faces the American public right now. I think these are key pieces of it that we could develop and work on together, but we cannot drop any of them off. They need to all be here so that we can drive these energy prices down so the American family can have a little bit of money left over after the month instead of pumping it all into their gas tank.

I appreciate your holding the hearing.

Senator DURBIN. Senator Chambliss.

STATEMENT OF SENATOR SAXBY CHAMBLISS

Senator CHAMBLISS. Thank you very much, Chairman Durbin. I commend both you and Chairman Harkin for holding this hearing this morning.

Let me just say that all Americans have you folks in Illinois, Iowa, and throughout the Midwest in our thoughts and prayers. We all have had some difficult issues this year with the tornadoes and whatnot through the Southeast, and we are certainly thinking about all of your folks.

There has been far too much discussion about the matters that we are going to be talking about outside the committees of jurisdiction, and I am happy that we are now turning our attention to hearing from these witnesses so that the Agriculture Committee can take the lead in coordinating any necessary oversight or legislative action.

While I recognize that the resources of the Commodity Futures Trading Commission are insufficient when compared to the increased workload they are experiencing and I am pleased that we will be taking a thorough look at that issue today, I would like to focus my comments on the particular issues that do fall within the jurisdiction of the Agriculture Committee.

Several pieces of legislation, which have been introduced, address speculation in the energy markets and several hearings have been held in many different Senate committees on the topic. I have heard several Senators speak on the Senate floor about this matter, and I would like to take this opportunity to sort of set the record straight based upon the facts that we have seen from an Agriculture Committee perspective.

First, I think it is very irrational that some in Congress have gone so far as to blame the Acting Chairman of the Commodity Futures Trading Commission for $4 gasoline when, in fact, the Acting Chairman of CFTC, Walt Lukken, who will be testifying before us today, has probably done more than anyone to try and shed some light on what is actually occurring in the markets.

Last year he launched an investigation into practices surrounding trading of crude oil and related derivative contracts.

He recently developed an interagency task force with the Federal Reserve, the Department of the Treasury, the Securities and Exchange Commission (SEC), the Department of Energy, and the Department of Agriculture (USDA) to study the role of speculators and index traders in energy markets.

The Acting Chairman also created and convened the Energy Markets Advisory Committee to look into energy market transparency, including the impact that trading on foreign boards of trade is having on such markets.

Further, Acting Chairman Lukken led efforts to develop an agreement with a key foreign board of trade to ensure that the CFTC has access to the trading data they need to monitor activity in the global oil market.

And in the past month, he has begun requiring traders to provide monthly reports of their index trading; information that should help the Commission determine the impact of index trading on the market. Certainly, Acting Chairman Lukken, you have made great strides in trying to create more and better transparency, and we should all be grateful for that.

These recent efforts, again, all initiated by Acting Chairman Lukken, will provide the data necessary to make an informed and rational decision of how speculation is affecting the price of oil. I believe we should not rush to legislate an uninformed solution, particularly when we might create more problems by driving speculators into markets for which the CFTC receives no trading data and has no ability to monitor.

And I agree with you, Senator Durbin, in your quote as I wrote it down, "too many questions to be answered in this hearing". And I think you are exactly right. That is why I am pleased we are starting here, and I look forward to working with you, as well as Chairman Harkin, on additional hearings.

In addition, simply assigning blame will not yield real results, particularly when the main problem is supply and demand. In this case, the data that I have seen so far does not show that blaming speculators will yield the result that we are all looking for, and that is lower gas prices.

Here is a chart. This shows who is holding large positions, those over 350 contracts, in west Texas intermediate (WTI) crude oil contracts on the New York Mercantile Exchange where approximately

70 percent of trading for the WTI occurs. The data shows that while there may have been an increase in market participation overall, the proportion of positions held by commercial participants, those who can physically deliver crude oil or accept delivery of crude oil, and noncommercial positions, those held by speculators, has not changed over the past 2 years. Speculation in this contract by noncommercial participants seems to have held steady at about 20 percent.

So if we are to fault market speculators for current gas prices, we cannot blame it on their increased market participation when we compare their level of participation to that of commercial participants. Rather, we need to allow the CFTC to implement those initiatives that they have just recently announced and complete their ongoing investigation. With this critical information, we can then make a real assessment of any role speculators are playing.

Some of our colleagues also like to claim that excessive speculation is occurring on unregulated foreign exchanges. Well, let us be clear. Any exchange in any country can list the west Texas intermediate crude contract for trading without any approval from CFTC. Just because west Texas intermediate crude is physically delivered in the United States does not mean that the United States can prevent other foreign boards of trade from listing and allowing traders to trade the contract on their platforms.

However, if these foreign boards of trade want to make their trading screens available to U.S. traders, then they must seek approval from the CFTC. Often this is done through what is known as a no action letter. The no action letter, which is obtained from the Division of Market Oversight at the CFTC, very simply absolves these boards of trade located outside the United States from the requirement to become a designated contract market so long as the regulatory regime in their country has determined to sufficiently regulate their activities in order to protect U.S. customers. These letters are granted only after the CFTC determines that the regulatory body in the country in which the foreign board of trade is located will supply the CFTC with regular market surveillance information, as well as meet other conditions required by the CFTC.

In the absence of such a letter, there would be no required coordination or information sharing between the U.S. regulatory authority, the CFTC, and the foreign based regulatory authority. Yet, the contracts would still be allowed to be traded on these foreign boards. Now, that seems to be truly a dark market and not one that I am interested in encouraging.

The no action letter process, whereby foreign boards of trade seek to accommodate the CFTC's demands prior to being allowed to offer contracts in the United States actually helps the CFTC ensure that they receive adequate data to monitor the activities of these foreign exchanges.

The example most often used by several of my colleagues is the trading of the west Texas intermediate crude contract on the London-based exchange, ICE Futures Europe. Yes, the CFTC, through no action relief, allows ICE to offer this contract to U.S. traders. In exchange, ICE Futures Europe has agreed to notify the CFTC when traders exceed position accountability levels established by U.S. exchanges for the WTI crude oil contract.

Additionally, the United Kingdom's regulatory authority, the Financial Services Authority, has been supplying the CFTC with requested surveillance data for several years.

And just last month, the CFTC worked with the United Kingdom regulators so that they will now provide the CFTC with daily large trader positions, as well as more detailed identification of market end users. The CFTC will review this data and determine if there is any manipulation occurring. That is their job, and we should insist that they get this information and properly review it before we request that they revoke no action letters and really force traders into the dark where CFTC has no ability to monitor what is occurring.

While I am discussing foreign boards of trade and ICE in particular, here is a chart that actually shows the volume of shares and open interest in the west Texas intermediate crude oil contract since it was listed on ICE in June 2006. The green line also shows the settlement price of this particular crude oil contract. You can see that beginning in August 2007, when the price began to rise sharply, the open interest on ICE and the share of market volume traded on ICE was actually falling.

Again, we need to be cautious that we get our facts straight before we start pointing fingers at what some Senators have called excessive speculation on a foreign board of trade. The American people are interested in real solutions. Simply blaming foreign boards of trade or the regulatory agency for not overseeing these foreign boards of trade properly for the problems we are facing is irresponsible, particularly when the data does not support the accusation.

I am happy to work with my colleagues on efforts to find solutions to high gas prices but only after we have all the facts. So Chairman Durbin, Chairman Harkin, I again appreciate your holding this opportunity to let us begin gathering those facts.

Senator DURBIN. Thank you, Senator Chambliss.

Chairman Lukken, the floor is yours.

STATEMENT OF WALTER LUKKEN, ACTING CHAIRMAN, COMMODITY FUTURES TRADING COMMISSION

Mr. LUKKEN. Chairman Durbin, Chairman Harkin, members of the committees, I appreciate being invited here to talk about the CFTC's role, responsibilities, and resources at the agency.

During the last few years, the futures markets have changed dramatically in size and complexity, experiencing 500 percent growth in both volume and products listed. Once member-owned and dominated by open-outcry trading, today exchanges are technology-driven corporations that primarily trade electronically, 24 hours a day, all around the globe. Approximately $5 trillion of notional transactions flow through these U.S. exchanges and clearing houses every day. This description alone would make the oversight of these markets a challenge for regulators, but add to it the subprime crisis, record energy and agricultural prices, the influx of financial funds into futures, and historic low staffing levels at the

CFTC, and it is clear that these are challenging times for this agency.

Recent substantial increases in the price of crude oil and other commodities have had a major impact on American consumers and put a considerable strain on U.S. households. These issues are a matter of intense focus at the Commission due to the key role that the futures markets play in the price discovery process.

The CFTC recognizes that these markets and their participants have evolved significantly in the last several years. Concerns have been raised recently regarding the role of speculators and index traders in the commodity markets. As prices have escalated, the CFTC has pursued an active agenda to ensure that the commodity futures markets are operating free of distortion. The Commission has undertaken several initiatives directed to enhancing the oversight of the energy and agricultural markets. These initiatives fall into five broad categories: one, increasing information and transparency; two, ensuring proper market controls; three, continuing aggressive enforcement efforts; four, improving oversight coordination; and five, seeking increased funding.

The proper oversight of markets requires transparency. Market regulators must receive the necessary information to conduct surveillance of market activity, study long-term financial trends, and evaluate policy changes as circumstances evolve. The backbone of the CFTC's market surveillance program is the large trader reporting program. All large traders must file daily with the CFTC their futures and options positions in the markets. This information enables the CFTC's surveillance economists to oversee all traders of size to ensure that no one is attempting to manipulate the futures markets.

As markets have become electronic and global, the CFTC has been working to expand and enhance its technology and trade data collection to accommodate these trends. Last spring, the CFTC announced a major technology purchase that will modernize our trade practice surveillance system, allowing the CFTC to more effectively sort through the millions of pieces of information generated by these electronic markets daily.

The CFTC is also working to increase the amount and quality of trader data we receive from the markets. Two weeks ago, the CFTC announced an agreement with the U.K. FSA to expand on the trader data already received from ICE Futures Europe on its linked crude oil contract that settles off the NYMEX crude oil benchmark. This agreement includes providing large trader data for the linked crude oil contract daily, extending trader information-sharing to all months traded, improving the identification of market end users to be completed in 2 months, and improving the formatting so trading information can be seamlessly integrated into the CFTC's surveillance system. This cross-border information sharing is unprecedented among global regulators.

The CFTC has also taken action to improve the transparency of index traders and swap dealers in the energy markets. There is public concern about the amount of index money flowing into the futures markets. Two weeks ago, the CFTC announced that it would use its special call authorities 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. These information requests have been sent and the CFTC expects in the coming weeks to begin receiving more detailed information on index funds and other transactions that are being conducted through swap dealers. After analyzing this data, the CFTC will provide a report to Congress by September 15 regarding the scope of the commodity index trading in the futures markets and recommendations for improved practices and controls, should they be required.

The Commission must also ensure proper controls in the marketplace. Last fall, the Commission announced its intention to address the mounting regulatory concerns surrounding exempt commercial markets that trade OTC energy products. The Commission held a public hearing and worked with Congress to enact legislation as part of the farm bill to oversee exempt commercial markets that trade these linked energy contracts and to provide the CFTC with large trader reports and impose position limits and accountability limits on such products. Congress and this agency believed that these authorities were necessary for the regulated energy marketplace.

As noted earlier, linkages between contracts are not purely a domestic occurrence, but also happen internationally across borders. Most energy and agricultural commodities are global commodities operating in a global marketplace, and the U.S. futures markets have been facing the challenges of cross-border trading and regulation for many years.

For more than a decade, the CFTC has worked to develop international regulatory networks to increase international cooperation and, most importantly, to maintain and improve U.S. futures markets oversight in the face of increasing globalization. Over the years, the CFTC has developed a mutual recognition process that strikes the balance between the need for U.S. regulators to maintain confidence in the functioning and integrity of the markets and the acknowledgement that increased globalization of commodity markets requires international coordination and cooperation.

With this balance in mind, today the CFTC is announcing modifications to its foreign board of trade process. After consultation with the British FSA, the CFTC is announcing that ICE Futures Europe has agreed to begin the process of implementing position and accountability limits on its linked crude oil contracts. The CFTC has revised ICE Futures Europe's no action letter to reflect this change. The CFTC will also require other foreign exchanges that seek such direct access to provide the CFTC with comparable large trader reports and to impose comparable position and accountability limits for any products linked with a U.S. futures contract. This combination of enhanced information sharing and additional market controls will help the CFTC in its surveillance of its regulated domestic exchanges while preserving the benefits of its mutual recognition program.

During these turbulent market conditions for crude oil, the environment is ripe for those wanting to illegally manipulate the markets, and as a result, the Commission has stepped up its already aggressive enforcement efforts. Two weeks ago, the Commission took the extraordinary step of disclosing that in December 2007, its

Division of Enforcement launched a nationwide crude oil investigation into practices surrounding the purchase, transportation, storage, and trading of crude oil and related derivatives contracts. Strong enforcement is imperative during this time.

Given the CFTC's size and the enormity of the global marketplace, the CFTC must also engage others in Government as we seek to find important information about these markets. Last week, the CFTC announced the formation of an interagency task force to evaluate developments in the commodity markets, which includes staff from the CFTC, the Federal Reserve, the Department of the Treasury, the SEC, the Department of Energy, and the USDA. It is intended to bring together the best and brightest minds in Government to aid public and regulatory understanding of the forces that are affecting the functioning of these markets.

If the CFTC sounds busy, it is, especially given the agency's staffing levels are near record low numbers. Since the CFTC opened its doors 33 years ago, the volume on futures exchanges has grown 8,000 percent, while the CFTC staffing numbers have fallen 12 percent. The agency's lack of funding over the course of many years has had a negative impact on our staffing situation, rendering it unsustainable for the long run. The CFTC is a small agency doing an extraordinary job under difficult circumstances. The dedicated and skilled individuals at the CFTC are working tirelessly to ensure the integrity of these markets. The recent fiscal year budget allowed for moderate hiring and additional technology investments, and we deeply appreciate your support, Mr. Chairman, for this funding.

However, as the agency embarks on new authorities and initiatives in order to respond to changing market conditions, it is imperative that the CFTC receive additional resources. The CFTC is in the midst of implementing its new farm bill authorities which require many programmatic changes and plain old hard work for a staff that is already under significant strain. Additionally, the agency's staff is racing to implement the many recent agency initiatives I outlined earlier in my testimony. Recall as well that our employees are also full-time regulators charged with overseeing these markets each and every day, upholding the agency's mission to safeguard the futures markets. Given our staffing numbers, the agency is working beyond its steady state capacity and is unable to sustain the current situation for much longer without being forced to make tough decisions about which critical projects should be completed and which ones should be delayed.

Given these new authorities and the unprecedented market conditions of the day, the Commission requested an additional $27 million beyond the President's $130 million budget number of fiscal year 2009, which would allow the agency to hire approximately 100 additional staff. In making the request, the Commission is mindful of the need to maintain fiscal restraint in appropriations and the competing needs of other parts of the Federal Government. However, we believe that this proposed funding level is the appropriate level of resources required to fulfill our immediate and growing responsibilities.

In summary, I want to thank these committees for the support they have shown this agency over the years. Under Chairman Harkin's leadership, last month the Senate Agriculture Committee successfully reauthorized this agency with important modifications to our authority. I also appreciate the legislation that Chairman Durbin introduced last week that requests additional funding for the CFTC and incorporates some of the initiatives I have outlined today.

As I stated in my earlier testimony—and it bears repeating, given the challenges of the last several weeks—I am deeply proud of our highly skilled and productive staff. This small agency is working hard to protect the public from manipulation, fraud, and abuse in order to ensure that the futures markets are working properly.

Thank you very much for allowing me to testify this morning, and I welcome any questions you may have.

[The statement follows:]

PREPARED STATEMENT OF WALTER LUKKEN

Chairman Durbin and Chairman Harkin and other distinguished members, thank you for inviting me to testify before these Committees on the role, responsibilities and resources of the Commodity Futures Trading Commission (Commission or CFTC).

During the last few years, the futures markets have changed dramatically in size and complexity, experiencing 500 percent growth in both volume and products listed. Once member-owned and dominated by open-outcry trading, today exchanges are technology-driven corporations that primarily trade electronically, 24 hours a day, all around the globe. Approximately $5 trillion of notional transactions flow through these U.S. exchanges and clearing houses daily. This description alone would make the oversight of these markets a challenge for regulators. But add to it the sub-prime crisis, record energy and agricultural commodity prices, the influx of financial funds in futures, and historic low staffing levels at the CFTC and it is clear that these are challenging times for this agency.

Recent substantial increases in the price of crude oil and other commodities have had a significant impact on American consumers and have put considerable strain on U.S. households. These issues are a matter of intense focus at the Commission due to the key role that futures markets play in the price discovery process. We share the concerns of Americans and Congress, and the CFTC is committed to ensuring that our nation's futures markets operate fairly and efficiently, and that commodity prices are determined by the fundamental forces of supply and demand, rather than abusive or manipulative practices.

The CFTC recognizes that these markets and their participants have evolved significantly in the last several years. Concerns have been raised recently regarding the role of speculators and index traders in the commodity markets. As prices have escalated, the CFTC has pursued an active agenda to ensure that the commodity futures markets are operating free of distortion as the agency looks to better understand the implications of these structural market developments. The Commission has undertaken several initiatives directed to enhancing the oversight of the energy and agricultural markets. These initiatives fall into five broad categories: (1) Increasing Information and Transparency; (2) Ensuring Proper Market Controls; (3) Continuing Aggressive Enforcement Efforts; (4) Improving Oversight Coordination; and (5) Seeking Increased Funding.

ENHANCING INFORMATION AND TRANSPARENCY

The proper oversight of markets requires transparency. Market regulators must receive the necessary information to conduct surveillance of market activity, study long-term financial trends and evaluate policy changes as circumstances evolve. The backbone of the CFTC's market surveillance program is the large trader reporting system. All large traders must file daily with the CFTC their futures and options positions in the markets. This information enables the CFTC's surveillance economists to oversee all traders of size to ensure that no one is attempting to manipulate the futures markets. This amount and detail of trade data collected and analyzed at the CFTC is unprecedented among regulatory financial agencies.

As markets have become electronic and global, the CFTC has been working to expand and enhance its technology and trade data collection to accommodate these trends. Last spring, the CFTC announced a major technology purchase that will modernize our trade practice surveillance system to enhance basic trade surveillance and permit nearly real-time analyses of all trading activity. Investments in technology are critical for the CFTC to sort through the millions of pieces of information generated by these electronic markets daily.

The CFTC is also working to increase the amount and quality of the trader data we receive from the markets. Two weeks ago, the CFTC announced an agreement with the U.K. Financial Services Authority (FSA) to expand the trader data received from ICE Futures Europe on its cash-settled light sweet crude oil contract that settles off the NYMEX benchmark crude oil contract. When first listed in 2006, this linkage between the two 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. Once the surveillance issue was identified, the CFTC worked with its foreign counterpart, the FSA, to share large trader data for these linked contracts to ensure that traders were not gaming one market to influence the other. At that time, the CFTC's agreement with the FSA provided the CFTC with weekly trader information, and daily information in the final trading week, to facilitate the ability of the CFTC and FSA to oversee trading in these related contracts.

Building on these efforts, the CFTC and FSA two weeks ago announced an expanded information-sharing arrangement, including: (1) providing daily large trader positions in the linked ICE Futures Europe crude oil contract; (2) extending trader information sharing to all contract months; (3) a near-term commitment to improve the identification of market end users to be completed within 2 months; (4) improved formatting so trading information can be seamlessly integrated into the CFTC's surveillance system; and (5) CFTC notification when traders exceed NYMEX position accountability levels. This cross-border information sharing is unprecedented among global regulators.

The CFTC also has taken action to improve the transparency of index traders and swap dealers in the energy markets. There is public concern about the amount of index money flowing into the futures markets. Pensions, endowments and other long-term investors increasingly are investing a portion of their portfolios in a broad mix of commodities in order to diversify their holdings and reduce volatility and risk. Unlike traditional speculative trading by hedge funds and other managed money, index investors are typically non-leveraged entities utilizing a long-term buy and hold strategy. Most of this type of investment comes through major Wall Street swap dealers that sell their clients broad exposure to the commodity markets through an over-the-counter commodity index contract. Swap dealers then are exposed to commodity price risk as a result of aggregating these transactions and must utilize the futures markets to manage their own remaining residual risk. This "netting out" of risk by swap dealers before coming to the futures markets makes it difficult for regulators to determine the total amount of index trading occurring in the energy markets.

Two weeks ago, the CFTC announced that it would use its special call authorities 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. These information requests have been sent and the CFTC expects in the coming weeks to begin receiving more detailed information on index funds and other transactions that are being conducted through swap dealers. After analyzing this data, the CFTC 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.

ENSURING PROPER MARKET CONTROLS

Last fall, the Commission announced its intention to address the mounting regulatory concerns surrounding exempt commercial markets that trade over-the-counter energy products. The Commission held a public hearing and worked with Congress to enact legislation as part of the Farm Bill requiring exempt commercial markets that trade contracts linked to regulated U.S. futures contracts to provide the CFTC with large trader reports and impose position and accountability limits on such products. Congress and this agency believed that these authorities were necessary to protect the regulated energy marketplace.

As noted earlier, linkages between contracts are not purely a domestic occurrence but also happen across international borders. Most energy and agricultural commodities are global commodities operating in a global marketplace, and the U.S. futures markets have been facing the challenges of cross-border trading and regulation for many years.

For more than a decade, the CFTC has worked to develop international regulatory networks, to increase international cooperation, and—most importantly—to maintain and improve oversight of U.S. futures markets in the face of increasing globalization. Over the years, the CFTC has developed a mutual recognition process that strikes the balance between the need for U.S. regulators to maintain confidence in the functioning and integrity of our markets, and the acknowledgement that the increased globalization of commodity markets requires international cooperation and coordination.

With this balance in mind, today the CFTC is announcing modifications to its Foreign Board of Trade process. After consultation with the British FSA, the CFTC is announcing that ICE Futures Europe has agreed to begin the process of implementing position and accountability limits on its linked crude oil contract. The CFTC is currently revising its access letter to reflect this change. The CFTC will also require other foreign exchanges that seek such direct access to provide the CFTC with comparable large trader reports and to impose comparable position and accountability limits for any products linked with U.S. regulated futures contracts. This combination of enhanced information data and additional market controls will help the CFTC in its surveillance of its regulated domestic exchanges while preserving the benefits of its mutual recognition program that has enabled proper global oversight over the last decade.

CONTINUING AGGRESSIVE ENFORCEMENT EFFORTS

During these turbulent market conditions for crude oil, the environment is ripe for those wanting to illegally manipulate the markets and as a result, the Commission has stepped up its already aggressive enforcement presence. Two weeks ago, the Commission took the extraordinary step of disclosing that in December 2007, its Division of Enforcement launched a nationwide crude oil investigation into practices surrounding the purchase, transportation, storage, and trading of crude oil and related derivatives contracts. Although the Commission conducts its enforcement investigations in full confidentiality, today's unprecedented market conditions and the desire to maintain public confidence justified disclosing the existence of this investigation.

Since December 2002 to the present time, the Commission has filed a total of 39 enforcement actions charging a total of 64 defendants with violations involving the energy markets. The agency has assessed almost half a billion dollars in civil monetary penalties in settlement of these enforcement actions. The Commission also has achieved great success in this area by working cooperatively with the Department of Justice on over 35 criminal actions concerning energy market misconduct. Strong enforcement is imperative during this time.

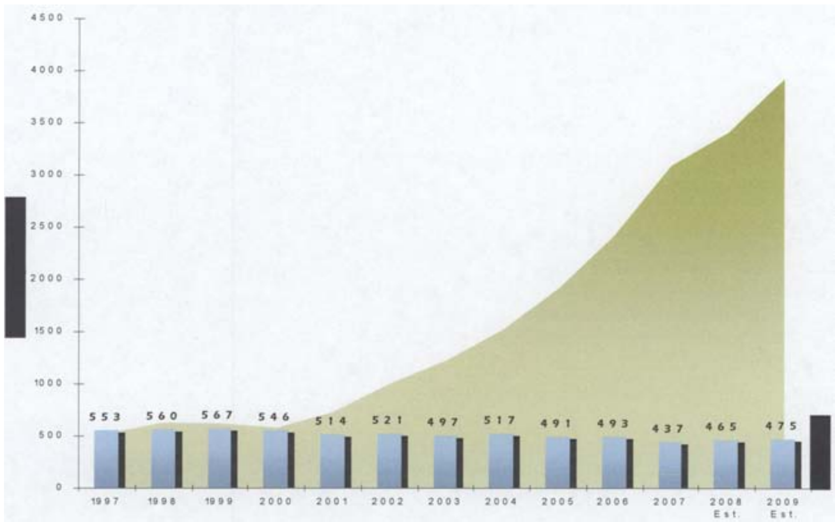
IMPROVING OVERSIGHT COORDINATION

Given the CFTC's size and the enormity of the global marketplace, the CFTC must engage others in Government as we seek to meet our important mission. Last week, the CFTC announced the formation of a CFTC-led interagency task force to evaluate developments in the commodity markets. The task force—which includes staff representatives from the CFTC, Federal Reserve, Department of the Treasury, Securities and Exchange Commission, Department of Energy, and Department of Agriculture—is examining investor practices, fundamental supply and demand factors, and the role of speculators and index traders in the commodity markets. It is intended to bring together the best and brightest minds in Government to aid public and regulatory understanding of the forces that are affecting the functioning of these markets. We convened the first meeting last week and will strive to complete this work quickly and make public the results.

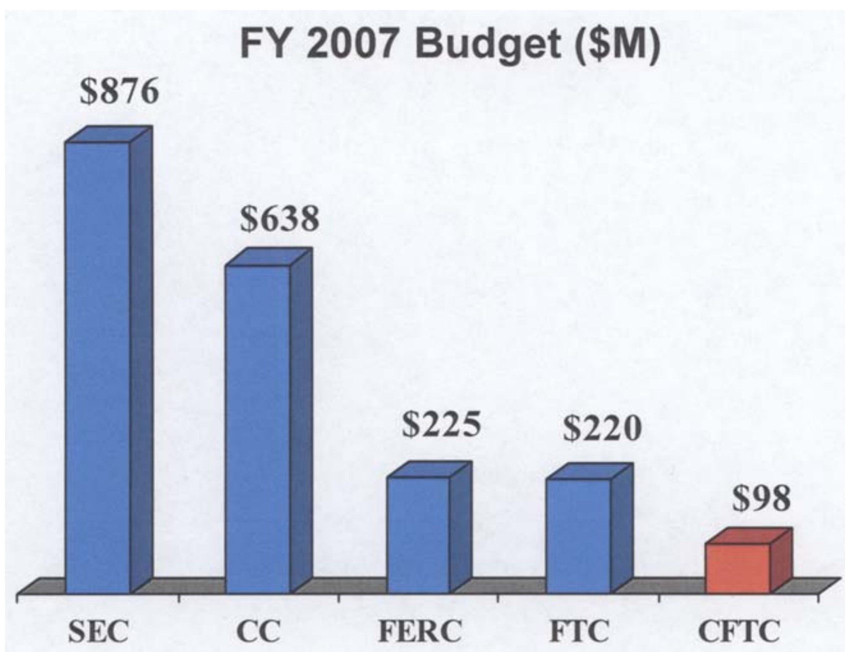
The CFTC also recently hosted its second international enforcement conference—a 2-day event focusing on global trading in the energy markets with senior enforcement officials from 10 countries. Our goal was to enhance the ability of the CFTC and its fellow regulators to detect and deter misconduct affecting commodity prices in the energy sector, and I am confident that it was a success that will bear the fruit of coordinated international enforcement for manipulation.

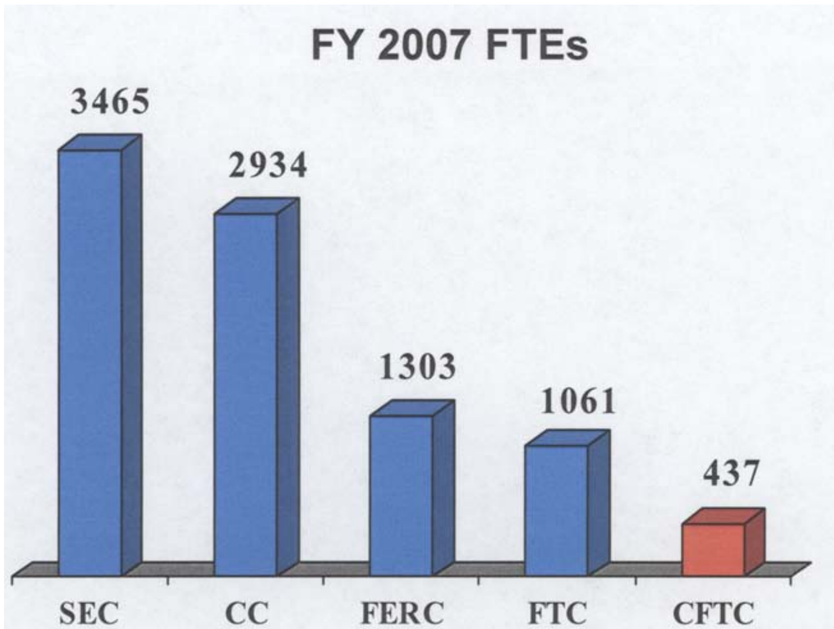
SEEKING INCREASED FUNDING

If the CFTC sounds busy, it is—especially given that the agency's staffing levels are near record low numbers. Since the CFTC opened its doors 33 years ago, the volume on futures exchanges has grown 8,000 percent while the CFTC's staffing numbers have fallen 12 percent. The following chart shows the exponential growth in contract volume, compared to CFTC staff numbers.



The CFTC's resources simply have not kept pace with the growth of the markets and the growth of similar financial regulators. As you can see, the CFTC lags other comparable agencies in funding levels by substantial margins. This agency's lack of funding over the course of many years has had a negative impact on our staffing situation, rendering it unsustainable for the long run.





The CFTC is a small agency doing an extraordinary job under difficult circumstances. The dedicated and skilled individuals at the CFTC are working tirelessly to ensure the integrity of the markets. The recent fiscal year budget allowed for moderate hiring and additional technology investments. We deeply appreciate your support to secure increased funding and have acted quickly to bring on additional staff to handle the agency's increasing workload.

However, as the agency embarks on new authorities and initiatives in order to respond to changing market conditions, it is imperative that the CFTC receive additional funding. The CFTC is in the midst of implementing its new Farm Bill authorities, which require many programmatic changes and plain old hard work from a staff that is already under significant strain. Additionally, the agency's staff is racing to implement the many recent agency initiatives I outlined earlier in my testimony. Recall as well that our employees are also full-time regulators, charged with overseeing these markets each and every day, upholding the agency mission to safeguard the futures markets. Given our staffing numbers, the agency is working beyond its steady state capacity and is unable to sustain the current situation for much longer without being forced to make Hobson's choices about which critical projects should be completed and which ones will be delayed. And while we welcome discussions of any appropriate and necessary legislative or agency changes, our agency is clearly unable to accommodate additional tasks at our current resource and personnel level.

As you are aware, the administration has proposed for the Commission a budget of $130,000,000 for fiscal year 2009. The Commission is very appreciative of the budget proposal—which reinforces the reversal of an almost two-decade-long downward trend in real funding. The $130,000,000 is greatly needed to continue the implementation of the long-delayed information technology modernization initiative first begun in fiscal year 2008, and enables us to take the first steps to address our staffing shortage.

Given these new authorities and the unprecedented market conditions of the day—conditions that could not have been anticipated when the fiscal year 2009 budget was first formulated last summer—we welcome this hearing at a critical and opportune time. After reviewing the impact of recent initiatives and the projections associated with legislative changes, the Commission is requesting an additional $27,000,000 for a total of $157,000,000 and 596 FTEs. The additional $27,000,000 is comprised of $21,000,000 to continue existing efforts to ensure the integrity of the futures and options markets and $6,000,000 to undertake new responsibilities as mandated in the Farm Bill of 2008.

In making this request, the Commission is mindful of the need to maintain fiscal restraint in appropriations and the competing needs of other parts of the Federal Government. However, we believe that the proposed funding level of $157,000,000 is the appropriate level of resources required to fulfill our immediate responsibilities. The increase will restore staffing to a level last sustained almost two decades ago when market volume, innovation, and complexity were significantly less than today and when the agency did not yet have to face the expanded workload brought on by globalization of the marketplace and the emergence and widespread use of derivatives and hedge funds. This of course means the Commission is now doing much more with less and continues to deliver a good return on investment for the American taxpayer. The Commission's ratio of workload to resources has always been lean compared to other financial regulators. But we have reached our limit and cannot uphold our mission without immediate additional resources.

In summary, I want to thank these Committees for the support they have shown this agency over the years. Under Chairman Harkin's leadership, last month the Senate Agriculture Committee successfully reauthorized this agency with important modifications to our authority. I also appreciate the legislation that Chairman Durbin introduced last week that requests additional funding for the CFTC and incorporates some of the initiatives I have outlined today. As I stated in my earlier testimony, and it bears repeating given the challenges of the last several weeks, I am deeply proud of our highly skilled and productive staff. This small Federal agency 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.

Senator DURBIN. Thanks, Chairman Lukken.

The CFTC's mission, as stated in the law, is to protect market users and the public from fraud, manipulation, and abuse of practices related to the sale of commodity and financial futures and options, to foster an open, competitive and financially sound futures and options market.

Back a few years ago there was a request from Enron relative to OTC trades in energy futures, and there was included in the bill passed in the waning hours of the 106th Congress a provision which exempted these OTC electronic exchanges from CFTC oversight.

Then at a later period, in January 2006, your agency decided that ICE futures related to energy would not be subject to the same reporting requirements, large trader reporting requirements, as trades, for example, at NYMEX here in the United States.

So my question to you is twofold because of this announcement that you made today. When you take a look at the volume of trading in energy futures, combining what we know that you regulate here in the United States, ICE's transactions, and OTC transactions, what percentage are you currently regulating before the issuance of this new order? In other words, what percentage of the market is being watched closely to see if there is fraud, abuse, and manipulation?

Mr. LUKKEN. I think what is of greatest concern for the CFTC is the price discovery markets which I would say are the ICE markets in London, as well as the NYMEX markets. So that is where we focus our attention. As mentioned, in our mission, price discovery is an important part of that element.

Senator DURBIN. I am going into a specific question. What percentage of this price discovery are you currently regulating? In other words, what percentage of the market do you feel is reporting to you the large trader reports so that we can see if there is any manipulation? Is it one-third, one-half, three-fourths?

Mr. LUKKEN. I am not sure I can give you exact percentages. I am not sure of the OTC trades. Since that is not reported.

Senator DURBIN. Precisely. Precisely. And that is one of the reasons we are here. You do not know. You cannot answer that question because there is no regulation of OTC markets.

Now, let me ask you about what you have announced today. Is this going to lead to comparable regulation and disclosure by the ICE exchange on energy futures as those who are involved at NYMEX?

Mr. LUKKEN. Absolutely.

Senator DURBIN. Exactly comparable. By what statutory authority can you do this?

Mr. LUKKEN. Through our no action letter, we are going to receive large trader reports that are exactly the same as we will be receiving from NYMEX. ICE is implementing position limits, as well as accountability limits that are——

Senator DURBIN. So the regulation is identical.

Mr. LUKKEN. For those provisions. And this will also come into our commitment of trader reports as well so that we are able to show the public what is happening not only on our markets but also what is happening in London as well. So people will get to see the entirety, the transparency that I think people have been looking for.

Senator DURBIN. Will this only relate to trading based in America?

Mr. LUKKEN. No. We receive the entirety of all the trading that is going on in London for this product.

Senator DURBIN. So for west Texas intermediate, if someone in France is buying a contract through ICE in the future, they will have to make the same disclosures to CFTC as an American trading through NYMEX today for the same WTI.

Mr. LUKKEN. Yes. And that is the beneficial thing of this program, is we get to see non-U.S. participants in the market. And that is why our recognition program has been so useful, seeing the rest of the world that is trading these products.

Senator DURBIN. And if there is a Dubai exchange opened, which is going to trade in WTI in the future, what will be the position of the CFTC?

Mr. LUKKEN. The exact same position.

Senator DURBIN. The same requirement of large trader reports.

Mr. LUKKEN. And accountability and position limits.

Senator DURBIN. Now, what are you going to do about OTC, over-the-counter trades, these look-alike trades?

Mr. LUKKEN. Well, this was our announcement 2 weeks ago. We have asked for additional information from swap dealers to find out what types of transactions they are bringing onto the futures markets. So this will give us a look through into what types of transactions that may include. Index traders, which a lot of people have concern about, other types of swaps——

Senator DURBIN. So will require the same reports then from the OTC markets that are going to be required of NYMEX and ICE and the future Dubai exchange?

Mr. LUKKEN. Well, we are going to have to look at the data before we can make any determination.

Senator DURBIN. Do you have the authority to ask for large trader reports for OTC trades?

Mr. LUKKEN. For OTC, if it is linked to the futures markets, we will have to determine whether we can get that information.

Senator DURBIN. What I understand is the law that we passed in 2006, if I am not mistaken—pardon me—in the year 2000, the Modernization Act, here took away that authority for the CFTC for OTC trades. You say you have the authority or you do not?

Mr. LUKKEN. Well, right now the farm bill closed this perceived gap for OTC swaps that are traded electronically—once they start to link to the regulated marketplace, we can get this data.

Senator DURBIN. So you will have the same authority, large trader reports in the same detail for all of the energy futures markets that we know of.

Mr. LUKKEN. Right, for those traded on an electronic exchange.

Senator DURBIN. I did not dwell much on the appropriations side of this, but let me just say at the outset, I think you are right. Those who wanted to get Government off our back ended up taking the cops off the beat, and so we saw a dramatic increase in the transactions taking place here, and I am afraid it has been to the detriment of our economy. I think it is important that you have the qualified professionals and computer technology to keep up with this expanding market.

Chairman Harkin.

Senator HARKIN. Thank you very much, Mr. Chairman.

Just about the time I think I have a good handle on some of the different trading that is going on in commodities, something new comes up and I ask where did this come from. And what I would like you to go into a little bit more is this netting out of the position of the index traders that are coming into the market and how that works. What is the extenet of this activity? You put out a special call on this—right—to get more information.

Mr. LUKKEN. Correct.

Senator HARKIN. Could you just elaborate a little bit more how this netting out is affecting our futures markets?

Mr. LUKKEN. Well, we typically have not looked through the futures markets to get data from index traders. Swap dealers are Wall Street firms that aggregate lots of their clients' businesses together. These clients may have different exposures that they want to manage risk on. It may be different airlines around the world that are trying to get risk management exposure through these Wall Street firms. There may be others that want broad index exposures, pension funds and endowments. Some may be long the market, some may be short the market. Swap dealers provide a tailored service to bring all those together, sell them products. They figure out what the residual risk might be left over for the firm itself, and then they turn around in the futures markets to manage that.

So typically we have not looked past what the futures markets positions have been. It is unprecedented for us to do this. And it will be complex. We are going through the billion dollar portfolios of large Wall Street firms to figure this out and trying to convert this into the equivalence of futures contracts. So it is going to be a difficult proposition, a complex proposition, but something we have to do to bring transparency to these markets so we have a better understanding of what is going on.

Senator HARKIN. Tell me more about the danger of this netting out. What could it lead to? If you do not get a handle on it, you do not understand it, what could it lead to?

Mr. LUKKEN. Well, I think there are concerns that people, through swap dealers, might be trying to evade position limits. Speculators that might go directly to the market are going through swap dealers in order to avoid those limits. So that is something we will be looking for.

But the futures markets are helpful for these firms. We do not want these firms to not manage the risk of their exposures. We do not want a systemic event where they melt down and they have not been able to manage risk in the futures markets. So we are going to have to find a balance, finding the right controls, the right transparency for these, but it is complex. Like I said, hopefully by September 15, hopefully sooner, we are going to try to get recommendations to Congress on this.

Senator HARKIN. By September 15?

Mr. LUKKEN. Yes, sir.

Senator HARKIN. By then you will know the magnitude of it?

Mr. LUKKEN. Yes, sir.

Senator HARKIN. Will you also be making it more transparent for the public to understand this, for us to understand it?

Mr. LUKKEN. That is our hope, is that we can start putting into a lot of our public data some of these transactions.

Senator HARKIN. Now, mostly we are talking about energy here, but is some of the same thing taking place in agricultural markets, agricultural commodities?

Mr. LUKKEN. Yes, and we put out a commitment of trader report weekly that does break out index trading for agricultural markets. The reason we are able to do that is the swap dealers are almost one for one selling index products to clients and turning around and managing that entire risk in the futures markets. So we know for certain that swap dealers' books are index trading in the agricultural futures.

It is not the case for energy. That is why it is a more difficult proposition, why it has been harder for us to get at this data, but it is imperative we do get the data. And that is why we, 2 weeks ago, announced that we are going to put out special calls to get it.

Senator HARKIN. So to sum up, would you say this relatively new facet where all these index traders are coming in now and these large firms are trying to net it out to cover their exposure—has this really grown substantially? How much has this grown in the last couple years?

Mr. LUKKEN. It certainly has grown. We are trying to figure out how much it has grown. I think the estimates range anywhere from $150 billion to $250 billion on the high end. But it is difficult to tell, and that is something we are trying to figure out.

And then also what is its impact? We have anecdotal evidence. Obviously, when you see an influx and a rise in prices, that raises concerns, but we also have evidence where in cash and cattle, which have a very high percentage of index trading—I'm sorry—of hogs and cattle, a very high percentage of index trading they are down negative for the year. So, yes, we are trying to find the smoking gun, and that is what this data will help us to find out.

Senator HARKIN. Thank you, Mr. Chairman.

Senator DURBIN. Senator Brownback.

Senator BROWNBACK. Thank you, Mr. Chairman.

Chairman Lukken, who are the swap dealers? Who are the major swap dealers?

Mr. LUKKEN. Wall Street firms such as Goldman Sachs, Morgan Stanley, J.P. Morgan, those sorts.

Senator BROWNBACK. Are there a lot of them or is this a small universe of very large players?

Mr. LUKKEN. Anywhere in the range of 5 to 10 Wall Street firms.

Senator BROWNBACK. That are doing this $150 billion to $250 billion investing in the commodities?

Mr. LUKKEN. That is correct.

Senator BROWNBACK. I am curious just on a couple of things. Because of the high volatility of futures markets in commodities, should Congress look at whether these are suitable investments for pension funds altogether? These are very volatile markets, and yet you apparently have a lot of pension fund monies going into them.

Mr. LUKKEN. Correct. Well, that is something that we are trying to get better information on. As I mentioned, this special call that went out will get us the data to try to find out exactly how much is going in, what its impact might be, and then whether there are controls we can put onto these types of investments to make a recommendation for Congress.

We also have convened this interagency task force. This is not just a micro participant level question for the CFTC, but also we are trying to get the people who see the macro fundamentals of these markets, such as the USDA, Department of Energy, the Federal Reserve, to bring in their expertise and their economists to look at this data as well. Hopefully this collective group, along with our information requests, can help bring more understanding to these markets.

Senator BROWNBACK. Well, I raise a real question whether or not these are suitable investment vehicles for pension funds. I mean, we are going through a subprime housing market meltdown because there was a new investment vehicle of sorts that was really ramped up in a major way, and now we are suffering the consequences. Are we going to see that if there is a bust in this futures market bubble in a number of these pension funds? So I think that is well worth looking at.

One of the things I want to ask you is, would increasing margins have any practical impact on the activities of pension funds and index funds in the commodity markets?

Mr. LUKKEN. Margins in the futures markets are different than the securities markets. Margins in a securities market are a down payment on buying stock. A margin—or they call it a performance bond in the futures market—is trying to cover a 1-day price move of the commodity because in the futures markets, you are not buying the underlying commodity. You are buying the change in price when you buy it and sell it. And so a margin has been used to cover those price moves and ensure and protect the clearing house from default, and this has worked incredibly well over the 150 years of the futures markets. Raising margin to try to limit participation and drive down prices——

Senator BROWNBACK. Let me be tighter on my question. Raising margins on speculators or those noncommercial interests or those entering into the swap market that are noncommercial players.

Mr. LUKKEN. Right. I think if you raise margin—I would assume that people want to try to drive speculators and drive prices down. I am not sure that would be the ultimate effect. Certainly, it would probably drive these markets elsewhere where there are competitive choices—overseas or OTC. So that is a concern. I think there are more direct ways to try to get at this activity through transparency and spec limits that we currently have in place.

Senator BROWNBACK. Well, I appreciate what you are announcing on London today because I think that is a major step, getting them to comply to the same standards as are taking place here. And I think we are going to have to do this in other markets as well. But I would think we would need to look at the same thing on speculative or noncommercial players in the swap market as well.

I had people suggest to me to apply higher margins on long positions than on short positions. Now, that seems that would be a manipulative move by the Government, but a number of people are getting to their wit's end on what these markets are doing in driving up prices that seems to be far and above what the fundamentals support.

Do you have a thought on making a different margin position on long versus shorts?

Mr. LUKKEN. Again, I think if you take it away from what it was intended to do, protect the clearing house, and trying to manage prices using margin I think is a dangerous precedent.

Senator BROWNBACK. Well, I think we need to get at the question of these volatile markets on pension funds. Pension funds drive them up. But if we are in a speculative bubble, they could see huge losses on a near-term basis because bubbles are—by their very nature—things that pop, and then you have a big problem on the other end, as we have experienced.

Thank you, Mr. Chairman.

Senator DURBIN. Senator Chambliss.

Senator CHAMBLISS. Thank you, Mr. Chairman.

Mr. Lukken, we have heard some call for revocation of the no action letter process. I am somewhat concerned about that because I think it adds to the transparency. Can you describe for us the process whereby the Division of Market Oversight at CFTC issues those letters and what would happen if they were halted?

Mr. LUKKEN. The no action process was begun in 1996 at the agency trying to deal with some of the global considerations of futures trading markets existing around the world. Rather than require all U.S. participants—or foreign markets to come and register everywhere around the world, a system of mutual recognition was developed. And this allows the home regulator to be the primary regulator, but the CFTC has to go through an analysis to ensure that the home regulator is comparable to the CFTC's regulatory objectives. And so that is what we do, what we go through when somebody comes in from a foreign board of trade. We look at their regulatory status and their systems, and we make sure that it has comparable regulatory objectives.

But we can also condition these no action letters, and this is where we gain our leverage with these entities. As you mentioned, anybody can list these contracts without our approval, but when they want U.S. participant access, we can condition it to get the information, as we announced today, to impose position limits and accountability limits. And the benefit is not only do we get to see the U.S. participants on those markets, but we also get to see the foreign participants. It would be completely opaque to us had we not issued these no action letters.

So I think it has been helpful for us as a recognition program to recognize the global marketplace we live in, but also ensure proper controls are in place and that we are getting the proper surveillance information from these markets.

Senator CHAMBLISS. Let me go back to I think what you were getting to with Senator Brownback's first line of questioning there. Some Senators have suggested that CFTC should increase the margin requirements for crude oil trading, and that seems to be confusing what the margins in the futures markets are truly designed to ensure, which is they are a performance bond against potential loss on an open futures contract and are not to be used to restrict market volume volatility or price.

Can you explain a little bit about how individual clearing houses and not the CFTC develop margin formulas or, more accurately, performance bond formulas?

Mr. LUKKEN. Well, they look historically at volatility in price changes in the markets. They want to make sure that every day the winners are able to be paid by the losers and that there is not a chance or a high degree of default of one of their customers. If there is a default, a lot of bad things happen. Potentially, if people walk away from trades, that could lead to a systemic event in the clearing system and it could ripple through our economy. So this is why margin is such an imperative and first point of protection for the CFTC and it is why we hold it sacred in protecting the clearing house.

The clearing house every day, using a computer program called SPAN, looks at volatility in the prices in the markets. They run the formulas to make sure that they are covering these 1-day price moves, and they do it with excess capacity in mind, knowing that it could go beyond a traditional 1-day move. And when we look at this, we see that they are covering about 99-point-something percent of the moves in a typical year. That is very good. They are doing exactly what they need to be doing to protect the clearing house.

Using it for other purposes, again, gets into dangerous territory. Hopefully, we would never use it when prices are low trying to bring up prices or prices are too high, to try to bring them down. I just think it is dangerous precedent to set when we have other, more specific tailored controls in place.

Senator CHAMBLISS. As Acting Chairman, you have done a great deal to ensure that we have more transparency in the futures market on energy, and I believe transparency is the key to gathering the necessary information we need to determine if speculators are playing a role in oil prices. Could you briefly describe the efforts that you have initiated?

Mr. LUKKEN. Well, certainly beginning with the exempt commercial markets, the so-called "Enron loophole," we wanted to make sure that those markets were giving us the proper data, the proper transparency. And this was a topic of conversation, obviously, in the Congress and something that was raised at the CFTC when I first took over. We held a hearing on that, reported to Congress the need to give us the information for these exempt commercial markets. Congress thankfully passed that as part of the farm bill. So that is bringing additional transparency to us.

On the foreign markets, we have turned to and worked with the FSA to get the proper data. We are now receiving virtually identical large trader reports from ICE Futures Europe on these trades so we can seamlessly put these into our systems. That is extremely helpful.

Swap dealers and the "swaps loophole," as it is called—that is what we are trying to get information on. We are going to try to find more information with swap dealers, with index traders to try to bring additional transparency and sunshine to what is going on. It is difficult. It is complex. But it is going to help us to make informed decisions at the agency.

Senator CHAMBLISS. Thank you, Mr. Chairman.

Senator DURBIN. Thank you very much.

We are going to use the so-called early bird rule, and on the Democratic side, I note the following Senators as they arrived: Senators Brown, Salazar, Murray, Dorgan, Klobuchar, and Lincoln. On the Republican side: Senators Roberts, Lugar, Crapo, and Thune. And I will now call on Senator Salazar.

Senator SALAZAR. Thank you very much, Chairman Durbin and Chairman Harkin and others, for holding this hearing.

I have a question relating to the so-called elimination of the funny money and margin requirements and the capital reserve requirements. I know for all of us, whenever we are back in our States, we get asked what can we do about the high cost of gas, with the high cost of food, and there is a lot of pain all across America. But it seems like many people are saying that it is speculation that is really driving a lot of these high costs, especially in the area of gas and diesel.

I have a letter from a person that I know well who runs one of the largest oil and gas exploration companies in Colorado, a person I have known for a long time. And he says to me, Dear Ken, I share your concerns that the prices of oil and natural gas, not to mention basic foodstuffs, are escalating too rapidly. I believe the strongest short-term influence on price is the world's extraordinary speculation in these commodities, fostered by light and overly generous regulation. And he goes on.

But the central question is why should the United States Congress not order the increase in commodity contract margins from 5 percent to perhaps 40 percent. So some of the recommendations that we have heard from many people are what we ought to be able to do is to get a handle on this speculation by increasing margin requirements and reserve requirements so that we do not have anyone walking up these large supplies of oil with very little money.

What is your response to that kind of reform, Mr. Lukken?

Mr. LUKKEN. Well, certainly we have taken steps to try to address the concerns about speculation starting with aggressive enforcement, but also beyond that trying to increase transparency, as I have laid out, to ensure that everybody sees what is going on in the markets. I think there is lots of fear that there are speculators not currently being made a part of our reporting mechanism. And so that is something we have to ensure that they are doing.

Senator SALAZAR. Let me be more specific. I know you are trying to increase transparency so the world knows what is going on, but should we as a Congress in our ability to pass legislation to enhance regulation through the CFTC require margin requirements and reserve requirements to try to take speculation out of the market? Is that a good idea? Is it a bad idea?

Mr. LUKKEN. Right. As I mentioned, using margin, I think is a very blunt tool and may potentially drive these markets overseas. Although we are very glad that NYMEX is the benchmark of crude oil contracts, I would hate if that shifted somewhere else around the world or if a lot of this trading went underground where we could not see it. So I think margin would be a very blunt instrument and could potentially move these businesses overseas.

Senator SALAZAR. How about capital reserve requirements?

Mr. LUKKEN. We typically follow the Basel rules on capital, and we are not a part of the Basel Committee—that is mainly run out of the Fed and through the bank regulators and the SEC. But it is certainly something that we try to consult with them on.

Senator SALAZAR. There is some notion also that there are good traders and there are bad traders out there, and that one of the things that we ought to do is to have a much more aggressive oversight of the traders that are participating in these markets. Would you as the Acting Chairman of the CFTC propose or think it is a good idea that we have registration and certification of traders in these markets?

Mr. LUKKEN. Well, we certainly get all the data from the traders. Typically, our registrants—we have to register pool operators. We have to register those who advise people about commodity investments. We have to register futures commission merchants, which is our equivalent of broker-dealers in the securities markets. So we have lots of registration. Not all traders are registered, but we certainly do get to see every trader position and we have strong enforcement efforts to go after those individuals, should they try to manipulate the markets.

Senator SALAZAR. But if you do not have the traders now registered, how do you know whether or not there is that kind of manipulation going on by those traders?

Mr. LUKKEN. Well, we see those traders' positions. They may not go through an official registration with the agency, but we see who they are, what they are doing, and if they are in any way manipulating the markets, we can take strong action against them.

Senator SALAZAR. The broader question here, in terms of—people are saying speculation accounts for 30–40 percent of the high price that we are seeing. Do you agree with that conclusion or not?

Mr. LUKKEN. Well, we try to look at this from the data that we have. We are trying to figure out—our chief economist has testified that we are trying to see if speculators are systematically driving the prices. We have not seen evidence from our data. It is difficult to prove a negative. And we certainly encourage those that are saying this, you know, where the prices should be and that speculators are doing this, to provide the data to us so that we can look at it and make an informed decision. But currently now, we have not found a smoking gun.

Nevertheless, we are not sitting. We are definitely taking constructive steps to make sure the markets are working correctly, that there is not excessive speculation driving the markets. And those are the steps I outlined today in my testimony.

Senator SALAZAR. Thank you, Mr. Chairman.

Senator DURBIN. Thank you very much, Senator Salazar.

Senator Roberts has deferred to Senator Lugar, whom I will now recognize.

Senator LUGAR. Well, thank you very much, Mr. Chairman.

I think that a constructive action that the Senate can take would be to confirm the three nominees for the CFTC Board. Here we are discussing today a monumental problem, and we are stressing the need for more budget, and I would agree with the chairman that is certainly imperative if they are to have staff and if they are to meet this objective. I would just say that the American people anticipate action on the part of us, in addition to the CFTC, and our part of it, it seems to me, ought to be to confirm three out of the five nominees so that in fact there is a structure to do the job.

Now, beyond that, I am just simply impressed by the fact that the speculation side, at least as I have read about it—and you would know more, Chairman Lukken—that is maybe 30 to 40 percent in the energy business, and that maybe true for corn likewise or for beans, which you have not got into today, but which is also a part of your purview.

A very large portion of that appears to be, if not the pension funds, some group of people who are supporting at least that idea that they are going to make money for people that they are trying to represent by going long on oil. They get into the market and they do not leave. So they are not coming and going, there is not an influence daily or monthly or what have you on the price.

I think Milton Friedman, in his thesis on speculation in 1953, said, in fact, if the speculators are right, if these are fairly bright people—and they try to be because their living depends upon it, as well as their clients'—then they smooth out the pricing situation. They create a situation in which the rest of the market is informed.

Now, in the current predicament with oil, OPEC to a large extent controls supply. Demand is only controlled ultimately by price. That is the hurt that we all feel. The fact is, as prices have risen, we rebel against that. We wish this was not the case. We have not taken steps as a Nation really to increase our supply of oil particularly, and yet at the same time, we are very unhappy the price is higher. But it does affect ultimately what occurs.

Now, Friedman also pointed out if the speculators as a group are absolutely stupid and dull, so then we have trouble—because at that point, they are going to lose money and there will be a crater of the markets. So there is always going to be an argument on the philosophy of speculation on the basis that the majority of people who are making these investments, passive as they may be, are probably right, that there is a shortage of whatever it is and therefore, they will make money over a long period of time, some of them, months and years.

Now, what I just simply wanted to use the rest of my time to say is I believe that the actions that you have taken are very positive actions. In fact, amazing that you have reached that agreement with ICE in Great Britain so rapidly. It must mean that a number of people in Great Britain and in world markets sense precisely what we are talking about today, and that is the imperative need for transparency in a worldwide sense, these screens that you describe that we can all look at. To the extent that you can get all the screens up with these so-called no action letters, more power to you because then it does make the information available. We may not like the information. We may wish the price was coming down on oil, not up, but at least we are informed and then can take actions as individual consumers, as a Government, or as people to mount this.

So I have no questions of you. I just am pleased to have these 5 minutes to comment because I believe the progress of the Commission, even with three of five unconfirmed, has been exemplary, and I hope that you will have more progress.

Thank you, Mr. Chairman.

Senator DURBIN. Thank you, Senator Lugar.

Senator Murray.

Senator MURRAY. Thank you very much, Mr. Chairman, both chairmen's ranking members. I really appreciate you having this hearing today. I think it is very timely and very important.

I was home this weekend. I went to the gas station on Sunday, and I paid $4.45 a gallon. So people who are paying $25 or $30 just a few years ago are paying $50 or $60. This has a huge impact on families' pocketbooks. It is affecting absolutely everyone from small businesses to our school districts, to our transit agencies, and obviously to families. Farmers in our State are really being hurt right now. Some of our State's farmers are saying they are spending up to $500 per day. That is about 60 percent up from last year on diesel costs alone. So we are just getting into the harvest season right now. These costs are going up on top of record fertilizer prices. I mean, this is really impacting everyone in our economy. The rising cost of food, health care—I mean, I do not have to say it. This is real and it is big.

So I wanted to ask you whether you think there are any short-term things we can do to reduce the speculative premium on fuel prices and bring some relief to these families.

Mr. LUKKEN. Well, certainly the steps that we tried to outline today about trying to ensure that there is equivalent position and accountability limits at all points of entry for the crude oil markets—we addressed the London exchanges to ensure that there are proper speculative and accountability limits there. That is useful.

The farm bill that was just implemented—we are also putting position and accountability limits and large trader reporting on those entities, those swap dealing markets that are electronically traded.

Senator MURRAY. Do you think we will see some relief in the short term from those steps?

Mr. LUKKEN. It is difficult to say. I am not sure short-term relief is going to be a result of some of these measures, but certainly we are going to get greater transparency in these markets so that we are assured that these markets are not being manipulated. I guess the concern is that these markets are acting irrationally, but I am not sure I can lay that at any one participant's doorstep. But certainly we need the proper controls in place for speculative behavior to ensure that they are not artificially driving the markets.

Senator MURRAY. Well, as you know, in my home State of Washington back in 2001, the west coast saw this western energy crisis, and for years the industry regulators and representatives testified before us time and time again that market forces were the source of skyrocketing electricity costs. It was not until we actually saw the tapes of those traders that we realized there were manipulative schemes going on at Enron. So you understand I come from my perspective a little bit skeptical of some of the people who are saying that this is different.

I think we do have a lot of important lessons that we did learn from that Enron scandal, the potential for moral hazard when industry is left unchecked. It reminded us of the importance of market transparency that you have talked about, strong Government oversight.

Now, I know the fundamentals of the oil prices are different and unique, but I am very concerned about the rhetoric that I am hearing that just dismisses the possibility that market manipulation is occurring.

Can you tell me is the CFTC able to rule out market manipulation as a factor affecting these skyrocketing fuel prices?

Mr. LUKKEN. Well, market manipulation is different, I think, than what we have been discussing, sort of this upward pressure that speculators may or may not be having on prices. Manipulation is an illegal act of somebody individually or cooperatively with others trying to game the system for a profit without risk. And so that is what we look for. In December, we announced we have a national crude oil investigation that is looking into storage practices, how these things are purchased in the cash markets, as well as the derivatives markets, pipelines, shipping, all these things that factor into the price of crude oil. We are moving forward with that investigation and hope to have results in the coming time period.

Senator MURRAY. When will we know what you have found?

Mr. LUKKEN. Well, these cases have to be developed, and these are complex legal cases. But hopefully, soon.

Senator MURRAY. Is there any question in your mind that we should be looking for or are you finding solid evidence that you think does not lead to market manipulation?

Mr. LUKKEN. We have seen cases in the past where people attempt to manipulate the markets by holding one leg of their position on the futures markets where they can benefit, but then doing something outside of our view. So these transparency measures we mentioned are helpful. We are able, under current law, to go after OTC positions when we see problematic trading on the futures markets, and we do that quite frequently.

Manipulation is typically a very short-term move of the market for profit. It should not be confused with sort of this upward pressure we are discussing.

Senator MURRAY. But right now we cannot rule it out.

Mr. LUKKEN. No. We always are looking for manipulation. In fact, we settled our record manipulation case last fall with BP for manipulating the propane markets. So it happens all the time, and we go after it aggressively.

Senator MURRAY. And your budget request gives you enough resources to be able to go after that.

Mr. LUKKEN. The request we made today for an extra $27 million certainly would give us the enforcement tools to go after this, yes.

Senator MURRAY. Because I do think we need to know the answers to those questions, Mr. Chairman. Thank you very much.

Senator DURBIN. Thanks, Senator Murray.

Senator Roberts.

Senator ROBERTS. Thank you, Mr. Chairman. And I want to associate myself with your remarks and that of my colleague from Kansas in regards to your very timely statement with our concern and our prayers for people who are suffering from the weather damage, floods. We just went through another round of tornadoes in Kansas. I do not know what we did to Mother Nature, but she sure is responding in a way that we do not like. And it was due to the tornadoes that we experienced—and Sam and I were out in Chapman that lost about 70 percent of the town and in Manhattan, home of the ever-optimistic and fighting Wild Cats of Kansas State, but the tornado did not do that much damage to the university but did to the community.

And then a little small town called Soldier. At the south edge of the town of Soldier, there is John Growell and Larry Holiday, two farm families, two cattle operations. And both couples were in the basement when the storm hit and then awoke to find no house, nothing, no operation. But both farms were swarming with people to help pick up and burn up and haul off the rubble. In a shorter time period than we think, I think both John and Larry will be back in business.

Now, I am standing there talking to a guy who has lost his home. I am standing there talking to a person where a tornado completely just wiped him out, he and his neighbor across the highway. Does he talk about the tornado? He just stands there and said, look at all the friends that I have got. But he said, Senator, what I really want to talk to you about are these high fuel prices. And that is amazing. I mean, that shows you the real concern on the part of people. Senator Murray was talking about the same thing.

Chairman Lukken, thank you for quickly responding to my questions from your nomination hearing nearly 2 weeks ago.

Let me say that basically I am just going to cut to the chase. Your challenge is that before you can implement all the changes that we gave you in the farm bill, many are calling for greater authorities. I do not know if we are pushing the rope or not. One suggestion is to increase the margin requirements. Senator Salazar talked about that. We are going to hear testimony on the second panel on both sides of this issue. Currently the exchanges, obviously, set their own margin rates to protect themselves and to cover their liabilities.

Based on comments and responses to the CFTC's agricultural market roundtable back in April, what effect would increased margin rates have on agricultural producers and, in particular, the grain elevators? They are going through a very tough time, as you know. There are people that say what is good for energy is good for agriculture. I am not sure that is the case. Now, you answered that in part with Senator Salazar, but tell me what the CFTC's agricultural market roundtable in April would say or did say about the increased margin rates on the producer, more especially the elevator.

Mr. LUKKEN. Well, margin rates, as you mentioned, have been going up. They are going up because of higher prices. And the clearing house is making sure that people are able to cover losses, potential losses, in case of default. This has had a tremendous impact on agricultural producers and merchandisers, especially we saw in the cotton markets where a couple-day price run-up caused cotton merchandisers having to go to their banks to find hundreds of millions of dollars of lines of credit at a time when credit was shrinking in the markets. This was a terrible situation. And so what we have tried to do in the futures markets is to work with the exchanges to develop good practices for setting margins, but we have also had to reach out to people outside of our normal responsibilities, which are the banks, the agricultural lending authorities that oversee a lot of these agricultural loans.

And so we had the Farm Credit Administration, we had the Kansas City Fed at our recent agricultural forum. We have been talking to the Chicago Fed, the Farm Credit Administration, and all these folks together to try to collectively think through these situations so that farmers can meet these margins, so that they are not exposed to risk when prices move. It has been difficult. I mean, corn, above $7. It is a difficult situation right now for all people in agriculture, and we are trying to facilitate a discussion with lenders on the margin issue.

Senator ROBERTS. Senator Chambliss informed me corn just went to $9. Oh, no. I am sorry. He says no, no, that is not the case. Well, he certainly got my attention at any rate.

Mr. LUKKEN. It got my attention too.

Senator ROBERTS. No. Let us not have any heart attacks.

I want thank you for your statement. I have a feeling here, Mr. Chairman, that everybody in America and their dog is aware of the fact that fuel prices have gone up dramatically. We talk about supply and demand. I do not think there is an instant answer here. And we talk about speculation, whether that is 20 to 30 percent.

But when I was talking to those two gentlemen who lost their houses and their operations in Kansas, I said, well, you know the CFTC is conducting an investigation on this. And they said, who? I said, the CFTC. I had to say the Commodity Futures Trading Commission. Here are two cattlemen that basically were somewhat aware of what you do but not really, and I think there are a lot of folks in agriculture and a lot of folks around the country that are just really not aware that you exist and that there are $5 trillion of notional transactions that now flow through the U.S. exchanges and the clearing houses daily.

I commend you. I am trying to find your statement here. Two weeks ago the Commission took the extraordinary step of disclosing that in December 2007, its Division of Enforcement launched a nationwide crude oil investigation into practices surrounding the purchase, transportation, storage, and trading of crude oil and related derivatives contracts. And you are going to make a report to us on September 15. I am not sure the American public knows that. I sure hope they know it now that you are doing your job and you are doing that.

And then you have this unique task force which includes staff representatives of CFTC, obviously, the Federal Reserve, the Department of the Treasury, the Securities and Exchange Commission, the Department of Energy, the Department of Agriculture, all examining investor practices, fundamental supply and demand factors and the role of speculators and index traders in the commodity markets. So I commend you for doing that. And I do not think a lot of people doing a lot of the finger pointing are really aware of that.

I think we should not tarry, as the chairman has said. We do not even have you out of the Agriculture Committee yet in terms of not being active, let alone on the floor. So I think you ought to be confirmed, along with the new commissioners.

And we need to see if this new authority works before we add more authority on, I would hope. Maybe there is something there with the new authority that we could add in.

And we need to get the funding, Mr. Chairman. I back you all the way on this funding. We ought to have the $157 million or billion or whatever it is. You can pick.

But at any rate, on the funding issue—I see I am over at least 2:25. That was the price of corn back in 19—whenever it was. So I better quit at that point.

But we need to quit tarrying on our part as well in regard to the funding issue and getting you confirmed and waiting on your report. And thank you for a very good statement.

Senator DURBIN. I have remaining on the list Senators Dorgan, Klobuchar, and Lincoln. Senator Dorgan.

Senator DORGAN. Mr. Chairman, thank you very much. Thank you for allowing me to sit in on this subcommittee. I serve, of course, on five other subcommittees.

Mr. Lukken, I was looking at the statements that you have made, and it seems to me you have already made a judgment about whether there is excess speculation or whether there is manipulation in the markets. I would say to my colleague from Kansas, I do not mind pointing fingers. If there is excess speculation that is driving up the cost of energy, I say let us point some fingers and find a way to get that excess speculation wrung out of the system.

But, Mr. Lukken, on May 7, you said, we can say with a high degree of confidence that people are not manipulating the energy markets. That was May 2008. And I believe you just told the chairman that you do not know what quantity of contracts you regulate or do not regulate. How can you, on May 7, say that you can say anything with a high degree of confidence?

Mr. LUKKEN. We talked about this a bit earlier, but manipulation is different than I think what people are concerned about—an asset bubble in commodities. Manipulation under our law is somebody intentionally individually or with a group of individuals trying to push up prices illegally. It can occur and we have not seen the entire marketplace collaborating together to manipulate.

But having said that, we are taking significant steps to ensure the latter, which is ensuring that there is not an artificial price due to these structural changes in the markets, which are index traders, swap dealers, we are trying to get more information about these new market participants, what they are bringing to the market, and how that is impacting prices. That is something we have announced today, that we are, by September 15, going to provide to Congress some recommendations on practices for those types of participants.

Senator DORGAN. So you're saying that what you said in May does not apply to the issue of speculation. It applies to manipulation, which you say is distinct from speculation.

But you have indicated in July last year, January this year, and February this year, that the markets are functioning well. The exchanges are functioning well. The underlying fundamentals of the markets have been reflecting price. That would suggest to me that you do not pay much attention to this issue or do not give much credence to the issue of whether there is excess speculation.

Again, I would ask the question, if, in response to Senator Durbin, you do not have the foggiest idea what percent of the contracts you are seeing or regulating, how would you have a conclusion about whether there is excess speculation in these markets?

Mr. LUKKEN. Well, we certainly see all the contracts that are discovering prices, and that is our main focus, those contracts that people are referencing every day. How do you know that the price of oil is $130-plus a day? Well, it is traded on the NYMEX, and that is the price discovery mechanism. We work very hard to protect that entity, and that is why we are going to ask for additional information from exempt commercial markets which also service price discovery, from the London markets that also service price discovery, and the NYMEX, the regulated markets. So that is where we focus our attention.

If we see problems in the over-the-counter markets, we have the authority to reach out and get that information on a need to know basis, and that has been very helpful.

Senator DORGAN. But, Mr. Lukken, you do not have a classification of what is speculative. My understanding is you are classifying as commercial accounts that which could be pure speculation. I guess I am trying to understand where your mind is on this. There are a lot of folks who have said—and I think with some credibility—that there is a substantial amount of speculation in these markets, excess speculation. This is not new. We have seen speculation in markets before. We understand the result of it. We understand the consequences of it, and it is what requires regulators to be aggressive and active in trying to deal with it.

Now, let me go to these no action letters. The staff of the foreign board of trade no action letters—did they contemplate that exchanges that may be owned in part or in whole by American interests would escape the CFTC regulation on U.S. exchanges even when they trade on U.S. exchanges?

Mr. LUKKEN. This was the International Petroleum Exchange, a British exchange started in the 1980s. It was, as you mentioned, bought by ICE here in the United States, but it has been regulated by the Financial Services Authority for 20-plus years. Its compliance department is there. Its board is there. And up until 2006, they did not list any contracts dealing with the United States. When they did, we held a hearing. We did a rulemaking, and we changed our policy to get additional information from these markets. And that has provided a great transparency to the markets.

We recently announced that we are getting additional information that is comparable to our regulated marketplace, and today we announced we are getting position and accountability limits for those markets. So we have taken constructive steps to ensure that these markets are properly——

Senator DORGAN. I see what you are announcing in the last few weeks when there is a great deal of pressure, but I must say that you approved a foreign entity, partially owned or substantially owned by U.S. interests, to put computer terminals in a U.S. city and trade in a circumstance that should have represented in my judgment regulated trading here in this country.

I am out of time, so let me ask this question. Do you think, based on what you know now, that what has happened to the price oil and therefore gasoline in the last 15–17 months is simply the fundamentals? Because you have said that several times. As you know, 4 of the last 5 months, we have seen increased crude oil supplies in this country. In 4 of the last 5 months, demand is going down. If supply was going up, demand is going down, and price is going up like a Roman candle, and you are sitting there saying, it is just the fundamentals, do you still think that it is the fundamentals and there is no significant speculation problem here?

Mr. LUKKEN. Well, obviously, there are powerful fundamentals in play in these markets. The Dollar, when we look at it, could potentially have as much as a 25 percent impact on commodity prices.

But regardless of that, our job is to ensure excessive speculation is not artificially driving prices, and that is what we have done with our constructive steps over the last 9 months. Again, we are full-time regulators even beyond the initiatives we have announced today, the farm bill legislation that we are implementing, the reports that we are going to provide to Congress. So it is a strain on an agency that is low on staff.

Senator DORGAN. I just observe that your constructive steps over the last 9 months are at odds with your statements in recent months. I mean, you have already made the statement that this is just the fundamentals at work, which is a way of saying you all that are finger pointing on excess speculation——

Mr. LUKKEN. I would look at the actions that the CFTC has taken over the last year, and I think it is pretty powerful.

Senator DORGAN. Well, I am just looking at what you have said and what you have told the American people and what you have told the Congress. I believe it is at odds with aggressive action to try to respond to this. It seems to me you have already made a decision about your position on this issue.

Senator DURBIN. Thank you, Senator Dorgan.

Senator Harkin had to leave but wanted me to add for the record, because this has been raised by a couple Senators, on the nominations to the Commodity Futures Trading Commission, that the Agriculture Committee received answers to written questions from the nominees on Friday, June 13, and that he will be moving on this information very soon.

We have Senator Thune.

Senator THUNE. Thank you, Mr. Chairman.

Mr. Lukken, what percentage of—maybe this question has been asked. If it has, then I apologize. But what percentage of long energy contracts are held by noncommercial investors would you say?

Mr. LUKKEN. By noncommercials? I am not sure I have those—I think it is near 30 percent. I have my staff here, but I think it is around——

Senator THUNE. Do you have any idea how that percentage has changed over the past 10 years?

Mr. LUKKEN. I think it has been roughly the same percentage-wise, maybe slightly increased.

Senator THUNE. Has that had any impact on market price? Has the amount of those who are taking those types of positions—if that has, in fact, impacted price?

Mr. LUKKEN. I think that is something we are studying. We have not seen direct evidence of that, but we are taking steps to try to ensure that it is not.

Senator THUNE. And the CFTC does have the authority and/or the resources to track that sort of information.

Mr. LUKKEN. Well, we are asking for additional transparency into certain activities, such as swap dealers and index trading, and we are also asking for more funding for technology and other resources and people in order to go after this type of activity.

Senator THUNE. You said in your testimony the backbone of the CFTC's market surveillance program is the large trader reporting system. All large traders must file daily with the CFTC their futures and options positions in the market. This information enables CFTC's surveillance economists to oversee all traders of size to ensure that no one is attempting to manipulate the futures markets. That is your quote.

Just how well is that large trader reporting system working today in your estimation?

Mr. LUKKEN. Well, as far as the technology, that is something we definitely need to modernize. We are taking steps to do that over time. I think it has worked as a control on the market very well. I mean, our concern typically in the futures markets is as these prices expire, that somebody—similar to the Hunt silver crisis in the 1980s—could hold a large futures position, at the same time holding the underlying cash market, owning silver, for example. That causes manipulation. That causes severe distortions in the prices. We have controls in place to ensure that no one is holding a large enough of a futures position to try to distort the markets. And we can ask for information and jawbone them and ask them for economic justification, and ultimately ask them to get out of their positions. So this has worked very well over the years to try to prevent this.

But even if manipulation occurs, we have aggressively gone after manipulation over the last—especially since the California energy crisis, assessing nearly $500 million worth of penalties against these people trying to manipulate the markets.

Senator THUNE. Basically you have alluded to in your statement today the manpower and resource constraints that the commission is dealing with. Can you assure the committee today that no one is attempting to manipulate either the energy or any other commodity futures markets?

Mr. LUKKEN. No, I cannot. But we are looking for it and we are policing it aggressively if we find it. Policemen cannot always prevent crime, but crime happens and you go after it as aggressively as you can. And it is the same for the markets. You cannot stop all bad actors. We have systems in place to try to stop it, if we can, and if we cannot, we go after it on the enforcement side.

Senator THUNE. Do you believe then that there are problems due to lack of transparency? It has been, again, also mentioned earlier today with energy commodities with U.S. delivery points that are traded on exempt commercial markets, foreign boards of trade, such as the ICE.

Mr. LUKKEN. Well, certainly transparency is helpful for regulators, and that is what we have tried to improve on over the 2 years that this contract has been listed. We immediately started getting information from that contract in 2006. A month ago, we reached an agreement with FSA to get almost exactly the same information that we are getting from NYMEX now that can be seamlessly put into our systems. That is helpful.

Today we announced additional controls on those markets. So I think we feel very comfortable that we are seeing these markets and trying to ensure that manipulation is not happening on those markets as well.

Senator THUNE. Specifically, what issues do you think are created by a lack of transparency in these markets? If you do not have that kind of information.

Mr. LUKKEN. Well, seeing more of these transactions ensures that we can prevent manipulation when it occurs. It also allows us to understand sort of the intent behind some of these traders. Right now, we are asking for additional information for swap dealers and index traders. There is a lack of clarity in our data about how much is coming into our markets. We are going to start receiving that soon and hopefully can make informed decisions about that information in a report to Congress.

Senator THUNE. I would encourage you in all these steps that you are taking that I think are great. We look forward to the September 15 deadline. There is a widely held view, I think as you know, across this country that this is contributing to these volatile swings, and the more information, the better. Transparency in a lot of ways has got to be a part of the solution.

And if there are tools that you lack today or things that you need legislative authority or direction to accomplish, we would certainly appreciate and welcome those suggestions because we want—at least I do—to see the steps that we take actually correct the problems that exist out there, not create additional problems. So it is going to be very important that as you pursue some of these initiatives that you have undertaken, that you share your findings with us. There is a clear mood out there, I think, in the public that something needs to be done. Thank you.

Thanks, Mr. Chairman.

Senator DURBIN. Thank you, Senator Thune.

Senator Klobuchar.

Senator KLOBUCHAR. Thank you, Mr. Chairman. Thanks for holding this hearing.

Mr. Chairman, I was listening to the other Senators thinking what I saw at home, people waiting in line at a Costco station, going around the block in their minivans because they are just trying to save a few bucks. Or people I talked to in rural Minnesota can only afford to fill up one-half their tank, just because they do not have the pocket change to fill it.

And I was listening to what you were saying to Senator Thune about the criminal analogy. I am a former prosecutor. That was my old job, and we would always say you can have all the laws you want on the books, but you need people to enforce them.

And you should know I was just out with 50 Minnesota high school students who remembered my old job. As I walked into the hearing, they said, Amy, is that a murder prosecution going on in there? And you should be happy to know I said, no, that it was not.

But I wanted to ask you about this. We always say follow the money, and you find the bad guys. But you need the tools to do that.

And we had an interesting Commerce hearing maybe you heard about a few weeks ago with Senators Dorgan and Cantwell and others. And one of the witnesses talked about how the rule used to be before this Enron loophole got in the middle of the night in the year 2000, I think, that the burden shifted with that loophole and that still really has not been fixed. The burden, which we always cared about as prosecutors, used to be on the traders to show that something should not be regulated, and now it has shifted to you, to the CFTC, to say that something should be regulated.

Would you like that burden to be shifted back? Because, as far as I understand, the Enron loophole closure that we did in the farm bill did not fix that.

Mr. LUKKEN. Well, I think what we fixed in the farm bill was the most important aspect, which is the price discovery mechanism that has occurred in over-the-counter markets for electronic exchanges. And so that was something that we were able to get additional information, put position limits and accountability on those types of transactions. That has been truly helpful.

I think what has been referred to—I am not sure if Mr. Greenberger's testimony——

Senator KLOBUCHAR. I think that was him, yes.

Mr. LUKKEN. Yes, in regard to 2(g), another exclusion for swaps in our act.

And the main concern is that we do not have manipulation authority as a result of this. Our enforcement staff has been going after people manipulating these markets for many years since then, since 2000. We have never lost on this issue that we do not have manipulation authority.

Senator KLOBUCHAR. So you do not care about having—for us, as prosecutors, it was a big deal who had the burden.

Mr. LUKKEN. Again, we have not lost a case on this matter. So it has not affected us.

But the more important thing is what we did in the farm bill, which is ensuring that as these price discovery markets develop, that we have the proper information and proper controls in place.

Senator KLOBUCHAR. Exactly, and that was helpful, but from what I have heard, in addition to this burden issue, there is also the issue of foreign exchanges. I know you have gotten ICE to make some agreements and that you are going to get more data, but you can have all the information you want, and if you do not have the authority to prosecute, the authority to regulate, we are not going to get the results.

And you know, the oil companies testified before Congress saying that oil should be trading at $55 a barrel instead of where it is. And Senator Dorgan was asking about the fundamentals of the market. It seems that something is going on here.

And to me, the more enforcement actions that you do, whether it means more cops on the beat through more funding or more tools in your hands, that you would want to set those examples. And what I just find frustrating is that—I understand you are taking some measures here, but I would think you would want an even stronger law. And what I am asking you is what other things can we do to strengthen your hand.

Mr. LUKKEN. Okay, thank you.

Senator KLOBUCHAR. No. I am asking you right now.

Mr. LUKKEN. Well, certainly funding is something we cannot do on our own and something that we have talked about in my testimony. But we are taking the initiatives to try to get better information and after we look at the swap dealers and the index traders and the amount of monies and whether controls are necessary, if there are legislative fixes coming from that, we will certainly make sure that Congress knows about it.

Senator KLOBUCHAR. But even when you have reached this agreement and ICE is going to give you more data and do some things differently, does that really give you the authority to go after some of these foreign exchanges? I guess we will be hearing that from the next panel.

Mr. LUKKEN. Well, we certainly have the ability to go after U.S. participants that are trying to game London versus the United States. We can sue them under our manipulation authority.

The no action letter is the biggest tool we have against these exchanges. We can just pull it if they are not enforcing their laws or not enforcing limits, they are not overseeing the markets as we think they should. So that is a very powerful tool as well.

Senator KLOBUCHAR. Okay, but what is the difference between how you can regulate one of our exchanges versus what you can do with ICE? I mean, there still must be differences between your powers.

Mr. LUKKEN. Well, certainly there are differences, but we also have to recognize that we are in a global economy.

Senator KLOBUCHAR. But what are the differences? Just so I can tell those people in line at Costco. It is not going to make them feel good to say the Dubai exchange is regulating them.

Mr. LUKKEN. As far as the oversight of the markets, they are almost the same. We have self-policing authorities both on regulated exchanges, compliance departments, to make sure that people are not manipulating the markets. The London exchange requires the same. They require their exchanges to police these markets effectively.

What we have added on top of everything else—the 6,000-page rule book that FSA has for their registrants—is information that we need to surveil the markets, which is getting this 25 percent of the market share that they hold. We are going to get all those traders, and not just U.S. participants, but foreign participants we would not normally see. We are getting additional insights into these markets that we would not have but for this recognition——

Senator KLOBUCHAR. And I understand that. I have run out of time here.

You do not want a burden shift. Is this correct? You do not want to get back what you had before 2000?

Mr. LUKKEN. I am not sure of the burden shift, the legal argument. I have to admit I have not——

Senator KLOBUCHAR. Well, maybe we could write it down and then you guys can write back to us.

Mr. LUKKEN. Okay. We can try to answer your——

Senator KLOBUCHAR. Okay, thank you.

Senator DURBIN. Thank you, Senator Klobuchar.

We have one more panel, and I know Senator Lincoln and Senator Nelson have waited patiently. We have been told that one of the panelists has to leave by 1 o'clock, so we are going to ask people to stick as close as they can to the 5-minute rule. Senator Lincoln. No pressure.

Senator LINCOLN. Thanks. Well, it has all been said, but not everybody has said it. Is that how it goes?

A special thanks to the chairman and the ranking from both the committees for having the hearing today.

You know, I think we have all come to the conclusion that high energy and commodity prices have a tremendous impact on our constituents, and I think we have all shared stories. I visited with a director of a senior feeding program in my home State where not only were the high prices becoming a problem for food, but the fuel prices were phenomenal, to the extent that they were freezing meals instead of delivering them every day and delivering meals five and six at a time. And I asked her what impact that had made, and she said, well, one of our longstanding constituents passed away because nobody came to see him over 6 days because he had 6 days of meals' worth in his freezer. It has a real impact on the working people across this country.

I think at least most of us realize that there are multiple issues driving higher commodities and energy prices, whether it is the weak dollar, strong demand from emerging world economies, geopolitical tensions in some of these oil-producing regions, weather-related supply shortfalls. We have had wheat crops under water. We know our neighbors to the north in Iowa and Indiana with flood waters, increased production of ethanol. All of these things have a direct impact.

I think we all remain unclear about what the size of the impact that this huge influx of investment in commodities futures markets, particularly from institutional investors, is having. And so we are looking to you to be helpful to us in terms of what percentage of this is a part of this problem that we are seeing. We know there are long-term solutions to oil prices in terms of renewable fuels, but what is our best avenue to make an immediate and greater impact on the real lives of people that we represent in our States?

A couple of the questions that I had and a lot of people have already asked—but I think it was Senator Brownback that asked you about the swaps basically. I guess you were listing some of the firms that deal in swaps, Goldman and J.P. Morgan, and others. What percentage of those firms' dealings do you think are in swaps and in that tool?

Mr. LUKKEN. I think a large portion of their book is swap transactions. Again, they internally net out the risk before they come to the futures markets, but those pressures—it would be helpful to understand what is underlying those futures markets positions, and that is what we are attempting to find out. As I mentioned before, it is very complex to unwind the book of a multibillion-dollar firm, but it is something we are attempting to do over the next few weeks and hopefully report back to Congress some more transparency in this area.

Senator LINCOLN. But I think your average person would probably think that it is a small percentage of what they do, and yet, I do not think it is from what I am seeing and hearing. It is going to be a large percentage of what these financial houses are involved with.

Mr. LUKKEN. And interestingly enough on crude oil, I looked at the most recent stats for swap dealers. Their positions are roughly as much long as they are short. So they are only about a few hundred thousand contracts long, which may sound like a lot, but they are almost flat in their book, meaning that they are offering risk management products not only to people who are looking for the prices to increase, but also people who are trying to hedge transactions, commercial businesses on the short side that are looking for risk management products. So this is helpful. Swap dealers do provide a service of allowing people to manage risk in the markets, and that is helpful. And that is something we want to preserve.

Senator LINCOLN. Very real people like pensions and other groups too, which is a large portion of their operations as well. So I think that is important.

The last thing I just wanted to—I want to make sure I am clear. We keep questioning you about the OTC, the over the counter. You cannot do anything about that until it has happened. Right?

Mr. LUKKEN. Well, if we see an ongoing manipulation in the futures markets, we can reach into the OTC markets to see what their positions are and hopefully try to prevent things from happening. But typically we——

Senator LINCOLN. But that is not something you do on a regular basis. There is nothing that triggers you to do that.

Mr. LUKKEN. And the difficulty of the OTC markets is that they are not standardized, transparent. A lot of these are very individualized, negotiated transactions. It would be difficult. And the enormity of the task of getting all this information in, making some sense of it, what might be influencing prices, what is not—it would be very difficult, very expensive for the agency to do. What we do is try to concentrate on the price discovery markets to ensure that they are not being manipulated or artificially driven with the ability to reach into the OTC markets on a need-to-know basis.

Senator LINCOLN. Just one quick thing. As you are undertaking this transparency initiative regarding the swaps, do you anticipate any policy changes in the information that you are gathering?

Mr. LUKKEN. I do not want to prejudge the issue, but certainly we are open to looking at all options.

Senator LINCOLN. Great.

Thank you, Mr. Chairman.

Senator DURBIN. Thank you, Senator Lincoln.

Senator Nelson.

Senator NELSON. Thank you, Mr. Chairman.

When did you first become aware that there was at least a perceived problem in excessive speculation, at least that some people believed that there was excessive speculation? When did you first become aware of that concern?

Mr. LUKKEN. Well, certainly during the price run-up, people started to talk about this, and we wanted to make sure that our controls in place were proper. So certainly over the period of time that people have been concerned, over the last 6 to 9 months.

Senator NELSON. At what point in the run-up? Where was the flash point from your standpoint? Obviously, from the standpoint of others, it was probably sooner than it was for you, but where did you first decide there could be a problem here?

Mr. LUKKEN. No. We certainly started taking steps in regards to some of these actions as much as 1 year ago.

Senator NELSON. $50, $60? What I am trying to get to is what number or numbers caused you more concern than not?

Mr. LUKKEN. I am not sure I can put a certain number on it, but we have been working actively over the last——

Senator NELSON. 6 months?

Mr. LUKKEN [continuing]. 9 to 12 months on all these initiatives.

Senator NELSON. Well, but then why are we waiting until September to have a report back? You know, the sense of urgency on the street seems to be different than the sense of urgency in the bureaucracy. And we have to match that sense of urgency. It does not seem to be matched, as far as I am concerned, if we are waiting until September.

And then in terms of the tools, you do have certain tools. Have you chosen to exercise some of those tools to dip into the market to spot check, to audit to find out what is going on?

Mr. LUKKEN. Well, that is what we are doing now with the swap markets. We are reaching into those markets in an unprecedented way. We have never reached beyond the futures markets to see what an underlying customer's book might be.

Senator NELSON. Well, why did we not do that back 9, 10 months ago when you began to see things moving faster than they had moved previously? I think you would agree that the run-up was unprecedented in terms of the size and perhaps even in terms of the timing. Is that accurate?

Mr. LUKKEN. Well, we are certainly, given our resources and staffing levels, doing as much as we can as fast as we can, probably beyond capacity right now. So we are doing it as quickly as we can.

Senator NELSON. We have had emergency legislation. If that were the case, then why were we not made aware to be able to move more quickly on appropriations instead of in this process right now?

You know, I do not recall any other potential legislation outside of the farm bill. Is there other potential legislation that was offered or suggested by your agency to us?

Mr. LUKKEN. Beyond the farm bill? No. We have tried to provide technical assistance to the Agriculture Committee on different proposals that they had.

Senator NELSON. But any other suggestions as to what we might have done in that bill or in other legislation to help deal with this issue?

Mr. LUKKEN. Well, certainly if we feel that we need more legislative authority coming out of this request for information from swap dealers and index traders, we will ask for it.

Senator NELSON. Okay.

Well, you know, we talk about silver and what happens and why we try to protect those markets in terms of outside acquisition, such as the Chrysler Building. Silver is optional. The Chrysler Building, sort of optional. But commodities, in terms of food and fuel, are not optional items.

Can you tell us? Is the next target going to be a commodity market for healthcare costs? That certainly would have a great deal of impact on people if somebody, aside from insurance, but in the market start protecting. Is that happening today? Do you know, is somebody trying to do that?

Mr. LUKKEN. I am not aware of anything——

Senator NELSON. If they were, would you be interested in it and concerned about, and would you think that you had the adequate tools to deal with something like that today?

Mr. LUKKEN. If there was a contract listed for healthcare issues?

Senator NELSON. Forward contracts of not insurance policies but for forward contracts of healthcare providers, not the insurers.

Mr. LUKKEN. It was a futures contract, it would certainly be under our jurisdiction.

Senator NELSON. Well, I know it would, but would that be different than worrying about silver?

Mr. LUKKEN. Absolutely not. We treat every commodity the same.

Senator NELSON. Maybe that is part of the problem. Maybe that is part of the problem. We do not recognize, we do not define the differences between silver/healthcare, silver/fuel, silver/food. It seems to me that there is a need to prioritize, and if your agency cannot prioritize, if you do not have the authority to do it, maybe that is something that we ought to establish so that we get beyond what Will Rogers was reportedly to have said about commodities.

Somebody buying something that they do not expect to get from somebody who does not have it.

And if you cannot see that there is a tie between speculation today, between those who are buying the forward contracts for their own future needs and those who are putting them in hedge funds or putting them in pension plans, and it is all treated the same, we are not going to get out of this mess no matter what you report to us on September 15.

Thank you, Mr. Chairman.

Senator DURBIN. Thank you, Senator Nelson.

Chairman Lukken, thank you for your testimony today.

I ask the second panel to take the chairs at the table here and apologize that this has gone on a little longer than expected, but it is because of the intense interest. Fifteen Senators came to this room today. That is a pretty substantial turnout in the United States Senate, and I think it is an indication of how important this issue is. I thank Senator Harkin for this joint hearing. I thank all my colleagues who have been part of this.

Again, Chairman Lukken, thank you for coming. I appreciate that very much. And all the commissioners. If you would like to stay, you are welcome to do so.

So on the second panel, Mark Cooper is here, Director of Research, Consumer Federation of America; Terrence Duffy, Executive Chairman of the CME Group from Chicago; Jim May, President and Chief Executive Officer of the Air Transport Association; Dr. James Newsome, CEO and President of the New York Mercantile Exchange; and Charles Vice, President and Chief Operating Officer of the Intercontinental Exchange.

Your statements will be made part of the record. Again, I apologize that the hearing has gone on a little longer than we expected, but it is a good thing. It is an indication of the level of interest. So if you would give us your best executive summary for the record, we may have time to ask a few questions here, though we are a little bit pressed.

Mr. Cooper, would you like to start?

STATEMENT OF DR. MARK COOPER, DIRECTOR OF RESEARCH, CONSUMER FEDERATION OF AMERICA

Dr. COOPER. Thank you, Mr. Chairman, members of the committee.

The story has been told many times, but the lessons have still not been learned. The lack of effective prudential regulation of financial and commodity markets leads to excessive speculation that disrupts the economy and costs consumers hundreds of billions of dollars.

Two years ago, the Senate Permanent Subcommittee on Investigations estimated the speculative premium on oil at $20 to $30 a barrel when the price was $77. Today the premium is over $40 a barrel, $1 a gallon.

Oil executives have testified in Congress that it costs $50 to find and deliver a barrel of oil to a refinery. OPEC says it is defending $80 a barrel, but the speculators have driven the price to over $130 a barrel and the declining dollar does not account for more than one-quarter of that.

Over the past 2 years, the speculative premium has cost the typical American household $1,500, if we include natural gas, and the economy over $500 billion. $500 billion down the drain 3 years after granting the exemption, and the CFTC discovers it does not have enough information, that the foreign boards of trade do not set adequate position limits and accountability limits, that there might be a problem with OTC and swap trades. Frankly, they have waited far too long.

In March 2006, I wrote a report for four Midwest attorneys general that concluded that something was wrong in the natural gas market. We came to Washington and we shared it with the CFTC, and they assured us that they had their finger on the pulse of that market. You may recall that March 2006 was the month when Amaranth was running its corner and the CFTC did not have a clue.

You are perfectly right to be skeptical about the program and assurances that have been offered to you today. The 2 years' worth of assurances since we and the permanent subcommittee first sounded the alarm were full of hot air. The CFTC now admits that they really did not know.

Congress must enact broad reforms that close the loopholes, remove the discretion that was given to the CFTC, and compel it to do its job. No more discretion for administrators to decide that this foreign board of trade can go under these terms. This is your job to protect the American public.

There are five areas in which we believe action is necessary.

One, we have to chase the bad guys out. All traders must register and be certified. All trading must be reported across all transactions.

Two, eliminate the funny money. Reserve margin requirements must be increased and capital reserve requirements must be increased as well. It is too easy to leverage in this market and trade on thin air by asset-light corporations like Enron who do not have the backing to withstand serious problems.

Three, reduce the ability to push up prices. Lower position limits and tie position limits and margin requirements to the needs of physical traders. That is who this market is supposed to serve, not speculators and investors. We must ban conflicts of interest so that people who issue loud reports and then profit from them have to stop. That is what got us into trouble with the tech bubble.

Four, restore the proper function of commodity markets and their regulators. Close all the loopholes. Enforce meaningful speculation limits. Do honest analysis by classifying traders correctly. The numbers we have seen here and heard about here today about who the speculators are include big banks as commercials. They do not belong there. Make sure you find out who they are counting when they tell you that the positions have not changed. And remember, a few hundred thousand contracts is actually a huge quantity of oil, equal to 1 month's supply that that handful of companies is holding. So understand how big they are and what they can do.

Finally, we must redirect investment to productive long-term uses. It is too easy. We reward too much flipping stuff in our economy. We need a short-term capital gains tax. We used to have one. And that will restore the balance between long-term investments and short-term investments. We should move the pension funds out of this. We should move the institutional index funds out of it.

Now, the speculators will say this will squeeze liquidity out of the market, but in fact, these markets suffer from excess liquidity. And the malfunctioning markets and abusive practices that afflict commodity trading today were illegal and largely unheard of just a decade ago. The unregulated markets and exotic financial instruments that were allowed by the irrational exuberance for deregulation in the Commodity Futures Modernization Act over the past decade have done vastly more harm than good. We were better off without them.

If the Congress restores order, I guarantee you the foreign boards of trade will, in fact, comply. They need to trade in legal American documents, and the individual traders, frankly, will comply too. They do not want to have to go to places like Bangladesh and Zimbabwe which do not have extradition treaties, and they certainly do not want to live in Leavenworth if they do not obey the law.

Be firm. Re-establish order. We can regulate American commodities and America markets. Thank you.

Senator DURBIN. Thank you, Mr. Cooper.

[The statement follows:]

PREPARED STATEMENT OF DR. MARK COOPER

Mr. Chairman and Members of the Committee, My name is Dr. Mark Cooper. I am Director of Research at the Consumer Federation of America. I greatly appreciate the opportunity to testify today on the immense burden that the speculative bubble in commodities is placing on American households.

The story has been told many times, but the lessons have still not been learned. The lack of effective prudential regulation of financial and commodity markets leads to excessive speculation, bubbles and bursts that disrupt the economy and cost consumers hundreds of billions of dollars.

Congressional studies, like that prepared by the Senate Permanent Subcommittee on Investigations, Committee on Homeland Security and Governmental Affairs [1] and industry analyses [2] have become convinced that speculation is contributing to skyrocketing energy prices—by adding as much as $40 per barrel or more. Natural gas prices have been afflicted by a speculative premium of a similar order of magnitude.[3] Since the Senate Permanent Subcommittee on Investigations first flagged this problem 2 years ago, the speculative bubble in the energy complex has cost the economy more than $500 billion—i.e. half a trillion dollars. Expenditures for household energy have more than doubled in the past 6 years and speculation has played a significant part in that run up.[4] In the past 2 years, the speculative bubble has cost consumers over $1,500. Speculation in food commodities is adding billions to the burden.

While this speculative bubble imposes this cost on consumers and the Nation, the Commodity Futures Trading Commission (CFTC) did nothing to slow the speculative rampage. On the contrary, it insisted that the markets were functioning properly, that the problem was entirely caused by fundamentals, and that excessive

[1] Senate Permanent Subcommittee on Investigations, Committee on Homeland Security, *The Role of Market Speculation in Rising Oil and Gas Prices: A Need to Put the Cop Back on the Beat* (June 27, 2006).

[2] Akira Yanagisawa, *Decomposition Analysis of the Soaring Crude Oil Prices: Analyzing the Effects of Fundamentals and Premium* (Institute of Energy Economics, March 2008; Robert J. Shapiro and Nam D. Pham, *An Analysis of Spot and Futures Prices for Natural Gas: The Roles of Economic Fundamental, Market*.

[3] Mark Cooper, *The Role of Supply, Demand and Financial Commodity Markets in the Natural Gas Price Spiral, A report Prepared for the Midwest Attorney General Natural Gas Working Group (Illinois, Iowa, Missouri, and Wisconsin* (March, 2006) *Structure, Speculation and Manipulation (August, 2006)*.

[4] Statement of Dr. Mark Cooper, "Consumer Effects of Retail Gas Prices," Judiciary Committee Antitrust Task Force, United States House of Representative, May 7, 2008.

speculation was not a problem. It went so far as to distort its own data to hide the problem, while it continued to irresponsibly deregulate trading.

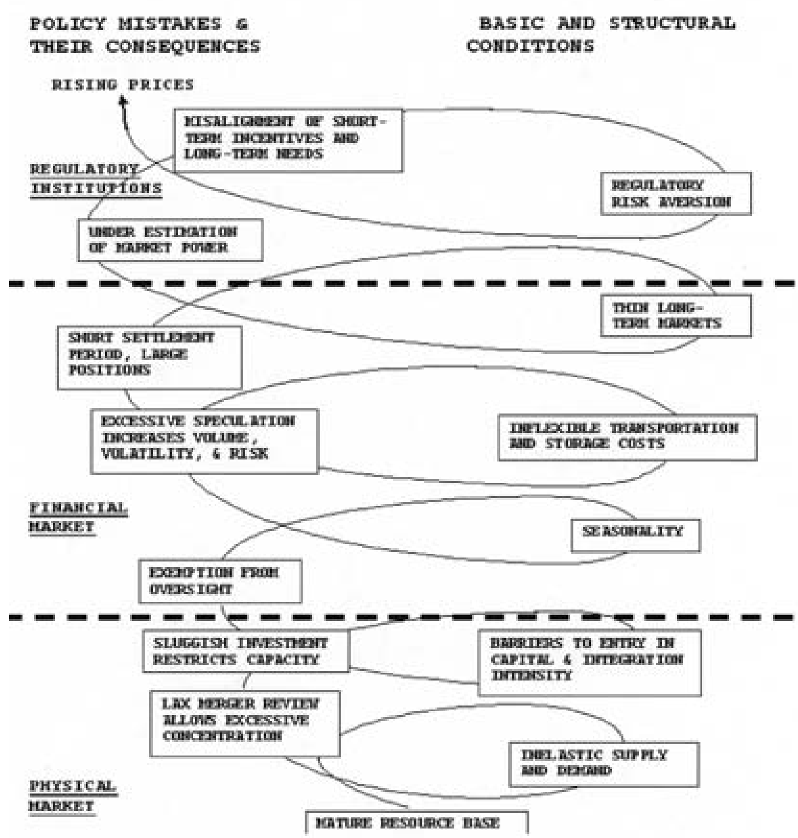
While market fundamentals have pushed prices up, the evidence is now overwhelming that speculation has made matters much worse. In an analysis of natural gas markets I prepared for four Midwest attorneys general a few months before the Permanent Subcommittee on Investigations issued its first report on speculation, I showed that there is a powerful interaction between physical market problems and financial market problems that creates a vicious, anti-consumer price spiral (see Exhibit 1). There is not doubt that speculation has been a major contributor to recent price increases and consumers are now paying a huge speculative premium.

IRRESPONSIBLE DEREGULATION IS THE PRIMARY CAUSE OF THE SPECULATIVE BUBBLE

The speculators will say we cannot live without these trading practices, but the malfunctioning markets and abusive practices that afflict commodity trading today were illegal and largely unheard of just a decade ago. The unregulated markets and exotic financial instruments that were allowed by irrational exuberance for deregulation over the past decade have done vastly more harm than good. We were better off without them.

EXHIBIT 1:

PHYSICAL, FINANCIAL AND REGULATORY FACTORS IN THE ENERGY PRICE SPIRAL



Source: Mark Cooper, "The Failure of Federal Authorities to Protect AmericanEnergy Consumers from Market Power and Other Abusive Practices," *Loyola Consumer Law Review*, 19:4 (2007), p. 318.

If the Congress subjects these markets and practices to effective regulatory oversight, it will restore commodity markets to their proper and useful function in society. More importantly, subjecting these markets to sound prudential regulation is the only way to bring down gasoline and food prices in the short term because it will burst the speculative bubble that has taken hold of commodity trading.

Speculative bubbles have diverse origins and are difficult to analyze and predict, but there is widespread agreement that the underlying cause of the bubble in recent years is a massive influx of money into the commodity markets. "Disappointing" returns on stocks and other investments are frequently cited as a reason that the money has rushed into commodities, but there is also no doubt that lax oversight and easy terms have made these markets magnets for money.

The Commodity Futures Modernization Act of 2000 (CFMA), which was slipped into an omnibus bill with no hearings or debate at the eleventh hour of a lame duck session of Congress, created what is known as the "Enron loophole," allowing a huge trade in energy commodities and other financial instruments, that is beyond regulatory oversight. The CFTC has added insult to injury by issuing "no action letters" allowing contracts designated in U.S. commodities to be traded without exercising oversight over those contracts. It has allowed foreign exchanges to trade in U.S. commodities on U.S. soil, subject to foreign, not U.S. regulatory review.

Where commodities are traded on exchanges that are subject to U.S. regulatory authority, the rules are far too lax. Traders in stocks are required to meet margin requirements of 50 percent. Traders who buy an energy commodity on an exchange only have to meet a margin requirement of 5–7 percent. This low margin requirement allows people to leverage their assets multiply their trading volume. Capital reserves for traders are far too low—creating "asset-lite" companies (like Enron) who do not have adequate equity to ensure soundness. Simply put, low margin and reserve requirements artificially inflate the amount of trading that takes place. The exchanges also set limits on positions that are far too high, allowing single entities to control large quantities of supply, and, in the case of natural gas, have a very short settlement window, which means a small number of trades set the closing price.

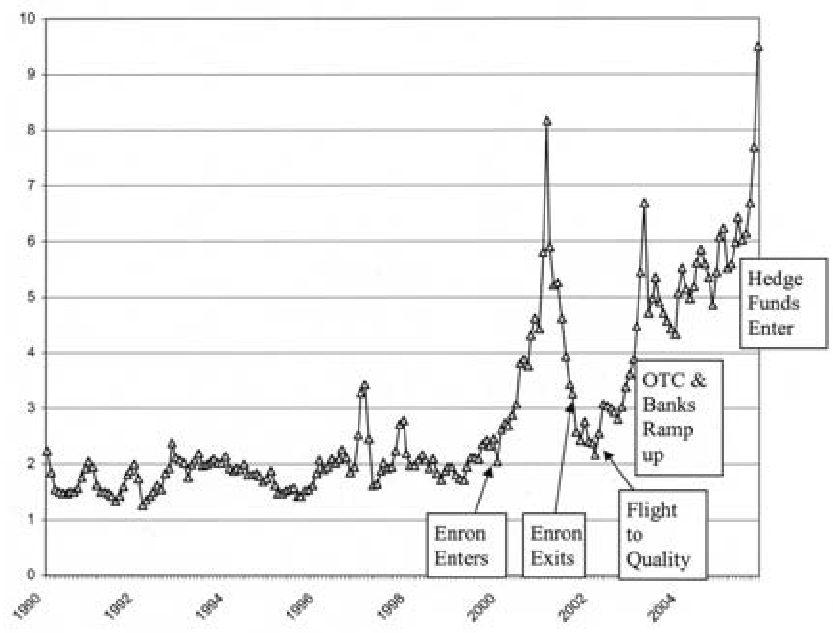
Institutional investors and new trading instruments like index funds have poured hundreds of billions of dollars into commodity markets at such a rate that speculation overwhelms the markets, accounting for the vast majority of trading. The markets no longer provide their proper role to assist commercial traders, buyers and sellers who actually use the physical commodities, to hedge and smooth their physical production and consumption of the commodities. Instead, the contracts have become assets, traded hundreds of times without ever being physically delivered. The volatility and speculation driving price increases have forced smaller commercial traders out of the market. The exchanges have allowed this to happen by failing to impose effective speculation limits or position limits. The CFTC has obscured by problem by misclassifying large speculators (banks like Goldman Sachs and Merrill Lynch) as commercial traders.

THE PROBLEM OF HYPER-SPECULATION AFFLICTS A WIDE RANGE OF MARKETS

Natural Gas

In March of 2006 I published a report for the Attorneys General of Illinois, Iowa, Missouri, and Wisconsin that concluded that all was not right in natural gas financial markets. The report showed a close correlation between the escalation of prices and changes in trading policies and practices (see Exhibit 2). The report combined that empirical observation with a detailed explanation of the cause of the problem, which is excerpted below.

Exhibit 2:
Natural Gas Wellhead Prices and Major Changes In Trading Activity



Source: Cooper, Mark Cooper, *The Role of Supply, Demand and Financial Commodity Markets in the Natural Gas Price Spiral*, p. 8.

—Thus, while there is a spiral of upward pressure on prices radiating from the physical market and filtered through regulation, this analysis shows that the financial commodity markets may be dramatically accentuating the problem of high and volatile prices.
—Defenders of the financial markets want to blame the whole problem on the physical markets and even claim that traders will help solve the problem. But the evidence suggests that the financial commodity market bears at least some of the blame for pushing prices up. Today, the evidence that the financial commodity markets are significantly accelerating price increases in natural gas markets is circumstantial, but quite strong.
—The overall pattern of prices supports the proposition that they have run up beyond anything that is justified by the problems in the physical market.
—We have a commodity that is vulnerable to abuse, in a new market that has been under-regulated from its birth.
—Public policy adopted in 2000 further reduced regulation and opened the door to counterproductive, if not outright manipulative, behaviors and pushed prices higher.
—We have a clear theory about how consumers could be hurt in this market.
—The problem is that both the structure of the market and the behaviors of market players are biased in favor of higher prices and against consumers.
—We have evidence at the micro levels of a pervasive pattern of past abuses and rumors about suspicious behavior in the current market.[5]
—There are several ways in which financial markets may be magnifying the upwardly volatile spiral of prices and contribute to the ratchet:

[5] Cooper, Mark Cooper, *The Role of Supply, Demand and Financial Commodity Markets in the Natural Gas Price Spiral*, p. 88.

—Financial markets thrive on volatility and volume, but volatility and volume have costs. Producers of gas demand to be paid a higher premium to bring their gas to market sooner rather than later. Traders demand to be rewarded for the risks they incur, risks that are increased by the trading process itself.
—The influx of traders fuels volatility and raises concerns about abusive or manipulative trading practices.
—Econometric analyses of the natural gas markets in recent years raise important questions as to how well the natural gas markets work. Given the uncertainty about the functioning of these markets, the claim that the market price is always right because it's the market price should be questioned:
—The economic analysis does not support the claim that these markets operate efficiently to establish prices.
—Risk premiums, which raise the price substantially (10–20 percent), are high and rising.
—Prices are well above the underlying costs of production.
—The operation of financial markets is no accident. Trading reflects the rules that are established—by law and through self-organization. The most troubling part about natural gas trading is that policy makers really have no clue about what goes on:
—The majority of transactions take place in markets that are largely unregulated.
—These over-the-counter markets, reported in unaudited, unregulated indices, are a major factor in setting the price of natural gas. And these unaudited, unregulated markets have behaved very poorly in recent years, with numerous instances of misreporting of prices.
—Even where there is light-handed regulation, the rules are inadequate to protect the public:
—Players in the natural gas markets can hold very large positions without having to disclose the size of their positions to any regulatory authority, and a small number of large players can influence the price that consumers pay in a very short period of time and under circumstances that place the consumer at risk.
—Index prices are often based on a small number of self-reported transactions and there are no mechanisms for determining if such transactions represent an accurate sampling of the natural gas market. When even the hint of accountability was imposed by merely being asked to certify the veracity of reported transactions, traders stopped reporting.[6]
—There has been a failure of public policy at every level to build a system that protects the public. The structure of the physical markets induces conduct that has created and is sustaining a tight market. The structure of the financial commodities markets induces conduct that magnifies upward pressures on prices . . .
—The financial markets are not only largely unregulated, they are structured in such a way that there are a large number of small buyers who have weakened incentives and limited ability to resist price increases facing a small number of large sellers who have a strong incentive and a much greater ability to hold out for higher prices. Holding out on the supply side may simply mean buying and holding assets in the ground or positions in the futures market and waiting for buyers who need the commodity to blink.
—Most troubling is the fact that many of the impacts of many of the legislative and regulatory policies that have worked to the detriment of consumers were predictable and preventable, given the nature of the commodity and the type of market that Congress and the regulatory agencies in Washington created.[7]

When the Federal Energy Regulatory Commission got wind of the report, without ever talking to us about it, they ridiculed it at an open meeting of the Commission. The Chairman of the FERC, reflecting the party line of the administration, insisted that all the price gyrations were the result of market fundamentals. He was absolutely certain that the FERC had its finger on the pulse of the commodity markets. He was absolutely wrong.[8] At the very moment he was rejecting our analysis, unbe-

[6] Cooper, Mark Cooper, *The Role of Supply, Demand and Financial Commodity Markets in the Natural Gas Price Spiral*, p. 9.
[7] Cooper, Mark Cooper, *The Role of Supply, Demand and Financial Commodity Markets in the Natural Gas Price Spiral*, p. 89.
[8] A point-by-point response to the FERC's misguided comments on the report was provided to but never acknowledged by the Commission (Letter Appendix to Cooper, The Role of Supply, Demand and Financial).

knownst to him, the Amaranth corner was taking place. Neither the FERC nor the CFTC had a clue about what was going on.

Missing a massive manipulation is embarrassing, but the real damage came when the blind ignorance of the FERC led it to waste the chance to use its newly minted powers under the Energy Policy Act of 2005 to follow our recommendations to adopt a broad view of abusive behaviors that afflict energy commodity markets.[9] As I wrote in the natural gas report:

—The FERC has also issued rules implementing the Energy Policy Act of 2005 that change its market monitoring procedures and implement new powers granted in the Act. It has entered into a vague memorandum of understanding about sharing information. The foregoing analysis demonstrates that a lot more than manipulation is at issue in the natural gas price spiral and suggests that much more needs to be done. Both the FERC and the CFTC are looking for a very narrow range of manipulative behaviors with a very narrow telescope. Unlike other physical commodities, a vast amount of trading of natural gas goes on in the over-the-counter markets that are hidden from the view and beyond the authority of these agencies. The indices that are based on this unregulated market activity have been unreliable and remain subject to doubt.

—In the case of regulated activities the changes at the FERC replicate the weaknesses of the CFTC approach by adopting its definitions and case law. It may be illegal to contrive to manipulate markets and there are new fines if you are caught doing so, but the FERC is going to have great difficulty proving manipulation, when prices are "moved." It is precisely for this reason that the CFTC and the exchanges subject to its jurisdiction do more than rely on narrowly defined manipulation statutes to prevent abuse.[10]

The FERC and the CFTC have failed to adopt a broad view of abuses in financial markets. They cannot see the abuse because they are not looking for it. My earlier analysis of natural gas markets identified the numerous ways that prices can be moved by actions that are well below the radar of the FERC and the CFTC.

—There are strands in this literature that identify potential and actual abusive practices . . .
—manipulation facilitated by large positions,
—lack of transparency,
—structural advantages enjoyed by large traders or the exercise of market power,
—insider trading and self-dealing,
—trading practices that accelerate market trends, perhaps causing them to overshoot.[11]

Instead of taking a hard look at the broad pattern of abuse, the FERC adopted a very narrow view of manipulation, taking on the existing CFTC case law and definitions. Instead of providing new and vigorous oversight over the natural gas market, we have a second cop walking the same beat with it eyes half shut.

Unfortunately, the Federal Trade Commission has started down the same useless path. The lengthy discussion of intension (scienter) in the advanced notice of proposed rule making points the FTC down the same dead end path that the FERC took. The FTC needs to break out of the narrow "scienter" manipulation view to identify and attack the broad range of practices and structural conditions that can and have been moving prices in the markets.[12]

Policymakers must recognize that certain commodities are fundamentally different. Energy is at the top of the list of commodities that have special vulnerabilities, but energy commodities are not alone. The transformation of commodity markets into speculative engines is hurting food commodities as well. The description I wrote of natural gas applies to greater or lesser degree to the entire energy complex and many food commodities.

—Because natural gas is a physical commodity that is actually consumed (unlike a pure financial instrument), difficult to store, and expensive to transport, natural gas markets are challenging . . . The key elements identified are the supply-side difficulties of production, transportation and storage, and the demand-

---

[9] Federal Energy Regulatory Commission, Order No. 670, Prohibition of Energy Market Manipulation, Docket No. RM06–3–000, January 19, 2006; Memorandum of Understanding Between The Federal Energy Regulatory Commission and the Commodity Futures Trading in Commission Regarding Information Sharing and Treatment of Proprietary Trading and Other Information, October 12, 2005.

[10] Cooper, Mark Cooper, *The Role of Supply, Demand and Financial Commodity Markets in the Natural Gas Price Spiral*, p. 93

[11] Cooper, Mark Cooper, *The Role of Supply, Demand and Financial Commodity Markets in the Natural Gas Price Spiral*, p. 68.

[12] Federal Trade Commission, *Prohibition on Market Manipulation and False Information in Subtitle B of the Energy Independence and Security Act of 2007*, 16 CFR 317.

side challenges of providing for a continuous flow of energy to meet inflexible demand, which is subject to seasonal consumption patterns. "[T]he deliverables in money markets consist of a "piece of paper" or its electronic equivalent, which are easily stored and transferred and are insensitive to weather conditions. Energy markets paint a more complicated picture. Energies respond to the dynamic interplay between producing and using; transferring and storing; buying and selling—and ultimately "burning" actual physical products. Issues of storage, transport, weather and technological advances play a major role here. In energy markets, the supply side concerns not only the storage and transfer of the actual commodity, but also how to get the actual commodity out of the ground. The end user truly consumes the asset. Residential users need energy for heating in the winter and cooling in the summer, and industrial users' own products continually depend on energy to keep the plants running and to avoid the high cost of stopping and restarting them. Each of these energy participants—be they producers or end users—deals with a different set of fundamental drivers, which in turn affect the behavior of energy markets . . .

—What makes energies so different is the excessive number of fundamental price drivers, which cause extremely complex price behavior."

—Complexity of physical characteristics translates into a highly vulnerable product in this commodity market.

—"Although the formal analysis examines transportation costs as the source of friction, the consumption distortion results suggest that any friction that makes it costly to return a commodity to its original owners (such as storage costs or search costs) may facilitate manipulation.

—The extent of market power depends on supply and demand conditions, seasonal factors, and transport costs. These transport cost related frictions are likely to be important in many markets, including grains, non-precious metals, and petroleum products.

—Transportation costs are an example of an economic friction that isolates geographically dispersed consumers. The results therefore suggest that any form of transactions cost that impedes the transfer of a commodity among consumers can make manipulation possible.[13]

These characteristics demand much more vigorous oversight of energy and food commodity markets than other commodities, especially financial instruments and precious metals that have few physical uses. Unfortunately, for about a decade we have had much less oversight of energy markets. More broadly, the transformation of commodity markets generally has created problems for physical markets. When commodity markets lose touch with the underlying physical market fundamentals, they do more harm than good.

Physical traders get frozen out. I found this in my study of the natural gas market. The utilities that actually sell the gas to the consumer could not play in the hyper-inflated commodity markets. They simply tied their purchases to the indexes, hoped for the best and let the consumer suffer the consequences.

—There is a general consensus that utilities are not in the markets as hedgers, although a small number are. Moreover, there is a belief that hedging has declined, as volatility and large financial players have moved into the market.

—"Most utilities have stopped hedging and instead rely on the fuel-adjustment clause that allows them to pass on to consumers . . . Many utilities exited trading, Duke being the last one. The point is they are not really in the game except for Constellation, Sempra, Dominion, and a few others. That more customers are exposed to price risk because they are passing on the higher costs to customers."

—Cooper said many utilities probably have stopped hedging in such a risky environment because they have to eat their losses if they miscalculate. "Utilities are not in the business of predicting prices," he said. "They don't care what the price it. They pass it on to customers."

—While the institutional context in which utilities function certainly restricts their inclination to play in the financial market, as volatility and prices mount, it becomes more burdensome for all users. The cost of hedging becomes higher and higher.

—But with gas above $10/mmBtu and futures market direction unpredictable, even hedging and other risk management tools are becoming more and more expensive—raising the question of whether the benefit is worth the cost . . .

—For example, Invista uses financial derivatives, collars and similar tools to hedge against current market conditions. But gas at $10/mmbut or higher and

[13] Cooper, Mark Cooper, *The Role of Supply, Demand and Financial Commodity Markets in the Natural Gas Price Spiral*, pp. 28–29

unprecedented volatility "makes all of these actions a little more costly," Poole noted. "It raises the question: is the elimination of price volatility worth the cost?"

—And while Invista has the money and in-house expertise to handle risk management activities internally rather than farming them out to marketers or energy service companies, "unfortunately, for smaller-volume companies that may not be a feasible option."

—Tying prices to indices is the ultimate short-term strategy. This institutional view raises concerns because the capital-intensive infrastructure of the industry has historically been financed by long-term contracts. The deregulation and unbundling of the industry inevitably shortened the time horizon of the participant. Flexibility and choice loosens commitments and makes "bypass" possible. Pipelines cannot count on shippers as much as in the past. Utilities cannot count on load as much as in the past. Merchants demand faster recovery of costs.

—In fact, a major impetus for restructuring of the natural gas industry was the high social cost associated with rigid long-term contractual arrangements . . .

—With the natural-gas sector restructuring . . . trading arrangements have become much more short term and flexible in both price and in terms and conditions. We have observed this phenomenon throughout the natural-gas sector, from gas procurement, gas storage, and retail transactions, to capacity contracting for pipeline services.

—Long-term commitments to transportation and storage facilities, exposes the contracting parties to greater risk in this environment, especially where long-term commitments to supply cannot be secured. The mismatch between the incentive structure and the necessary time horizon results in missed opportunities. For example, Jack Flautt, Managing Director of March & McLean, suggested there is an anomaly in the storage investment area. It is strange, in his view, that investors are not trampling one another to participate in the storage development market. "The value of storage today is greater than at any time in my lifetime," but Flautt reported he gets only blank stares from bankers at the suggestion.

—The hesitance of public utility commissions to push utilities to jump back in to long-term commitments is understandable and the task of realigning risks is challenging.[14]

Petroleum

The problems that have afflicted natural gas have afflicted other energy commodities as I explained in my natural gas analysis . . .

—Natural gas markets share this pattern of abuse with other energy markets. Unilateral actions by any of a number of individuals in any of a number of circumstances provide a landscape in which upward price movements are probable. "There are regular squeezes in the Brent [oil] market . . . The whole trick is to collect more money in CFDs [contract for differences] than you lose on the physical squeeze . . . People seem to do it in turn. It depends on who's smart enough to move in a way nobody notices until it happens."

—In a case brought by a private party in late 2001, the practical reality was revealed.

—Tosco won a settlement claiming that Arcadia Petroleum (a British subsidiary of the Japanese firm Mitsui) engineered an elaborate scheme to manipulate oil prices in September of 2001 through the use of OTC derivatives and a large cash market position to corner the market in Brent crude oil. As a result, the price of Brent crude soared between August 21st and September 5th and pushed its price to a premium over West Texas Intermediate crude oil (WTI) . . .

—Dated Brent, which acts as a price marker for many international grades, is physical crude traded on an informal market, rather than a regulated futures exchange. This lack of regulation poses problems for oil producers and consumers seeking a fair price . . . A typical Brent squeeze involves a company quietly building a strong position in short-term swaps called contracts for difference, or CFD's, for a differential not reflected in current prices. The company then buys enough cargoes in the dated Brent market to drive the physical price higher, which boosts the CFD differential . . .

[14] Cooper, Mark Cooper, *The Role of Supply, Demand and Financial Commodity Markets in the Natural Gas Price Spiral*, p. 83.

—The Company may lose money on the physical side, but it's more than compensated for by profits on its offsetting paper position in the short-term swaps market."[15]

The problem in oil markets has continued to mount, as I explained in a law review article written in 2007.

—On April 29, 2006, the New York Times ran a front-page article under the headline "Trading Frenzy Adds to Jump in Price of Oil."[16] The Times article opens with a brief paragraph on the conditions in the physical market but then devotes about 36 column inches to the proposition that financial markets are adding to the price increase.

—"A global economic boom, sharply higher demand, extraordinarily tight supplies and domestic instability in many of the world's top oil-producing countries—in that environment higher oil prices were inevitable.

—But crude oil is not merely a physical commodity . . . It has also become a valuable financial asset, bought and sold in electronic exchanges by traders around the world. And they, too, have helped push prices higher . . .

—"Gold prices do not go up because jewelers need more gold, they go up because gold is an investment," said Roger Diwan, a partner with PFC Energy, a Washington-based consultant. "The same has happened to oil . . ."

—"It is the case," complained BP's chief executive, Lord Browne, "that the price of oil has gone up while nothing has changed physically."[17]

—Three key factors serve to drive the price spiral higher: volume, volatility, and risk . . .

—The structure and availability of markets plays a role in allowing the volumes to increase.

—Changes in the way oil is traded have contributed their part as well. On Nymex, oil contracts held mostly by hedge funds—essentially private investment vehicles for the wealthy and institutions, run by traders who share risk and reward with their partners—rose above 1 billion barrels this month, twice the amount held 5 years ago.

—Beyond that, trading has also increased outside official exchanges, including swaps or over-the-counter trades conducted directly between, say, a bank and an airline . . .

—Such trading is a 24-hour business. And more sophisticated electronic technology allows more money to pour into oil, quicker than ever before, from anywhere in the world.

—The influx of new money is sustained by movements of different institutions and individuals into the market. "Everybody is jumping into commodities and there is a log of cash chasing oil," said Philip K. Verleger Jr., a consultant and former senior advisor on energy policy at the Treasury Department."

—This fundamental observation had been offered a couple of years earlier in a front page Wall Street Journal article entitled, "Oil Brings Surge in Speculators Betting on Prices: Large Investors Playing Ongoing Rise is Increasing Demand and Price Itself."

—Oil has become a speculator's paradise. Surging energy prices have attracted a horde of investors—and their feverish betting on rising prices has itself contributed to the climb.

—These investors have driven up volume on commodities' exchanges and prompted a large push among Wall Street banks and brokerage firms . . . to beef up energy-trading capabilities. As the action has picked up in the past year, those profiting include large, well-known hedge funds, an emerging group of high-rollers, as well as descendants of once-highflying energy-trading shops such as Enron Corp.[18]

A recent paper from the Japanese Ministry of Economy Trade and Industry (METI) has echoed my conclusion and the conclusion of the Senate Permanent Subcommittee on Investigations.

—According to the METI paper, during the second half of 2007, when the physical price of Wet Texas Intermediate crude averaged $US90 a barrel, market speculation, geopolitical risk and currency factors were responsible for $US30–$US40 of the price.

---

[15] Cooper, Mark Cooper, *The Role of Supply, Demand and Financial Commodity Markets in the Natural Gas Price Spiral*, p. 64.

[16] Jad Mouawad & Heather Timmons, *Trading Frenzy Adds to Jump in Price of Oil*, N.Y. TIMES, Apr. 29, 2006, at A–1.

[17] *Id.*

[18] *Id.*

—The average WTI “fundamental price,” consistent with the underlying supply/demand situation, was around $US60/barrel during the December half-year, according to the paper, citing research for the Institute of Energy Economics in Japan.

—Last week the benchmark WTI futures contract touched $US135/bbl, more than double the level of a year previously.

—“We cannot say exactly what the fundamental price is at the moment,” a METI official said yesterday. “But we believe the increases this year in the market price have much to do with the influx of speculative money.[19]

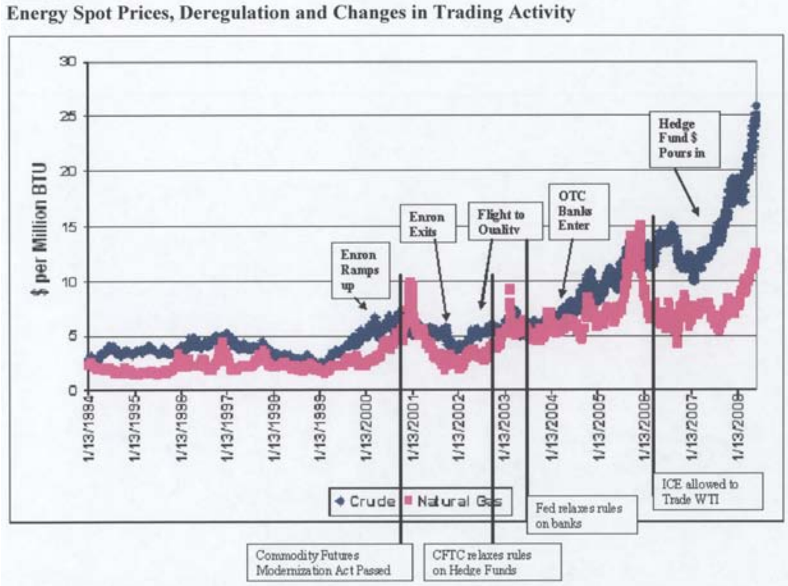
The study from the Institute on Energy Economics mentioned above draws a direct link between the growth in speculation and the rising price.

—In the futures market, oil-futures trading at New York Mercantile Exchange (NYMEX) are expanding faster than actual spots. While the futures markets are designed to hedge price fluctuations risks, oil is becoming a commodity, making the futures market something like an alternative investment target. As a result, long position by speculators (“non-commercial” and “non-reportable”) conspicuously leads to a rise in the oil prices in more cases.[20]

Exhibit 3 presents an updated version of the analysis that linked prices to changes in trading policy and practices base on spot prices for both natural gas and oil. It shows the close correlation of price movements and major institutional/structural changes in trading. The sharp increase in spot prices for West Texas Intermediate crude since early 2007 stands out. This actually links directly to one of the key policy issues that we have identified.

The Intercontinental Exchange, located in Atlanta, was granted a “no action letter” to trade contracts for West Texas Intermediate crude, exempt from U.S., regulation. There has been a rapid increase in trading Exhibit 4 shows this by contrasting the growth of open positions in West Texas Intermediate and Brent crude, another major marker crude. Starting in 2006 and accelerating in 2007 and 2008, the open positions in West Texas Intermediate left Brent crude behind. The extraordinary increase in the volume of trading puts upward pre

Exhibit 3:
Energy Spot Prices, Deregulation and Changes in Trading Activity

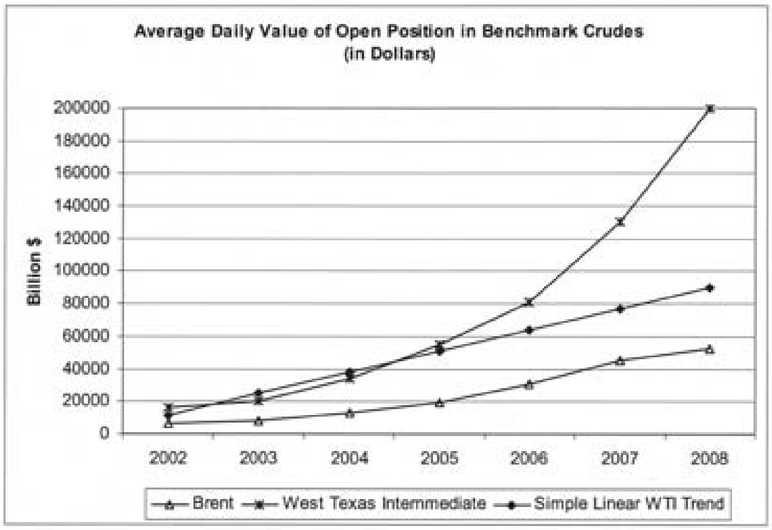


Source: Energy Information Administration, Database and Source: Cooper, Mark Cooper, *The Role of Supply, Demand and Financial Commodity Markets in the Natural Gas Price Spiral*, p. 8.

[19] Peter Alford, “Japan Blames Speculators for Oil Hike,” May 28, 2008.

[20] Akira Yanagisawa, *Decomposition Analysis of the Soaring Crude Oil Prices: Analyzing the Effects of Fundamentals and Premium* (Institute of Energy Economics, March 2008), p. 5.

Exhibit 4:



Source: Testimony of Michael Masters, Managing Member/ Portfolio Manager, Masters Capital Management, LLC, Committee on Homeland Security and Governmental Affairs, United States Senate, May 20, 2008, Note 16.

Food

The plague of the "influx of speculative money" has now spread to food commodities. For instance, the evidence is mounting that speculation is contributing to the run up in food commodity prices that we have experienced over the past year. Speculation can be seen as contributing to price increases and volatility, as a study from the University of Wisconsin recently noted.

—One unique aspect of the market the last year has been the size of the non-commercial position in the futures market for corn. Speculative traders have significantly increased their net long position over the last year, while non-commercial traders have tended to be net short. Note that corn prices have been highly correlated with the net positions of non-commercial traders since the first quarter of 2006/2007, and the speculators have had large net long positions most of the year. It is important to note that this does not imply causality, only correlation. However, there does appear to be reason to study more carefully the impact of speculative activity on both price levels and volatility.[21]

The disutility of hyper-inflated commodity markets was recently underscored by a study of food commodities conducted by Texas A&M University.

—The increased activity in futures markets has had the unexpected consequence of reducing producer's ability to manage price risk using futures markets. The large influx of money into the markets, typically long positions, has pushed commodities to extremely high levels. But, these funds also quickly move large amounts of money in and out of positions. This has generated much more price volatility in the futures markets. In response, the exchanges have increased the daily move limits for most of the agricultural commodities over the past 6 months . . .

—The up and down volatility in the market and expanded trading price limits mean that more margin calls occur. Small elevators and even large grain companies and cotton merchants, who are trading even larger volumes, not to mention farmers doing their own price risk management, have been unable to make the margin calls.

[21] T. Randall Fortenbery and Hwanil Park, *The Effect of Ethanol Production on the U.S. National Corn Price*, University of Wisconsin-Madison, Department of Agricultural Economics, Staff Paper 523, April 2008, p. 16.

—Producers, elevators, and companies use bank financing to finance their businesses and the price risk management. As the margin calls have increased, they have exhausted their ability to finance their normal hedging activities and have therefore been forced out of the market.[22]

Simply put, commercial entities that need the physical commodities to run their enterprises are priced out of the market. If you do not have deep pockets, are tied to the physical schedule of production and consumption, and live in the real world of bank finance, hyper-inflated commodity markets are a big part of the problem, not the solution.

REGULATORY REFORM IS THE WAY TO SOLVE THE PROBLEM

It would be reassuring if we could blame the current speculative bubble on the arrogance, ignorance and ineptitude of the regulatory agencies with oversight responsibilities. If that were the case, we could just fire the commissioners and secretaries and clean up the problem. Unfortunately, there is a more fundamental problem that must be addressed. Federal authorities must look broadly at the conditions in modern financial markets that feed volatility, amp up volume, and increase risk and policymakers must impose new structural oversight on these markets to return them to their proper role, as institutions that help smooth the functioning of physical markets. They have become centers of idle speculation that do vastly more harm than good.

With the commodities markets finally overwhelmed by speculation and the Congress empowering other agencies to do the job that the CFTC has failed to do, the CFTC has belatedly admitted that it did not have sufficient information to perform its primary function of preventing excessive speculation. The administration has formed a task force to look into the problem. The CFTC has finally asked that the foreign regulators to whom it abdicated its responsibility, to impose some order. Begging foreign exchanges for data and foreign regulators to act responsibly is not only embarrassing; it is absurd when the CFTC has not put its own house in order. These proposals are too little too late. The CFTC must be forced to assert regulatory authority over trading within the Untied States and trading in financial instruments designated in U.S. commodities.

Too much money chasing too few goods in the commodity markets has created the upward spiral, amping up volume, increasing volatility and adding to risk. We must turn down the volume in commodity markets. Sound prudential regulation is the key to restoring order.

The failure of the CFTC to act responsibly and in the past and the weak-kneed reaction to the dire crisis in commodity markets in the present ensure that Americans will continue to the victims of excessive speculation. Congress must enact broad reforms that close the loopholes, remove the discretion that was given to the CFTC and compel it to do its job. There are five areas in which reform is necessary, with a variety of policy making institutions needing to take action. It is a big job, but a $500 billion hit on the economy and household budgets that are being devastated by rising prices of basic necessities demand the effort.

Chase out the bad guys

All traders must register and be certified (for honesty and competence, like bankers and brokers). All trading must be reported across all transactions.

The CFMA created a market in over the counter trading that is beyond regulatory scrutiny. These dark markets have played a prominent role in major manipulations. Without comprehensive registration and reporting, there will always be room for mischief that is out of sight to the regulator. Large traders should be required to register and report their entire positions in those commodities across all markets. Registration and reporting should trigger scrutiny to ensure the good character, integrity and competence of traders.

Eliminate the funny money

Raise margin requirements. Increase capital reserve requirements.

We need to restore the balance between speculation and productive investment. Margin requirements on organized exchanges are a fraction of the margin requirements on stocks. If it is cheaper to put your money into speculation, why bother with real investment. The margin requirement for commodity trading among noncommercial traders should be 50 percent higher than the margin requirement for investment in stocks, but more lenient terms should apply to physical traders. Cap-

[22] David P Anderson, et al. *The Effects of Ethanol on Texas Food and Feed*, Agricultural and Food Policy Center, Texas A&M University, April 10, 2008, p. 32.

ital requirements should be increased to further reduce the amount of leverage in these markets and dampen excessive risk taking.

Reduce the ability to push prices up

Lower position limits and tie position limits and margin policies to needs of physical traders. Lengthen settlement windows. Ban conflicts of interest (analyst's reports that enrich analyst's portfolios).

Large position limits and short settlement periods invite efforts to influence prices. They should be reformed to reduce the risk. The practice of hyping prices by firms that stand to profit from the predictions should be should be banned.

Restore the proper functioning of commodity markets and their regulators

Enforce meaningful speculative limits. Do honest analysis (classify traders correctly). Close the loopholes (foreign boards of Trade exemptions, the Enron and swaps loopholes). Create minimum criminal penalties for violation of commodity laws

Public policy must return the futures markets to their function of supporting the operation of physical markets. Speculation should not be allowed to dominate these markets, and limits should ensure that genuine commercial traders are a substantial majority of the market by imposing strict speculative limits. Traders must be properly classified to ensure this outcome.

We must not only close the Enron-loophole, which allowed vast swathes of trading to take place with no oversight, but also ensure vigorous enforcement of registration and reporting requirements. We must take back the authority we have given to foreign exchanges and stop abandoning authority to private actors.

Failure to comply should result in mandatory jail terms. Fines are not enough to dissuade abuse in these commodity markets because there is just too much money to be made.

Redirect investment to productive long-term uses

Put a tax on short-term capital gains. Move pension funds out of speculation. Ban institutional index funds.

We must level the playing field between long-term productive investment and short-term speculative gains, with a tax on short-term capital gains between 33 and 50 percent to make holding productive investments for long periods as attractive as flipping short-term financial paper.

Speculators will insist that they will just go abroad, but the Congress need not fear such an outcome. If the United States is determined to assert jurisdiction over trading in the United States and for U.S. commodities, foreign exchanges will comply. To survive they desperately need to have access to legal instruments for U.S.-traded commodities. Individuals may chose to become expatriates and move to countries that chose not to comply, or they may break the law, but vigorous enforcement will put a stop to it. I suspect that the vast majority of traders do not want to live in places like Zimbabwe or Leavenworth, Bangladesh or Sing Sing.

If we do not do more than the half hearted approaches that are on the table, we will continue to lurch from crisis to crisis. American consumers are suffering needlessly from this speculative bubble in vital necessities. It is time for thorough reform and re-regulation of the financial commodity markets.

Senator DURBIN. Mr. Duffy.

STATEMENT OF TERRENCE A. DUFFY, EXECUTIVE CHAIRMAN, CME GROUP, INC.

Mr. DUFFY. Thank you, Mr. Chairman. I am Terry Duffy, the Executive Chairman of CME Group, and I want to thank you, Chairman Durbin and Chairman Harkin and Ranking Members Brownback and Chambliss, for this opportunity to present our views.

CME Group was formed by the 2007 merger of the Chicago Mercantile Exchange and the Chicago Board of Trade Holdings. CME Group is the parent of CME, Inc. and the Board of Trade of the city of Chicago. CME Group also owns Swapstream Operating Services, an OTC trading facility, and owns an interest in FXMarketspace Limited, an FX trading platform that is authorized and regulated by the Financial Services Authority.

CME Group offers a neutral marketplace. We serve the global risk management needs of our customers. Our agricultural markets also provide important price discovery that producers and processors rely on to make economic decisions. We do not profit from higher food or energy prices. Our congressionally mandated role is to operate fair markets that foster price discovery and the hedging of economic risks in a transparent, self-regulated environment, overseen by the CFTC.

CME Group provides a comprehensive selection of benchmark products across all major asset classes, including futures and options based on interest rates, equity indexes, foreign exchange, agricultural commodities, ethanol, and alternative investments such as weather and real estate. We also offer order routing, execution and clearing services to other exchanges.

We unequivocally support your efforts to materially improve the enforcement capabilities of the CFTC and to do so in a manner that does not increase the costs of trading on fully regulated U.S. contract markets. We are enthusiastic supporters of broadly expanding the mandatory reporting of energy trading and position information to the Commission. We believe that disclosure of trading and position information to the regulator, with sufficient resources to analyze and act on unusual or suspicious activities, will deter most potential manipulators and assure punishment for those foolish enough to attempt a manipulation when all of their actions are visible to the regulator. This is the philosophy upon which our internal regulation has been based and why it has been so successful.

We also clearly understand that the recent surge in many of the prices of commodities, particularly energy, has inspired Congress to look for assurance that the only price drivers are legitimate supply and demand factors.

As Senator Durbin noted, we have all witnessed the flooding crisis in Iowa and other Midwestern towns. We offer our sympathy to the victims and their families who are being displaced by these extreme weather conditions. Obviously, weather and other fundamentals are at play and pressuring the prices of agricultural commodities.

Some, however, who claim expertise or special knowledge have asserted that price inflation is caused by speculators and/or passive index funds that have invested billions in commodity markets. The more cautious critics have suggested that there may be a froth of inflation caused by speculation. Our careful, up-to-date evaluation of market participants and trading patterns in the commodities traded at CME Group are to the contrary. I have explained our findings and conclusions in my written testimony. We also will be placing relevant information on our website, which will permit others to review our findings to date respecting the impact of speculation in our markets.

Our economists make convincing arguments that neither speculators nor index funds are distorting commodity prices. As you can see from the slide attached, corn prices have increased more than 158 percent during the last 2 years, while index fund participation has declined slightly from 15 percent of the open interest to 12 percent of the open interest.

In the second slide, which shows corn prices and the positions of noncommercials since the beginning of the year, the percentage of open interest held by noncommercials has declined as corn prices have continued to rise.

Previous studies have concluded that speculation has not been responsible for any significant, persistent volatility in futures markets. Nonetheless, we are strong proponents of securing all of the relevant information from all sources and fairly testing the hypothesis and reconfirming previous academic studies.

While we expect that the evidence respecting the impact of speculation and index trading in energy markets will parallel the results we have found in our own markets, we agree that there is no reason to rely entirely on economic theory when the data is or can be made available. We support the CFTC's and Congress' efforts to secure this data and to assure that a thorough analysis informs any subsequent legislation or administrative efforts to deal with any uneconomic price inflation.

I want to thank you for your time and attention this afternoon, and I look forward to answering any of your questions.

Senator DURBIN. Thank you, Mr. Duffy.

[The statement follows:]

PREPARED STATEMENT OF TERRENCE A. DUFFY

I am Terrence Duffy, Executive Chairman of Chicago Mercantile Exchange Group Inc. ("CME Group" or "CME") Thank you Chairmen Durbin and Harkin and Ranking Members Brownback and Chambliss for this opportunity to present our views.

CME Group was formed by the 2007 merger of Chicago Mercantile Exchange Holdings Inc. and CBOT Holdings Inc. CME Group is the parent of CME Inc. and The Board of Trade of the City of Chicago Inc. (the "CME Group Exchanges"). CME Group also owns Swapstream Operating Services Limited, an OTC trading facility, and owns an interest in FXMarketspace Limited, an FX trading platform that is authorized and regulated by the Financial Services Authority. The CME Group Exchanges are neutral market places. They serve the global risk management needs of our customers and producers and processors who rely on price discovery provided by our competitive markets to make important economic decisions. We do not profit from higher food or energy prices. Our congressionally mandated role is to operate fair markets that foster price discovery and the hedging of economic risks in a transparent, self-regulated environment, overseen by the CFTC.

The CME Group Exchanges offer a comprehensive selection of benchmark products across all major asset classes, including futures and options based on interest rates, equity indexes, foreign exchange, agricultural commodities, energy, and alternative investment products such as weather and real estate. We also offer order routing, execution and clearing services to other exchanges.

We unequivocally support your efforts to materially improve the enforcement capabilities and machinery of the CFTC and to do so in a manner that does not increase the costs of trading on fully regulated U.S. contract markets. We also are enthusiastic supporters of broadly expanding the mandatory reporting of energy trading and position information to the Commission. We share the view of regulators and legislators most famously expressed by Justice Louis Brandeis:

"Publicity is justly commended as a remedy for social and industrial diseases. Sunlight is said to be the best of disinfectants; electric light the most efficient policeman."—Justice Louis Brandeis, Other People's Money, and How the Bankers Use It, 1933

We believe that disclosure of trading and position information to a regulator with sufficient resources to analyze and act on unusual or suspicious activities will deter most potential manipulators and assure punishment of those foolish enough to attempt a manipulation when all of their actions are visible to the regulator. This is the philosophy upon which our internal market regulation has been based and why it has been so successful.

We also clearly understand that the recent surge in the prices of many commodities, particularly energy, has inspired Congress to look for assurance that the only price drivers are legitimate supply and demand factors. Some who claim expertise or special knowledge have asserted that the entire price inflation can be laid at the door of speculators and/or passive index funds that have invested billions in commodity contracts. The more cautious critics have suggested that there may be a froth of inflation caused by speculation. Our careful, up-to-date evaluation of market participants and trading patterns in the commodities traded at CME and CBOT are to the contrary as I will explain below. We will be placing relevant information on our website, which will permit others to review our findings to date respecting the impact of speculation on our markets.

Our economists make convincing arguments that neither speculators nor index funds are distorting commodity prices. Previous studies have concluded that speculation has not been responsible for any significant, persistent volatility in futures markets. Nonetheless, we are strong proponents of securing all of the relevant information from all sources and fairly testing the hypothesis and reconfirming previous academic studies. While we expect that the evidence respecting the impact of speculation and index trading in energy markets will parallel the results we have found in our own markets, we agree that there is no reason to rely entirely on economic theory when the data is or can be made available. We support the CFTC's and Congress's efforts to secure this data and to assure that a thorough analysis informs any subsequent legislative or administrative efforts to deal with uneconomic price inflation.

SPECULATION IS ESSENTIAL TO EFFICIENT, LIQUID MARKETS

Current fuel and food prices are shocking and painful to consumers and the economy. Unfortunately, the pressure to reverse rising prices has led some to look for a simple, causal agent that can be neutralized with the stroke of a pen. The favored culprit is the traditional villain—speculators. But speculators sell when they think prices are too high and buy when they think prices are too low. They are not a unified voting block and are on both sides of every market. Speculative selling and buying send signals to producers and processors that help keep our economy on an even keel. High futures prices for corn induced farmers to bring new acreage to market. High forward energy prices encourage exploration and new technology to exploit existing untapped reserves and conservation and other behavioral changes to adjust demand.

Futures markets perform two essential functions—they create a venue for price discovery and they permit low cost hedging of risk. Futures markets depend on short and long term speculators to make markets and provide liquidity for hedgers. Futures markets could not operate effectively without speculators and speculators will not use futures markets if artificial barriers or tolls impede their access. Blaming speculators for high prices diverts attention from the real causes of rising prices and does not contribute to a solution.

The weight of the evidence and informed opinion confirms that the high prices are a consequence of normal supply and demand factors. The Wall Street Journal surveyed a significant cross section of economists who agreed that: "The global surge in food and energy prices is being driven primarily by fundamental market conditions, rather than an investment bubble . . ." [1]

The traditional production/consumption cycle that has governed prices in commodity markets is stressed by the confluence of a number of factors. David Hightower, author of the Hightower report summed up the supply/demand situation in corn last year as follows: "We have experienced three consecutive years of record corn production . . . and three consecutive years of declining ending reserves. Supply has put its best team on the field and demand keeps winning."

We have identified six significant factors that are influencing the supply and demand for grains and oilseeds; each is important.

—Weather/Disease/Pestilence;
—Increasing per capita consumption in the emerging markets;
—The dramatic impact of the demand for grain and oil seeds as feed stock for biofuel;
—Reactionary governmental trade policies; and
—Financial Market turmoil, including a weakened dollar.

These factors combine to create volatile markets and increased prices.

Weather/Disease/Pestilence.—This is of course a traditional factor in the grain markets. Wheat recently attained all-time record prices, coincident with 60-year lows in world stockpiles. In the past 2 years there have been production shortfalls in Australia, Argentina, Europe, North America, and the Ukraine due to a combina-

[1] Bubble Isn't Big Factor in Inflation, By Phil Izzo (May 9, 2008; Page A2).

tion of drought in some places, untimely rains in others, and even infestation by the Eurygaster beetle.

Per Capita Consumption in Emerging Markets.—While some projections imply a slowing population growth in this century, global population is still growing and from an ever increasing base. In the short-run, GNP and personal income levels in the large emerging market countries such as India, China, Russia, and Brazil are creating unprecedented per capita demand growth for animal protein. As is common in human history, as a society grows richer, its diet expands to include additional animal protein in the form of meat and dairy. According to a report on Bloomberg.com, worldwide meat consumption is forecast to increase by more than half by 2020; most of the new demand will come from China. The implications for grain demand will be staggering. Already in just the past 12 years, China has gone from a net exporter of soybeans to the world's largest importer of soybeans with soybean imports projected to easily exceed 30 million tons in 2007. Never before in history have we witnessed the impact of 2 billion people asking for a higher standard of living at the same time.

Growth in Biofuels.—The mandate to produce biofuels created additional market stress. The expectation is for continued growth in biofuel use/demand; politics rather than logic is at work—resulting in continued demand growth for feed grains and vegetable oils. To illustrate this point; The 2005 energy bill in the United States spurred the rush to plant approximately 93 million acres of corn in 2007, the highest level since World War II. The USDA recently reported that corn based ethanol production will continue to rise placing additional demands on the crop: "driven by continued expansion in ethanol production capacity, corn use for ethanol is projected at 4.1 billion bushels 2008–09, up 28 percent from the current year projection. Ethanol corn will now account for 31 percent of total corn use, up from a projected 25 percent for 2007–08." The amount of corn used in ethanol production just 5 years ago was approximately 10 percent. In addition to the U.S. initiative, the EU enacted legislation that will require significantly increased use of biofuel fuel by 2010. The problem is that there simply is not enough land to set aside in all of the EU to meet these ambitious requirements; they will need to import significantly higher levels of either finished product or higher levels of oilseeds in order to produce the needed biofuel.

Reactionary Government Trade Policies.—During the last 3 months, there has been an ever expanding pattern of increasing export tariffs and decreasing import tariffs on grains and oilseeds by foreign governments. Russia extended a grain export tariff from April 30 to July 1. In addition, they have placed an export ban upon their grain to the four CIS (Commonwealth of Independent States) members designed to prevent re-export of Russian grain to third countries. Argentina extended their wheat export closure to April 8, and announced a new, higher soy export tax that will rise by 7–9 percentage points based upon current prices. India increased its grain export tariffs while lowering import tariffs on edible oils. China has announced a further increase in edible oil imports in 2007–08 with projections currently up an additional 14 percent. South Korea announced the emergency lifting of import tariffs on 70 price sensitive products, including wheat and corn in an effort to confront rising inflation. The pattern we are witnessing is one of keeping domestic production off the global market while lowering barriers for the acquisition of grains and oils from the global market resulting in increased demand for U.S. grain and Oil Seed products.

Financial Market Turmoil.—The events that began in the sub-prime sector of the financial markets are now spreading out with very serious and negative consequences throughout the Nation's banking sector. Restrictive lending policies are having deleterious effects within our market place. High volatility leads to higher margins, large directional price moves require significant continuing variation deposits and all of this comes at a time when money is difficult to obtain.

In addition to concerns expressed about speculators in general, there have been more specific suggestions that money managers and hedge funds that operate under defined strategies may have impaired the price discovery process. The CFTC's staff responded to question implying that managed money traders, particularly hedge funds, "may exert undue collective influence on markets and thus move prices in ways that hinder the market's price discovery role, reduce the effectiveness of hedges constructed with contracts from those markets and raise trading costs." CFTC's professional staff conducted an analysis in 2005 which came to the following conclusions: [2]

[2] http://www.cftc.gov/opa/press05/opa5074-05.htm.

"Using a unique set of data from the Commodity Futures Trading Commission (CFTC), the staff studied the relationship between futures prices and the positions of managed money traders (MMTs), commonly known as hedge funds, for the natural gas and crude oil futures markets. The staff also examined the relationship between the positions of MMTs and positions of other categories of traders (e.g., floor traders, merchants, manufacturers, commercial banks, dealers) for the same markets.

The results suggest that on average, MMT participants do not change their positions as frequently as other participants, primarily those who are hedgers. The staff found that there is a significant correlation (negative) between MMT positions and other participant's positions (including the largest hedgers), and results suggest that it is the MMT traders who are providing liquidity to the large hedgers and not the other way around.

The staff also found that most of the MMT position changes in the very short run are triggered by hedging participants changing their positions. That is, the price changes that prompt large hedgers to alter their positions in the very short run eventually ripple through to MMT participants who will change their positions in response. The staff also found no evidence of a link between price changes and MMT positions (conditional on other participants trading) in the natural gas market, and find a significantly negative relationship between MMT position changes and price changes (conditional on other participants trading) in the crude oil market."

In recent congressional testimony the CFTC has reaffirmed the validity of this 2005 analysis.[3] It is instructive that CFTC's analysis parallels the conclusions of many other economists who have also studied the issue of causation in the context of speculators and commodity futures prices.[4]

RAISING MARGIN ABOVE PRUDENTIAL LEVELS IS COUNTERPRODUCTIVE

Neither the CFTC's study nor careful marshalling of the supply/demand factors driving the market has calmed the critics who demand an easy solution to high prices, which they claim can be mandated without cost or consequence. This vocal group insists that driving speculators from the markets will bring prices back to the correct level. Worse still, they argue for driving speculators from the market by Government-mandated increases in margins.

Legislation has been proposed to mandate increases in margin, by which is meant the performance bond required of futures traders to guarantee performance of their contractual obligations to the clearing house. The theory behind the legislation is that speculators who have long positions and whose participation in the futures markets is assumed to have caused price escalation, will be driven from the market and prices will retrench to a more comfortable level. This idea is flawed.

---

[3] During his appearance before the Senate Appropriations Committee on May 7, 2008, CFTC's Acting Chairman Walt Lukken stated that the CFTC's recent revisitation of the 2005 study using more current data for energy market trading affirmed the conclusions reached in the 2005 study. This conclusion mirrors the views of the majority of 53 economists surveyed by the Wall Street Journal in May 2008 which indicated that the global surge in food and energy prices is being driven primarily by fundamental market conditions, rather than an investment bubble. Wall Street Journal, May 9, 2008, page A–2. Similarly, the U.S. Department of Energy's Energy Information Agency's most recent "Short Term Energy Outlook" published in May 6, 2008 evidenced the tightness in world oil markets, with growth in world oil consumption outstripping growth in production in non-OPEC nations by over 1 million bbls/day, and dramatically increased demand coming from China, India, and other parts of the developing world.

[4] See, for example, Antoshin and Samiei's analysis of the IMF research on the direction of the "causal arrow" between speculation and commodity prices in "Has Speculation Contributed to Higher Commodity Prices?" in World Economic Outlook (September 2006):

"On the other hand, the simultaneous increase in prices and in investor interest, especially by speculators and index traders, in commodity futures markets in recent years can potentially magnify the impact of supply-demand imbalances on prices. Some have argued that high investor activity has increased price volatility and pushed prices above levels justified by fundamentals, thus increasing the potential for instability in the commodity and energy markets.

What does the empirical evidence suggest? A formal assessment is hampered by data and methodological problems, including the difficulty of identifying speculative and hedging-related trades. Despite such problems, however, a number of recent studies seem to suggest that speculation has not systematically contributed to higher commodity prices or increased price volatility. For example, recent IMF staff analysis (September 2006 World Economic Outlook, Box 5.1) shows that speculative activity tends to respond to price movements (rather than the other way around), suggesting that the causality runs from prices to changes in speculative positions. In addition, the Commodity Futures trading Commission has argued that speculation may have reduced price volatility by increasing market liquidity, which allowed market participants to adjust their portfolios, thereby encouraging entry by new participants."

First, it assumes that speculators are all on the long side of the market and that this herd approach to trading has driven prices above their legitimate equilibrium level. All of our internal studies and all of the academic work supports the opposite view, namely that speculators are about equally divided on both sides of the market.

Second, increasing margin to artificially high levels is most likely to cause a price spike rather than to systematically lessen commodity prices. We strongly believe that efforts to mandate price by direct price control or by indirect actions distort future production and cause costly misallocation of resources of production.

Performance bond is generally set at a level to cover, with a high degree of confidence, any change in the underlying value of a futures contract during a single day of trading. It has nothing to do with the notional or face amount of the contract. For example, performance bond on a $36,700 CBOT corn contract is currently set at $2,025 while performance bond on a $100,000 30-year bond contract is set at $3,510. In each case, the holder of the contract must make good on his losses and conversely gets credit for his gains on a daily basis. Our clearing system continuously holds 100 percent collateral for a near worst case loss scenario. The cost of depositing collateral or cash with the clearing house is considered a cost of trading.

The imposition of artificially high performance bonds is a tax on trading as it raises a trader's cost. It has been repeatedly demonstrated, and ever more so as markets have become electronic and available from anywhere on the globe, that excess performance bond levels will drive users away from transparent, regulated U.S. futures markets and into opaque, unregulated OTC markets with less liquidity, less price transparency and no public accounting for traders' positions. This is a net loss to the congressionally defined purpose of creating fair, efficient and well-functioning energy and commodity markets.

Our extensive market regulation experience and our experience with previous efforts to control commodity prices by means of adjusting the level of performance bond has established that artificially increasing margins is not effective. Raising margins to drive speculators on the long side of the market out of the market in a time of upward trending prices does not work. The speculators who have been long have been collecting the profits on their positions and are in an especially strong position to meet any additional margin call. Moreover, they are well aware that the short side of the market has been losing money and probably has been forced to borrow to support their short hedges.

A North Dakota farmer who sold corn futures at a new high of $5 a bushel and locked in a $2 per bushel profit needs to be able to carry his hedge until his crop is harvested. A single contract is 5,000 bushels and margin is now set at $1,000 per contract. Assume the farmer had sold 100 contracts. Corn was $7 this morning and the farmer has been forced to go to his bank to borrow $\$2{\times}5{,}000{\times}100{=}\$1{,}000{,}000$ to continue to carry the position. What should the long speculator expect when margins are raised and the farmer is forced to borrow $3 million or more to continue to hold his position? The cost to hedgers can be expected to be even more severe when the country is in the midst of a severe credit crunch.

Moreover, there is no evidence that artificially increasing performance bonds will drive well-capitalized index funds or other passive long-only investors to sell or that the impact of any such selling would be beneficial or positive for hedgers and commercial users of futures markets. Generally, these investors are not leveraged and are in the best position to margin up to 100 percent. Long index traders will not be driven from the market because they already have a fully collateralized account that is held on behalf of their clients. By increasing the amount of those funds that are required to be posted for margin, the index trader just transfers treasury bills from one account to an account accessible to the clearing house. There is no cost to this class of trader.

Performance bonds are designed to ensure that contractual obligations are met and that clearing houses can fulfill their responsibilities; they are not intended to create incentives or disincentives for trading decisions. Based on our strong track record of zero credit defaults in the 100-plus year history of CME Clearing, we believe our current system for calculating margin is the most prudent and sound approach to margining. Mandating arbitrary margin levels would not improve the functioning of energy and commodity futures markets and would interfere with the prudential risk management practices of central counterparty clearing houses.

Others have suggested excluding pension funds and index funds from participating in commodity futures markets. These funds are using commodity exposure to decrease volatility in their portfolios. Barring them from regulated U.S. futures markets will only push them offshore or into over-the-counter trading. These funds will continue to need commodities as an asset class and will need to find ways to invest on behalf of their clients. We believe it would be prudent to ensure this investment occurs on a regulated market instead of driving this capital into opaque markets.

CME Group has conducted a thorough review of the impact of index trading and speculative trading on its primary agricultural markets. We have found a negative correlation between price increases and index fund buying.

While we favor a broader study of the impact of index fund trading, we do not think it is appropriate to cast those funds as a villain in price inflation until the study is completed. Especially since in theory it is not likely that the index funds are having a detrimental impact. Index funds buy and hold. They may have some small impact on days when new money enters the market and they create additional net long positions, but those changes are transitory. The important statistic in this regard is new net positions not overall positions.

After the flow of new money into the market from the index funds, the price will, in the absence of other factors, revert to the equilibrium dictated by current supply and demand factors because the index traders simply sit and hold the positions until they roll to the next delivery month. Traders making informed trades should be expected to drive the market to equilibrium.

All price changes take place at the margin as those traders with information, meaning that they are hedging or expressing an opinion based on knowledge, buy and sell. Even if 30 percent of the open interest in a particular contract month of a commodity is held by index funds, buying and selling by a few traders based on need and knowledge drive the market to its fair equilibrium price. The open positions of the index traders have no impact on prices driven by informed trading activity.

Regulated futures markets and the CFTC have the means and the will to limit speculation that might distort prices or distort the movement of commodities in interstate commerce. Acting Chairman Lukken's recent testimony before the Subcommittee on Oversight and Investigations of the Committee on Energy and Commerce United States House of Representatives (December 12, 2007)[5] offers a clear description of these powers and how they are used.

CEA Section 5(d)(5) requires that an exchange, "[t]o reduce the potential threat of market manipulation or congestion, especially during trading in the delivery month . . . shall adopt position limitations or position accountability for speculators, where necessary and appropriate."

All agricultural and natural resource futures and options contracts are subject to either Commission or exchange spot month speculative position limits—and many financial futures and options are as well. With respect to such exchange spot month speculative position limits, the Commission's guidance specifies that DCMs should adopt a spot month limit of no more than one-fourth of the estimated spot month deliverable supply, calculated separately for each contract month. For cash settled contracts, the spot month limit should be no greater than necessary to minimize the potential for manipulation or distortion of the contract's or underlying commodity's price. For the primary agricultural contracts (corn, wheat, oats, soybeans, soybean meal, and soybean oil), speculative limits are established in the Commodity Exchange Act and changes must be approved via a petition and public rulemaking process.

With respect to trading outside the spot month, the Commission typically does not require speculative position limits. Under the Commission's guidance, an exchange may replace position limits with position accountability for contracts on financial instruments, intangible commodities, or certain tangible commodities. If a market has accountability rules, a trader—whether speculating or hedging—is not subject to a specific limit. Once a trader reaches a preset accountability level, however, the trader must provide information about his position upon request by the exchange. In addition, position accountability rules provide an exchange with authority to restrict a trader from increasing his or her position.

Finally, in order to achieve the purposes of the speculative position limits, the Commission and the DCMs treat multiple positions held on a DCM's market that are subject to common ownership or control as if they were held by a single trader. Accounts are considered to be under common ownership if there is a 10 percent or greater financial interest. The rules are applied in a manner calculated to aggregate related accounts.

Violations of exchange-set or Commission-set limits are subject to disciplinary action, and the Commission, or a DCM, may institute enforcement action against violations of exchange speculative limit rules that have been approved by the Commis-

[5] http://www.cftc.gov/stellent/groups/public/@newsroom/documents/speechandtestimony/opalukken-32.pdf.

sion. To this end, the Commission approves all position limit rules, including those for contracts that have been self-certified by a DCM.

It is clear that speculation is an important component of the futures markets, but there is a point when excessive speculation can be damaging to the markets. As a result, the CFTC closely monitors the markets and the large players in the markets, in addition to position and accountability limits, to detect potentially damaging excessive speculation and potential manipulative behavior.

THE CFTC'S EXCLUSIVE JURISDICTION OVER TRADING ON CFTC REGULATED MARKETS MUST BE PRESERVED

CME Group plans to join with other leading participants in the financial services industry to respond to the FTC's request for comments respecting its proposed rule respecting false reporting and manipulative activities in the wholesale oil market. We are concerned that the FTC's jurisdictional reach could come into conflict with the CFTC's exclusive jurisdiction respecting futures trading. While the statute very clearly limits the FTC's jurisdiction to conduct in connection with "the purchase or sale of crude oil, gasoline or petroleum distillates at wholesale," FERC, which has similar authority, has read "in connection with" to give it authority over conduct that took place entirely on a futures exchange.

In 1974, Congress recognized the overriding importance of entrusting to the expertise of the CFTC the exclusive regulatory authority over the Nation's futures markets. Congress preempted other Federal and State rules that would either assert parallel jurisdiction over the futures markets or produce conflicts with the CFTC regulatory regime. This system has produced the best regulated, most innovative and efficient futures market in the world.

As markets evolve and become more interrelated such agency "boundary disputes" can be expected and for the most part the agencies usually take pains to accommodate one another to allow each to accomplish the mission Congress mandated for them. We are concerned by the Federal Energy Regulatory Commission's (FERC) claim of jurisdiction in the Amaranth case, where the only manipulative trading alleged took place on a futures exchange. FERC has refused to recognize and yield to the CFTC's exclusive jurisdiction. The result is that participants in the natural gas futures markets no longer have legal certainty as to the legal standard governing their transactions.

The recently enacted farm bill demonstrates the continued vitality of the CFTC's exclusive jurisdiction. Congress reauthorized the CFTC for another 5 years and granted the CFTC new authority to regulate certain exempt commercial markets that are active enough to constitute price discovery markets.

POSITION LIMITS ON FOREIGN BOARDS OF TRADE LISTING CLONES OF U.S. DCM LISTED CONTRACTS

Position limits are a device to promote liquidation and orderly delivery in physical contracts. If two markets share the same physical delivery contract it is consistent to apply a single limit across both markets. However, we are not aware of a foreign board of trade that lists a physically deliverable futures contract that is a clone of a U.S. DCM's listed contract.

The ICE U.K. market lists a WTI crude oil contract that is traded and settled based on the settlement prices of the NYMEX WTI contract. The ordinary reasons for imposing position limits on futures markets do not apply in such a case. It is possible to imagine a trader who is long a limit position at NYMEX and double that position at ICE U.K. That trader might expect to profit, if not caught, by driving up the settlement price on the final day of trading on NYMEX by standing for delivery, even though he would be required to store and then sell the oil back at a loss, in the hope to profit from the settlement on ICE. Of course, such behavior will be obvious to the regulators and the markets and the manipulator would neither enjoy the profits nor much additional freedom. Moreover, the impact on the price of oil would be transitory.

Our theoretical understanding aside, we support a temporary imposition of position limits on the ICE Futures U.K. WTI contract until the CFTC is able to secure and analyze a more complete data set respecting the impact of speculation and/or indexed commodity trading on price inflation. We do not imagine that any harm will be done and this action will allay concerns.

THE EXEMPTION FOR COMMERCIAL MARKETS IN ENERGY PRODUCTS, EVEN AS LIMITED BY THE RECENT AMENDMENT OF THE CEA, IS UNNECESSARY AND CREATES INFORMATION GAPS

Section 5(b) of the Commodity Exchange Act charges the Commission with a duty to oversee "a system of effective self-regulation of trading facilities, clearing systems, market participants and market professionals" and to "to deter and prevent price manipulation or any other disruptions to market integrity; to ensure the financial integrity of all transactions subject to this chapter and the avoidance of systemic risk; to protect all market participants from fraudulent or other abusive sales practices."

These "purposes" and the statutory exemption for Commercial Markets found in Section 2(h)(3) are in conflict. The key purposes mandated by Congress in Section 5(b) are jeopardized if trading facilities for contracts in exempt commodities are permitted to coexist with regulated futures exchanges that list those same commodities. ECMs do not have any system of "effective self regulation" of their facilities or of their market participants. Their contracts are traded based on the prices of commodities that have limited supplies and that have often been the subject of manipulative activity and disruptive market behavior. There is no mechanism in place "to deter and prevent price manipulation or any other disruptions to market integrity." The Commission cannot track the build up of dominant positions. At best the Commission has power to punish such conduct after the fact. We find this to be a serious problem that is at odds with Congress's intent behind the CFMA, which, if left unaddressed, jeopardizes the public's confidence in the CFTC's ability to do its job.

The Section 2(h)(3) exemption for unregulated commercial markets should be eliminated. You can't fix the problem by merely changing reporting requirements. In order to secure accurate reports a market needs an effective surveillance and compliance system. This requires that an effective system of self regulation must be put in place. The logical conclusion is you must implement at least the core principles required of a DTEF to get a useful result.

In the aftermath of the Amaranth controversy, Congress provided CFTC new authorities in the farm bill to regulate "significant price discovery contracts" on platforms like ICE by requiring those platforms to meet certain core principles drawn from the longer list applicable to fully regulated exchanges. What is clear is that when Congress wants to insure fair dealing and regulatory propriety it uses as its comparative yardstick the regulatory regime imposed on America's fully regulated exchanges.

Trading that is conducted on fully regulated exchanges is an open book to which you already have complete access and accountability. Indeed, CFTC monitors that exchange trading daily and has repeatedly opined that speculation on those fully regulated exchanges does not raise regulatory concerns. But that is not the case with the other forms of energy commodity trading, which lie outside the reach of CFTC regulation and are far larger in size in terms of trading volume.

CONCLUSION

CFTC regulated futures markets have demonstrated their importance to the economy, the Nation's competitive strength and America's international financial leadership. Imposing arbitrary increases in margins in these markets, as has been suggested as a way to control prices, will result in the exportation of these markets to overseas competitors and to unregulated and non-transparent over-the-counter markets. We have the means and the power to protect markets against speculative excesses on our markets and are committed to doing so.

Similarly, James Burkhard, managing director of Cambrindge Energy Research Associates testified to the Senate Energy Committee on April 3, 2008 that: "In a sufficiently liquid market, the number and value of trades is too large for speculators to unilaterally create and sustain a price trend, either up or down. The growing role of non-commercial investors can accentuate a given price trend, but the primary reasons for rising oil prices in recent years are rooted in the fundamentals of demand and supply, geopolitical risks, and rising industry costs. The decline in the value of the dollar has also played a role, particularly since the credit crisis first erupted last summer, when energy and other commodities became caught up in the upheaval in the global economy. To be sure, the balance between oil demand and supply is integral to oil price formation and will remain so. But 'new fundamentals'—new cost structures and global financial dynamics—are behind the momentum that pushed oil prices to record highs around $110 a barrel, ahead of the previous inflation-adjusted high of $103.59 set in April 1980."

Senator DURBIN. Jim May is the President and Chief Executive Officer, Air Transport Association (ATA). Mr. May, thank you.

STATEMENT OF JAMES C. MAY, PRESIDENT AND CHIEF EXECUTIVE OFFICER, AIR TRANSPORT ASSOCIATION

Mr. MAY. Thank you, Mr. Chairman. In the interest of your time, let me abbreviate my written remarks and concentrate on a couple or three key issues.

First of all, it is my disturbing duty today to report to you that ATA has just changed its forecast for 2008, and we now project that this industry domestically is going to lose somewhere between $7 billion and $13 billion. That is a $10 billion midpoint, and if that is the case, it will be on par with the worst year in the history of this business.

Those numbers are due exclusively to the cost of fuel. We are going to spend $62 billion this year on fuel. By way of comparison, that is greater than the total of the 4 years in the first 4 years of this decade. We are going to spend $20 billion more than last year. So we have, as you might imagine, a rooting interest in what is going on here.

That is a worse shock than 9/11. It means that we are going to have some 14,000 to 15,000 employees who are going to have lost their jobs by the end of this year.

It means that as many as 200 United States communities will lose all air service. I counted up quickly this morning some 30 communities represented by members of this committee.

We are laying down older planes. We are eliminating orders for new aircraft. And it is a matter that impacts this industry dramatically.

Our average one-way fare—average across the country—is about $191 right now. Take out $25–$30 for taxes and fees, and we are spending $138 on fuel alone per passenger today. That leaves us with about $27 per passenger to cover every other expense in the business.

If Congress does not turn things around soon, the impact on the overall economy will be dramatic. This industry contributes well over $600 billion to the U.S. economy. That is 10 million jobs. And if we begin to cut back service to these small communities, especially small rural communities, across this country, it is going to have a devastating effect.

So I am sitting here listening to this testimony this morning. You have some stark fundamental choices. The first choice is status quo. We can continue to blame high oil prices on China and India and the weak dollar. Or you can look a little beyond that. You can study the problem and report back in 6 months or 6 weeks.

I note that the CFTC is going to report back sometime in September of this year. Well, I would suggest to you if status quo becomes the course of the day, we will not be here to see the results of it. There are already nine carriers that have declared bankruptcy. There will be others if the prices of oil continue at $135. Anything north of $100, they are going to continue.

Now, I do not come here as an expert in trading. You have got people on this panel who are experts and regulators. I can suggest to you that the president of Shell Oil is suggesting that the fundamental proper price for oil is somewhere between $35 and $65 a barrel. One of his colleagues said $90 a barrel. I can suggest to you that John Kilduff, who I think is a well recognized name in the business, M.F. Global Energy Risk, thinks that there is $20 to $30 a barrel that is a premium, if you will, for speculation. Goldman Sachs has expressed some concerns.

And I take you to something that you are familiar with, as I close it out, and it is the Senate Permanent Subcommittee on Investigations that all members and the staff are very well aware of. It has been around for years and years and always done great work. They say the following. Foreign exchanges such as ICE are allowed to accept energy trades from persons in the United States and elsewhere to "operate with no regulatory oversight, no obligation to ensure its products are traded in a fair and orderly manner, and no obligation to prevent excessive speculation." That is this Senate's Permanent Subcommittee on Investigations.

They go on and I will close with this because you have a very critical job in front of you. What do we do about these high oil prices? We know that there are many supply side solutions, conservation, others that are longer term, but immediate term, if there is an issue, what do you do? And I think that is not an easy task.

I would leave you with the findings of the permanent subcommittee. Congress needs to level the regulatory playing field between the NYMEX and ICE exchanges, increase energy price transparency, and strengthen the ability of the CFTC to analyze market transactions and police U.S. energy commodity markets.

Two, it is essential that CFTC have access to daily reports of large trades for energy commodities.

And three, surveillance tools have not matched the subsequent growth in commodity trading, electronic trading, speculative trading, et cetera.

Mr. Chairman, you have introduced legislation. I think at the last count, 37 of your colleagues in the Senate have introduced one form of legislation or another. We do not have as an industry time for status quo. We do not have time as an industry to wait. It is going to impact not just airlines, but the entire U.S. economy. Anything we can do to help you in your deliberations, we are happy to volunteer.

Senator DURBIN. Thank you, Mr. May. That was sobering testimony, but I am glad it is part of the record. And I hope all my colleagues will read it very closely.

[The statement follows:]

PREPARED STATEMENT OF JAMES C. MAY

Chairman Harkin, Chairman Durbin, and members of the committees, I welcome your leadership—in particular, Senator Durbin's—in examining the catastrophic impact of high fuel prices on the airline industry and the Nation's economy. I hope that the unusual nature of this combined Agriculture Committee and Appropriations Subcommittee hearing is an indication that Congress will move swiftly to find a solution.

My task today is to deliver what I consider to be an extremely disturbing report on the state of the Nation's airline industry. Today, we are revising our forecast: this country's airlines expect to lose in the range of $10 billion this year—a loss equal to or greater than the worst year in this industry's history. High fuel prices are the sole reason. This year, we will spend more than $60 billion on fuel, at least $20 billion more than last year and slightly more than our combined fuel bill for the first 4 years of this decade.

Sadly, 2008 could turn out to be the worst year in the industry's history. Unlike the temporary revenue hits from SARS, 9/11, and other one-time demand shocks, the airlines now are facing a massive structural increase—with no end in sight—in a virtually uncontrollable cost. Moreover, there is little low-hanging fruit left to harvest. Unfortunately, not even Chapter 11 can lower the price of fuel.

To many members of Congress, $10 billion is not a lot of money. Let me try to add some context. More than 14,000 airline jobs have been cut so far this year, and that is just the tip of the iceberg. It is not unrealistic to think that by cutting capacity, more than 200 communities could lose all commercial air service by early next year. Orders for new planes have been slashed and hundreds of older, less efficient planes have been taken out of service. We are burning through cash at unprecedented rates, barely surviving from month to month. The Nation's airlines will not ever fully recover from this economic blow, and more airlines—in addition to the eight that have already filed for bankruptcy or stopped operating—may simply shut down. That means even more job losses and untold harm to families and the economy.

I assure you that airlines are not gouging passengers with higher fares. As of June 1, analysts [Boyd Group] estimate the average gross fare, including all fees and taxes and all recent fare hikes, is $191. Eliminating fees and taxes brings it to $166. At current jet fuel prices, the cost of fuel per passenger is $138.80. That leaves only $27.37 to pay for every other cost—labor, airport fees, insurance, and facilities, to name but a few.

Committee members and Congress, for that matter, may ask why the country should care that its airlines are on the brink of financial disaster and—some would say—about to implode. The answer is simple: this Nation's economy is inextricably linked to the viability of its air transportation system. If the airlines continue to spiral downward, so will the economy. Aviation contributes $690 billion to the U.S. GDP—that's equal to heating oil costs for 376 million households for one winter, 24 million new cars, and 10 million new jobs.

If Congress does not turn things around very soon, the impact on the country's economy will be even worse. Analysts are predicting that a 20 percent reduction in capacity may not be enough to save the industry. If 200-plus communities lose all service, airline hubs will be decimated, tens of thousands more jobs will be eliminated, and tourist destinations will be devastated by huge cuts in the number of flights. Realistically, rural areas will be hit the hardest by the cuts, leaving thousands of square miles without air service.

This is not what we want to happen in this country. Ask any local chamber of commerce and they will tell you that convenient air service is absolutely critical to economic growth. Without it, businesses are isolated, communities fade away because they never recover from staggering job losses.

Mr. Chairmen, Congress has a choice: stay with the status quo or make the hard decisions. The status quo means continuing to blame high oil prices on the weak dollar and growing demand from China and India. Status quo means forming yet another commission or task force to study the problem and report back in 6 months. The airlines won't be around much longer if the status quo wins the day.

I am not an expert in the trading of energy commodity futures. In addition to the supply-side solutions where relief is on the long-term horizon, leading commodities experts believe that crude oil prices today are unnecessarily high due, in large part, to excessive market manipulation for which there are short-term solutions. As these experts tell us:

—The proper range for oil prices should be "somewhere between $35 and $65 a barrel."—John Hofmeister, President of Shell Oil Co.

—There may now be upwards of $25 to $30 of speculation in the price of crude, which continues to soar despite soaring stockpiles in the United States.—MF Global Energy Risk Management Group

—The increasing prevalence of futures contracts has transformed the nature of oil markets. It is no longer only about the value of oil as an energy commodity, but also . . . oil as a financial asset.—Goldman Sachs

—If the crude oil market is not physically tight now, there is at least a belief on the part of a bullish speculator that it will become so later. What has driven the market so far, so far, in our view, is that such a high percentage of the speculative trade has become aligned in one direction.—Tim Evans, Citi Futures Perspective

—It also seems hard to dispute that the growth in the size of futures and options trade has something to do with the price movement . . . [W]e believe that growth in NYMEX trade has certainly made it more dominant relative to the physical market in setting prices than in the past.—Tim Evans, Citi Futures Perspective

Mr. Chairmen, this country does not need another Enron scandal. Enron destroyed its pensions, its investors and its employees. One of the most disturbing aspects of the current energy market is that studies have shown that the airline and other transportation industries such as trucking have been victimized by loopholes in the law. We have to restore CFTC's authority to prevent improper and excess speculation in the energy sector. Foreign exchanges, such as ICE are allowed to accept energy trades from persons in the United States, and elsewhere, and "to operate with no regulatory oversight, no obligation to ensure its products are traded in a fair and orderly manner, and no obligation to prevent excessive speculation." Mr. Chairman, that quote is from the Senate Permanent Subcommittee on Investigations. Some aspects of problems caused by the Enron loophole were addressed in the farm bill—and those reforms are a good step forward—but more legislative changes are needed.

Mr. Chairmen, all we are seeking are common-sense measures to ensure transparency and an even footing between traders and speculators. I defer to your insight on ways to increase transparency and fairness in the energy commodity futures market—to reel back the overwhelming odds now favoring speculators and institutional investors, particularly those trading on foreign exchanges.

We need action, not more studies or expert commissions. Many have suggested a way forward: totally close the loopholes that permit large institutional traders to avoid any real oversight or financial requirements; curtail extremely risky investments by pension funds that jeopardize savings for employees across the country; eliminate trading advantages for the huge speculative traders over those who plan to use the products they buy rather than trading them over and over again for unbelievable profits; and make the commodity market true to supply-and-demand fundamentals.

As the Permanent Subcommittee on Investigations of the Senate Homeland Security and Government Affairs Committee found:

—Congress needs to "level the regulatory playing field between the NYMEX and the ICE exchanges, increase energy price transparency, and strengthen the ability of CFTC to analyze market transactions and police U.S. energy commodity markets."

—It is "essential" that CFTC have "access to daily reports of large trades of energy commodities . . . to deter and detect price manipulation."

—CFTC "surveillance tools have not matched the subsequent growth in commodity trading, electronic trading and speculative trading, especially for energy products." "The energy futures market is really about whether families will be able to afford to heat their homes and fill up at the pump." "More and more trading occurs on electronic markets without oversight."

Mr. Chairmen and committee members, your leadership and insight are greatly appreciated.

As I said at the beginning of my remarks, if Congress does not act soon, this country will not have a viable airline industry. Thank you.

Senator DURBIN. Dr. James Newsome is CEO and President of the New York Mercantile Exchange. Dr. Newsome.

STATEMENT OF DR. JAMES NEWSOME, PRESIDENT AND CEO, NEW YORK MERCANTILE EXCHANGE

Dr. NEWSOME. Thank you, Mr. Chairman, Senator Lugar. On behalf of the New York Mercantile Exchange, thanks for the opportunity to appear before this joint committee to address what we believe are the most important issues facing the global and domestic economies, as well as those of U.S. customers.

The Senate Agriculture Committee was primarily responsible for the drafting and passage of the Commodity Futures Modernization Act of 2000, still recognized as the gold standard for U.S. financial policy. I would like to share partial ownership as chair of the CFTC who was responsible for implementing that act in 2000. 99 percent of this act holds true today as outstanding policy. However, we did not have a crystal ball and it was impossible to determine how some markets would develop. And on at least two occasions, markets have developed differently than anyone anticipated.

First, the development of the over-the-counter natural gas market after the collapse of Enron which became much more exchange-like and actually started contributing to price discovery. This scenario was investigated by Senator Levin's office after the implosion of Amaranth and was addressed with the passage of this latest farm bill.

Second, the listing of U.S.-delivered energy contracts by foreign boards of trade under their no action authority without the transparency and position limits provided by U.S. exchanges to the CFTC. NYMEX began raising this issue 2 years ago and today it must be addressed.

We believe there are two important policy components.

One, transparency. Complete transparency is fundamental for competitive markets. The same large trader reporting for all U.S. and foreign boards of trade trading U.S. products is critical for the CFTC to determine whether there is either manipulation or substantive speculative activity. Further delineation of large trader reports to include customer positions behind swap dealers and the banks we think is imperative to addressing overall transparency.

Second, position limits. If a foreign board of trade decides that it wants to list U.S.-delivered contracts, which it has the right to do, then they must abide by U.S. position limits to control speculative activity just as U.S. exchanges currently do.

Finally, with regard to the CFTC resources, we believe that the CFTC has long been on a downward spiral regarding real resources and personnel. This has to be addressed. You are addressing it, and it is supported fully by the New York Mercantile Exchange.

Thank you, Mr. Chairman.

Senator DURBIN. Thank you very much.

[The statement follows:]

PREPARED STATEMENT OF DR. JAMES NEWSOME

Mr. Chairman and participants in this joint hearing, 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 committees for holding today's hearing on the role, responsibilities and resource needs of the CFTC, with particular focus on the oversight of energy markets and oil futures contracts. In the last several years, trading volume on regulated markets has expanded dramatically, yet, according to published reports, the CFTC's current staffing levels fall even below the levels in place when the agency commenced operations over 30 years ago. Like most industry participants, we believe that the Commission is doing a fine job in the face of severe budget, staffing and technology constraints.

We also believe that a compelling case can be made for immediate increases in the size of the CFTC's operating budget. My own views on the need for remedying this mismatch between duties and resources stem in part from my service as Chairman of the CFTC from 2002–2004 during the period when we were continuing to implement the provisions of the landmark Commodity Futures Modernization Act of 2000 (CFMA). As anticipated, that law brought new competition and enhanced innovation in derivatives markets, which contributed to the explosion in trading volume. It is imperative that the CFTC have all of the tools that it needs to carry out fully its obligation to maintain the integrity of U.S. futures markets.

BACKGROUND

NYMEX energy futures markets are highly liquid and transparent, representing the views and expectations of a wide variety of participants from every sector of the energy marketplace. Customers from jurisdictions around the globe can submit orders for execution on Globex. The price agreed upon for sale of any futures contract trade is immediately transmitted to the Exchange's electronic price reporting system and to the news wires and information vendors who inform the world of accurate futures prices.

Price signals are the most efficient transmitters of economic information, telling us when supplies are short or in surplus, when demand is robust or wanting, or when we should take notice of longer-term trends. NYMEX futures markets are the messengers carrying this information from the energy industry to the public. The wide dissemination of futures prices generates competition in the establishment of current cash values for commodities.

Analysis of the actual market data from the regulated exchange, which is the best evidence available to date, indicates that prices in our markets continue to be determined by fundamental market forces. Specifically, uncertainty about the availability of supply due to political and security factors, uncertainty about the actual levels of continuing growth of demand in developing parts of the world, and uncertainty about currency fluctuations materially weigh into the fundamental analysis.

In addition, the available data indicate that commercials continue to provide the majority of open interest in crude oil futures. Moreover, the extent of non-commercial participation in crude oil as a percent of open interest on NYMEX has actually declined over the last year. There is no evidence to date either that the trading by non-commercials has impaired the price discovery function of our markets.

NYMEX is the benchmark for energy prices around the world. Trading on NYMEX is transparent, open and competitive and highly regulated. NYMEX does not trade in the market or otherwise hold any market positions in any of its listed contracts, and, being price neutral, does not influence price movement or set prices for commodities trading on the exchange. Instead, NYMEX provides trading forums that are structured as pure auction markets for traders to come together and to execute trades at competitively determined prices that best reflect what market participants think prices will be in the future, given today's information.

The public benefits of commodity markets, including increased market efficiencies, price discovery and risk management, are enjoyed by the full range of entities operating in the U.S. economy, whether or not they trade directly in the futures markets. Everyone in our economy is a public beneficiary of vibrant, efficient commodity markets, from the U.S. Treasury, which saves substantially on its debt financing costs, to every food processor or farmer, every consumer and company that uses energy products for their daily transportation, heating and manufacturing needs, and anyone who relies on publicly available futures prices as an accurate benchmark. Legislative proposals intended to decrease overall liquidity and/or speculative participation, such as substantially increasing margin levels, would greatly harm the regulated market and damage the all important hedging and price discovery functions that provide important benefits to consumers and to the economy as a whole.

MARKET OVERSIGHT AND TRANSPARENCY

NYMEX has a strong historic and ongoing commitment to its self-regulatory organization responsibilities. The NYMEX regulatory program has a current annual budget of approximately $6.2 million, which reflects a significant commitment to both staff and technology. Generally NYMEX must comply with a number of broad, performance-based Core Principles applicable to DCMs that are fully subject to the CFTC's regulation and oversight. Of particular note is the series of Core Principles that pertain to markets and to market surveillance. A DCM must monitor trading to prevent manipulation, price distortion and disruptions of the delivery or cash-settlement process. Furthermore, to reduce the potential threat of market manipulation or congestion, the DCM must adopt position limits or position accountability for a listed contract, where necessary or appropriate.

NYMEX has numerous surveillance tools that are used routinely to ensure fair and orderly trading on our markets. The principal tool that is used by DCMs to monitor trading for purposes of market integrity is the large trader reporting system. For energy contracts, the reportable position levels are distinct for each contract listed by the Exchange for trading. The levels are set by NYMEX and are specified by rule amendments that are submitted to the CFTC, following consultation and coordination with the CFTC staff. The reportable level for the NYMEX physically delivered crude oil contract is 350. The NYMEX Market Surveillance staff routinely reviews price activity in both futures and cash markets, focusing on whether the futures markets prices are converging with the spot physical market as the NYMEX contract nears expiration.

Large trader data are reviewed daily to monitor reportable positions in the market. On a daily basis, NYMEX collects the identities of all participants who maintain open positions that exceed set reporting levels as of the close of business the prior day. These data are used to identify position concentrations requiring further review and focus by Exchange staff.

By rule, NYMEX also maintains and enforces limits on the size of positions that any one market participant may hold in a listed contract. These limits are set at a level that restricts the ability of speculators to carry large positions on NYMEX and also restricts the opportunity to engage in possible manipulative activity on NYMEX. Futures markets traditionally list futures and options contracts as a series of calendar contract months. For an expiring contract month in which trading is terminating, NYMEX uses a hard expiration position limit. The hard position limit for the NYMEX physically settled crude oil contract (CL futures) is 3,000 contracts. Breaching the position limit can result in disciplinary action being taken by the Exchange.

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. 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.

For back months of the CL futures contract, NYMEX currently maintains an any-one-month/accountability level of 10,000 contracts and an all-months-combined position accountability level of 20,000 contracts. When position accountability levels are exceeded, Exchange staff conducts heightened review and possible inquiry into the nature of the position which ultimately may result in NYMEX staff directing the market participant to reduce its positions.

RECENT CFTC ANNOUNCEMENT

The CFTC recently announced several new initiatives to increase the transparency of energy futures markets. NYMEX has advocated for greater transparency of futures activity linked to U.S. exchanges occurring on markets regulated by foreign regulators. We support the initiatives put forward by the Commission, which can only enhance the CFTC's regulatory mission.

One initiative is intended to expand information-sharing received from the U.K. Financial Services Authority for surveillance of energy commodity contracts with U.S. delivery points, including West Texas Intermediate crude oil futures contracts. The agreement includes implementing expanded information-sharing to provide the CFTC with daily large trader positions in the U.K. WTI crude oil contracts. NYMEX believes that including large trader reporting is an important market surveillance tool that provides important transparency to the market and to regulators.

NYMEX has advocated similar requirements for certain contracts traded on exempt commercial markets (ECM) and for foreign boards of trade (FBOT) that offer energy commodities with U.S. delivery points, such as the ICE Futures WTI contract. Position accountability levels and large trader reporting requirements, among others, were recently adopted into law for certain contracts traded on ECMs as an amendment to the farm bill. We believe that this new law will address the significant regulatory gap identified in the context of the Amaranth collapse.

NYMEX continues to believe that the same requirements should be imposed on FBOTs for contracts that directly affect U.S. consumers and the economy as a whole, such as the ICE WTI futures contract. Two years ago, the CFTC had authority over and could directly see 100 percent of the futures trading activity in the WTI futures contract. Today they regulate and can only directly see approximately 70 percent of that market. Thus, NYMEX believes that the "no-action" letter under which ICE Futures lists the WTI contract should be conditioned to require: (1) position accountability levels and/or position limits, as appropriate; and (2) large trader reporting. These requirements should mirror the requirements imposed on U.S. designated contract markets.

As noted above, another fundamental market surveillance and integrity tool is the use of position accountability levels and position limits. We believe strongly requiring FBOTs offering contracts with U.S. delivery points to impose position limits and/or accountability levels would be enormously positive and would strengthen the overall integrity of energy futures markets. This is particularly true when the contract trading on the FBOT has a U.S. delivery point and has a price that is linked to the settlement price of a U.S. regulated contract, such as the ICE WTI futures contract.

Moreover, 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. Some commentators have recently made sweeping assertions regarding the impact of index traders on the basis of distorted and patently erroneous information. Consequently, the Exchange 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. We look forward to the implementation of this proposal.

Finally, in response to the CFTC's extraordinary step of publicly acknowledging an ongoing investigation into crude oil practices generally, we have reaffirmed our long-standing commitment to provide full assistance to the CFTC on enforcement matters in order to ensure the integrity of U.S. markets.

FOREIGN BOARDS OF TRADE

While much of the focus on Capitol Hill has been on domestically based ECMs, similar issues potentially could arise with regard to U.S.-based products that are listed for trading on FBOT. As a note, NYMEX has long been a champion of vigorous competition and of greater globalization of services and products. As a rapidly growing global market presence, we have offices in London and Singapore.

We also note that there have been substantial advances in technology since the former era of closed end proprietary trading systems. New exchanges have emerged that operate on a solely electronic basis, and products have now been listed under the CFTC staff no-action process that are parallel (if not identical) to other products listed by existing U.S. exchanges that are subject to full CFTC regulation.

NYMEX believes that it would be prudent from time to time for the Commission or Commission staff to conduct a thorough review of foreign markets operating in the U.S. under existing staff no-action letters. A primary goal should be a "regulatory gap" analysis that can identify significant regulatory differences in the foreign board of trade's program that may raise significant market oversight and transparency concerns for U.S. regulators. The Commission should adopt a measured approach that will protect the regulatory and public policy objectives that have been tried and proven over the years, and that will further enhance the strong relationships developed with other international regulators.

In our recent experience, "regulatory arbitrage" is not a hypothetical concern but is actually already underway for certain of our listed products. This process could actually harm markets because of the distortion of market efficiency occurring when customers make choices among the same or similar products on the basis of differences in regulatory treatment among providers rather than on the basis of intrinsic distinctions in the products themselves or in related services. In addition, regulatory arbitrage potentially diminishes the breadth and depth of the CFTC's regulatory authority and, consequently, reduces much needed market transparency.

MARKET ANALYSIS OF THE CFTC-REGULATED ENERGY EXCHANGE

NYMEX staff monitors the supply and demand fundamentals in the underlying cash market to ensure that NYMEX futures prices generally are consistent with ongoing, cash market price movements and that there are no price distortions. In a highly transparent, regulated and competitive market, prices are affected primarily by fundamental market forces. Currently, uncertainty in the global crude market regarding geopolitical issues, refinery shutdowns and increasing global usage, 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.

Before turning to analysis of specific market factors, we note an article that appeared last month in the Wall Street Journal (WSJ). The WSJ conducted a survey from May 2–6, 2008 of 53 economists. According to that survey, the majority of economists have concluded that "the global surge in food and energy prices is being driven primarily by fundamental market conditions, rather than an investment bubble." "Bubble is not Big Factor in Inflation," May 9, 2008, page A–2. Fifty-one percent of those respondents said that demand from India and China was the prime factor in soaring energy prices, and 41 percent said that demand was the chief contributor to rising food costs. Constraint in supply was cited second most often; 20 percent blamed supply problems for higher food prices, and 15 percent for increasing energy prices. One economist noted that it was a combination of demand and supply issues.

The demand and supply fundamentals in the oil markets continue to be the driving factors in high oil prices. In a recent Energy Information Administration (EIA) Short-Term Energy Outlook, published on May 6, 2008, the demand and supply situation is summarized as follows:

> "The oil supply system continues to operate at near capacity and remains vulnerable to both actual and perceived supply disruptions. The supply and demand balance for the remainder of the year is tighter than in last month's Outlook. World oil markets are particularly tight during the first half of 2008, with year-over-year growth in world oil consumption outstripping growth in non-Organization of the Petroleum Exporting Countries (OPEC) production by over 1 million barrels per day. The combination of rising global demand, fairly normal seasonal inventory patterns, slow gains in non-OPEC supply, and low levels of available surplus production capacity is providing firm support for prices."

I wish to highlight this finding: growth in consumption has outstripped growth in non-OPEC production by over 1 million barrels per day. That is substantially tighter than a snug fit. Indeed, that may be said to be more akin to a chokehold. Conventional wisdom, borne out by substantial experience from over seas as well as here in North America, is that the short-run worldwide demand for petroleum products such as gasoline—especially retail demand—is highly inelastic: consumption does not decrease by much in the face of significant price rises. With projected demand exceeding supply by 1 million barrels per day, the only way a market with highly inelastic demand will equilibrate is through a substantive rise in price. The upward pressure has been there and, according to these projections, will continue to be there.

DEMAND

At NYMEX, we understand the difficulty of assembling accurate and timely information on non-OECD petroleum consumption and the corresponding challenge in projecting non-OECD consumption. However, the latest EIA Short-Term Energy Outlook projections provide important insight into the current state of global demand. EIA projects that world oil demand will grow by 1.2 million barrels per day in 2008, up a healthy 1.4 percent, with China accounting for 35 percent of this demand growth. The EIA predicts China's oil consumption will rise by 0.4 million barrels per day in 2008, up 5.6 percent from its record-high levels achieved in 2007. Almost all of the oil growth in 2008 is projected to come from the non-OECD countries, led by China, India, Middle Eastern countries, and Russia. U.S. oil demand is actually projected to decline slightly by 0.9 percent in 2008.

As a practical consideration, the most accurate data on energy consumption applies to the United States, followed by the OECD. However, the strongest source of projected energy demand is from the far-less visible reaches of developing countries such as China, India and the Middle East. While we respect EIA's efforts to project these numbers, we would caution anyone on oversimplifying the challenge of accurately assessing the demand in these countries, much less projecting it. The only thing we can be certain of is the relentless increase in petroleum demand pushed each year by the millions of people making the transition from less-developed circumstances to the beginnings of middle-class circumstances.

Currently, China is putting more than 8 million new cars on the road each year. Does anyone doubt that the average driver is increasing his/her amount of driving each year? India, the Middle East and Russia are experiencing similar transitions. We believe the sheer uncertainty around consumption in these economies, in combination with the extremely tight world market conditions, is a strong influence on price volatility in the world oil market. In concert with the tight market conditions and inelastic demand for petroleum products we highlighted above, that volatility is oscillating around ever increasing prices.

It is key to realize that the market tightness and the market's struggle to discern actual demand in growing and developing economies are both fundamental influences in the world oil market. The most visible signs of these conditions are the transparent market mechanisms that reside in the world today, such as NYMEX's futures and options markets, where prices are discovered and risk is managed. These mechanisms operate immediately. Compare that to fundamental market information, such as the consumption data referred to above. Consumption data, even for the most advanced economies that have been collecting these data and refining the process for collecting these data for decades (by the International Energy Agency), are provided on a preliminary basis 6 weeks after the fact. The data are then further refined 4 weeks later and again four weeks after that; all of this for a monthly statistic, which at the time of the final revision is 14 weeks after the month.

When you add onto that process the fact that the most dynamic component of consumption emanates not from those economies but from others where data collection is materially less advanced and the quality of the data much less certain, then the importance of immediate price discovery and transparency becomes even more evident. In a tightly supplied market where demand is highly inelastic, the only check on rising prices is competition and the price transparency and market liquidity that provide the support for it. Anything that reduces price transparency and liquidity under these market conditions will result in shifting price discovery to the collection of uncoordinated, opaque and, at times, esoteric mechanisms that comprise the cash market that provides limited transparency; a market not informed by the immediate discovery of value but by the relatively untimely release of fundamental information that is of uncertain quality and that provides limited transparency.

SUPPLY

On the supply side, global production of crude oil was relatively flat in 2007, despite rising demand and rising prices. It is important to note that this rising demand did not provoke a significant supply response. The EIA Short-Term Energy Outlook points to the slow growth in non-OPEC oil supplies, along with the OPEC quota constraints, which have given "firm support for prices."

Further, the geopolitical risks provide added uncertainty to the oil supply outlook. Moreover, various state-owned oil companies have not been investing adequately in oil production. Venezuela nationalized assets owned by U.S. oil companies and has generally proved to be an unreliable partner. Mexico's major oil field has been depleted, and Mexico will not allow United States companies to engage in deep water drilling. Colombian rebels have been blowing up pipelines with some frequency, and are being financially backed by the Venezuelan Government. Nigerian rebel forces routinely shut down oil fields—either through strikes, terrorism or sabotage. Russia has suffered a decline in production. Finally, U.S. production has declined dramatically in the past 20 years, and promising new drilling areas are generally not being opened up in this country due to environmental considerations.

In addition, the price for crude in Euros has risen, but much more modestly. For instance, the last time the Dollar and Euro were exchanged at par was during December 2002 when the spot price of oil was about $27 per barrel. By the end of April 2008, the price of oil in Dollars had risen 340 percent while the price in Euros had risen 180 percent, a substantial difference. Attached is a chart showing the price of oil in Dollars and Euros since 2000. So, while supply and demand fundamentals are the major determinants of price, at the margin, as the value of the dollar goes down, it may be providing some upward pressure on the price of oil in dollars so that it stays constant in value with the value of crude in Euros.

In the face of these market factors, NYMEX provides a level of economic stability to the market by offering a reliable and well-regulated price discovery and risk management mechanism. Our highly transparent, open and competitive market continues to work according to design.

ANALYSIS OF PARTICIPATION IN NYMEX'S CRUDE OIL FUTURES CONTRACT

Data analysis conducted by our Research Department indicates 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. NYMEX staff 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. The review period commenced at the beginning of 2006 and continues through to the present. During the last year, commercial longs and shorts consistently have comprised between 60 and 70 percent of all open interest.

On the other hand, non-commercial longs and shorts consistently have been in the range of 25–30 percent of the open interest Thus, non-commercials holding long or buy positions have not been participating in the market to the extent that they could have a significant impact on market price. Moreover, as noted, the extent of non-commercial participation in the crude oil energy futures contract has actually declined since the levels observed last summer. It should also be noted that the percentage of non-commercial longs (as a percentage of all long or buy open positions) is generally within just a few percentage points of the percentage of non-commercial shorts (as a percentage of all short or sell positions). In other words, non-commercial participants are not providing disproportionate pressure on the long or buy side of the crude oil futures market. Instead, non-commercials are relatively balanced between buy and sell open positions for NYMEX crude oil futures. In addition, "hedge funds" identified in analysis conducted by NYMEX staff only accounted for approximately 5 percent of the total volume in the NYMEX Light Sweet Crude Oil contract in 2007.

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. At NYMEX, margin generally is collected to cover a 99 percent probability of a likely 1-day price move, based on an analysis of historical and implied data.

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. We believe that this approach is misguided. As previously noted, in a highly transparent, regulated and competitive market, prices are affected primarily by fundamental market forces and imposing more onerous margin levels will not affect price levels. Currently, uncertainty in the global crude market regarding geopolitical issues, refinery shutdowns and increasing global usage, as well as devaluation of the U.S. Dollar, are now market fundamentals. 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 venues and onto less regulated and more opaque overseas markets.

Finally, Exchange staff has examined trends in margin levels at the Exchange going back to early 2000. The data clearly indicate that higher margin levels lead rather than follow increases in the price of crude oil futures products. In other words, when Exchange staff, in exercising their independent and neutral business judgment, determined to increase margin levels in response to changes in crude oil volatility levels, the higher margin levels were followed not by lower prices but instead by yet higher crude prices.

CONCLUSION

At all times during periods of volatility in the market, NYMEX has been the source for transparent prices in the energy markets as well as the principal vehicle by which market participants achieve stability. Futures markets provide the means by which to achieve price certainty and lock-in prices. Our price reporting systems, which provide information to the world's vendors, have worked flawlessly and without delay. The NYMEX marketplace continues to perform its responsibility to provide regulated forums that ensure open, competitive and transparent energy pricing. The market uncertainty and mayhem and further devastation to consumers that would unfold is clear if NYMEX were unable to perform its duty and prices were determined behind closed doors. Policies that would inevitably result in reducing transparency and liquidity would only succeed in conferring market power unto those who would benefit from price increases in the crude oil market, a market that is so prominently characterized by the inflexible demand of its end-users. Transparency and liquidity are the foundation that supports competition in the oil market.

Over the last several years, NYMEX has worked closely with congressional leaders providing information and other assistance on legislative initiatives that would add greater transparency to unregulated derivatives venues. We believe that these measures reflect a consensus regarding the need for greater transparency and oversight for certain specified products now trading in unregulated over-the-counter electronic trading markets.

We also hope that Congress does not misinterpret the lessons of the recent past by moving to impose new arbitrary and onerous burdens on futures exchanges, which are the most highly regulated and transparent segment of U.S. derivatives markets. Such steps would shift trading from regulated and transparent markets to unregulated and nontransparent markets and, thus, would constitute a significant step backward in transparency and market integrity. As markets continue to evolve, there is a regulatory and public interest rationale for increasing transparency in other venues in order to ensure that the CFTC has the data it needs to properly carry out its statutory duties.

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 committees may have.

Senator DURBIN. Mr. Vice is President and Chief Operating Officer of the Intercontinental Exchange. Thank you for joining us.

STATEMENT OF CHARLES A. VICE, PRESIDENT AND CHIEF OPERATING OFFICER, INTERCONTINENTAL EXCHANGE

Mr. VICE. Thank you, Chairman Durbin.

ICE operates several global futures marketplaces and OTC derivatives markets across a variety of product classes, including agricultural and energy commodities, foreign exchange and equity indexes. Headquartered in Atlanta, ICE has large offices in New York and London and smaller presences in several other cities around the world.

ICE owns and hosts four separate markets on its trading and clearing platforms, three regulated futures exchanges that were separately acquired over the last 7 years and one over-the-counter market.

My brief remarks today will focus on our energy futures exchange, ICE Futures Europe, acquired by ICE in 2001. Founded in London 27 years ago as the International Petroleum Exchange, this market is a recognized investment exchange, or RIE, under the supervision of the U.K. Financial Services Authority. Though a subsidiary of ICE, ICE Futures Europe has its own majority independent board and separate regulatory and operational staff. This degree of separateness from the parent group is mandated by the FSA in order for the exchange to maintain its status as a recognized body and self-regulatory organization.

As the home of the Brent crude and gas oil futures contracts, ICE Futures Europe has, since its inception, been the leading energy futures exchange in Europe. To complement its Brent crude contract, the exchange in 2006 added a future that settles on the next-to-last day settlement price as set somebody the NYMEX west Texas intermediate crude oil contract. Since the launch of electronic trading by NYMEX on CME's trading system, most of the growth in trading of WTI crude oil has been on the NYMEX rather than the ICE market. Nevertheless, the ICE WTI contract is an important contract for ICE Futures Europe as it is used by commercial participants to hedge exposure to small differences in WTI and Brent prices. Notably, NYMEX similarly offers a cash-settled Brent crude oil future settling on ICE Futures Europe's final settlement price for precisely the same reason.

Today ICE has a relatively small 15 percent share of total WTI futures equivalent open interest while NYMEX retains the remaining 85 percent.

ICE Futures Europe provides access to traders in the United States as a foreign board of trade operating under a CFTC no action letter issued in 1999 and amended several times. In granting a no action letter, the CFTC examines our trading status, our exchange's status in our home jurisdiction, and our rules and enforcement. Since Congress created this framework, the CFTC has granted no action relief to at least 20 foreign boards of trade.

Other countries have reciprocal policies in place upon which U.S. exchanges like the CME, NYMEX, and ICE Futures U.S. rely to offer access to their markets in more than 50 jurisdictions around the world. Disregard for this mutual recognition system would impair the competitiveness of U.S. exchanges abroad and represent a major step back for global cooperation and information sharing.

Consistent with this framework, ICE Futures Europe shares WTI trader positions with the CFTC through the agency's memorandum of understanding with the FSA. We require daily large trader reporting for members of all contract positions in nearby months that are over a given threshold, which for WTI is 100 lots. Where such positions are not held for members on account, members are responsible for reporting the name of their customer who holds the position. This information is collected on a daily basis and shared with the FSA and for our WTI contract, the CFTC.

ICE Futures Europe recently agreed to enhance this reporting to including WTI positions for all contract months and to notify the CFTC if a trader exceeds position accountability levels similar to those on U.S. exchanges. I would note as of today with the modified no action letter by the CFTC, this goes even further to actually place position limits and accountability limits that we administer on that WTI contract.

Much like the CFTC, the FSA is a principles-based regulator. As such ICE Futures Europe must comply with core principles that are similar to those imposed on CFTC-regulated exchanges. As an REI, ICE Futures Europe maintains a robust market monitoring program and has rules to prohibit and penalize misconduct. Market surveillance staff monitor trading on a real-time basis and review activity to identify any unusual trading patterns that warrant further investigation. Our systems maintain a detailed audit trail of every order and trade. For all contracts, ICE Futures Europe has the authority to take disciplinary action against its members and to order a member to reduce the size of a position that it considers to be too large. This is principally of concern in physically delivered contracts.

In concluding, ICE remains a strong proponent of open and competitive markets and of appropriate regulatory oversight of those markets. We recognize the severe impact of high crude oil prices on the U.S. economy and understand the congressional desire to leave no stone unturned. However, with a mere 15 percent share of global WTI open interest on a futures equivalent basis, we feel it is highly unlikely that the ICE Futures WTI market is the primary driver of WTI prices.

Furthermore, we note that prices for virtually all agricultural and natural resource futures contracts, not to mention non-exchange traded commodities, have surged at rates similar to crude oil and in some cases even more sharply and with greater volatility. Since none of these other commodities are known to feature a foreign board of trade offering a futures settling on a U.S. contract, it seems highly unlikely that the small differences in United States and United Kingdom regulation account for much, if any, of the dramatic rise in the price of WTI crude oil.

Despite our view that additional restrictions on ICE Futures Europe are unlikely to lower oil prices, we nonetheless look forward to working with Congress and the CFTC to ensure that their concerns with regard to our WTI contract are fully addressed while remaining fully compliant with obligations to our home regulator, the FSA.

Thank you.

[The statement follows:]

PREPARED STATEMENT OF CHARLES A. VICE

Chairman Durbin and Chairman Harkin, Ranking Members Chambliss and Brownback, I am Chuck Vice, President and Chief Operating Officer of the IntercontinentalExchange, Inc., or ICE. We very much appreciate the opportunity to appear before you today to give our views on energy markets.

ICE operates a leading global marketplace in futures and OTC derivatives across a variety of product classes, including agricultural and energy commodities, foreign exchange, and equity indexes. Commercial hedgers use our products to manage risk and investors provide necessary liquidity to the markets. Headquartered in Atlanta, ICE has offices in New York, Chicago, Houston, London, Singapore, Winnipeg, and Calgary.

ICE owns and hosts four separate markets on its electronic trading platform—three regulated futures exchange subsidiaries which were individually acquired over the last 7 years and one over the counter energy market, which operates under the Commodity Exchange Act (CEA) as an "exempt commercial market," or ECM. ICE's regulated futures exchanges include ICE Futures Europe, formerly known as the International Petroleum Exchange, which is a Recognized Investment Exchange, or RIE, headquartered in London and under the supervision of the U.K. Financial Services Authority (FSA); ICE Futures U.S., formerly known as The Board of Trade of the City of New York (NYBOT), which is a CFTC-regulated Designated Contract Market (DCM) headquartered in New York; and ICE Futures Canada, formerly known as the Winnipeg Commodity Exchange, which is regulated by the Manitoba Securities Commission and headquartered in Winnipeg, Manitoba.

ICE has always been and continues to be a strong proponent of open and competitive markets in energy commodities and related derivatives, and of appropriate regulatory oversight of those markets. As an operator of global futures and OTC markets and as a publicly-held company, we strive to maintain the utmost confidence in the integrity of our markets and in the soundness of our business model. To that end, we have continuously worked with the CFTC, the FERC, and regulatory agencies abroad in order to ensure that they have access to all relevant information available to ICE regarding trading activity on our markets and we will continue to work with all relevant agencies in the future.

ICE FUTURES EUROPE

I would like to take the opportunity today to discuss ICE's U.K. exchange subsidiary, ICE Futures Europe. ICE Futures Europe, formerly known as the International Petroleum Exchange (IPE), was formed in 1981 and acquired by ICE in 2001. Since its formation, ICE Futures Europe has operated as a self regulatory organization, and since 1986, has operated as an RIE under the supervision of the FSA. In this regard, ICE Futures Europe is the U.K. equivalent of what is known as a designated contract market, or DCM, in the United States, and is regulated by the equivalent of the Commodity Futures Trading Commission, or CFTC.

As the home of the Brent Crude Futures contract and the Gas Oil Futures Contract, ICE Futures Europe is, and has been since its inception, the leading energy futures exchange in Europe. Though a subsidiary of ICE, ICE Futures Europe has its own majority independent board and separate regulatory and operational staff. This degree of separateness from the parent group is mandated by the FSA in order for the exchange to maintain its status as a recognized body and self regulatory organization.

It is important to note that ICE Futures Europe, like the leading U.S. exchanges, is a global exchange. It is authorized to provide trading access in 51 jurisdictions around the world. ICE Futures Europe's customer base includes the largest energy companies and investment banks in the world, and its flagship contract, the Brent Crude Oil futures contract, is a global benchmark for the price of crude oil. In addition to its energy contracts, ICE Futures Europe partners with and hosts the European Climate Exchange, the largest pan-European exchange for carbon emissions trading.

REGULATION OF ICE FUTURES EUROPE

ICE Futures Europe is a RIE, subject to the regulation of the FSA. Much like the CFTC, the FSA is a principles-based regulator. As such, ICE Futures Europe must comply with core principles, which are similar to those imposed on CFTC regulated designated contract markets. Further, as part of its regulatory structure FSA incorporates the European Union's Markets in Financial Instruments Directive's (MiFID) principles. MiFID serves as regulatory backbone for the 30 member states of the European Economic Area. The FSA has been recognized globally for its leadership in global derivatives market regulation.

As a recognized investment exchange supervised by the FSA, ICE Futures Europe has a robust market-monitoring program. Like U.S.-based exchanges, ICE Futures Europe has detailed exchange rules to prohibit misconduct, with which members must comply, as well as enforcement authority that penalizes misconduct.

ICE Futures Europe monitors trading on its markets on a real-time basis. Trained staff supervise our markets every hour of the day. They use a variety of market-supervision tools and are responsible for ensuring that there is a "fair and orderly" market at all times. Our staff reviews trading activity each day to identify any unusual trading patterns that warrant further investigation. Our systems maintain a detailed audit trail of every order entered and every trade executed and allow compliance experts to drill into trading activity in great detail.

We conduct large trader reporting which obliges members to report to the exchange on a daily basis contract positions over a given threshold that is currently 100 lots for WTI. Where such positions are not held for a member's own account, members are responsible for reporting the name of their customer who holds the position. This information is collected on a daily basis and shared with the FSA, and—for our WTI contract—with the CFTC.

For all contracts ICE Futures Europe has the authority to order a member to reduce the size of a position that it considers to be too large. This is principally of concern in physically-delivered contracts where it appears that a member might have the ability to 'squeeze' the market by controlling a large amount of the contracts to be delivered. In practice it is rare for the exchange to need to mandate the reduction of positions as members wish to avoid disputes with the exchange and will take steps to reduce positions following enquiries from the exchange.

ICE Futures Europe also has the authority to take disciplinary action against its own members. Where necessary it can also notify the FSA, the CFTC or other regulators where it would be more appropriate for them to take action.

ICE FUTURES EUROPE'S ROLE IN THE GLOBAL OIL MARKETS

Since its inception, ICE Futures Europe has been a leader in the European crude oil markets. The exchange is the home of the Brent crude oil contract, which has traded in London for 25 years. Brent Crude Oil and West Texas Intermediate (WTI) crude oil grades (and to a lesser extent the OPEC Basket and the Dubai Crude Oil) set the global price of oil. The Brent Crude Oil contract is a light, sweet grade of oil and thus is highly correlated with the light, sweet WTI, which is slightly lighter. As one would expect in a global market, the two contracts usually settle within a few dollars of each other. This has been true since long before ICE purchased the IPE.

ICE Futures Europe introduced its cash settled WTI futures contract in 2006 to compliment its Brent crude oil contract. The ICE Futures Europe WTI contract is cash settled at expiry against the penultimate trading day settlement price established by the NYMEX WTI physically delivered futures contract. Our contract had been launched by ICE several years prior as an OTC swap used primarily by dealers to hedge their customer business. At that time, the NYMEX WTI futures contract was available for trading only on the NYMEX floor. Volume in our OTC WTI swap grew as users found that an electronically traded instrument offered far superior price transparency and execution compared to the NYMEX floor. In response to these growing volumes, we converted our WTI OTC swap to a cash-settled WTI future at ICE Futures Europe to complement our existing Brent crude oil contract. NYMEX subsequently responded to market demands for electronic trading and has recaptured some of the open interest that initially came to ICE Futures Europe. Following NYMEX' introduction of electronic trading, most of the growth in trading of WTI crude oil has been on the NYMEX, as demonstrated by the NYMEX's rising market share and faster growth rate relative to the ICE WTI contract. Nevertheless, the ICE WTI contract is an important contract for ICE Futures Europe, as it is used by commercial market participants to create spread positions with the Brent Crude Oil Contract to hedge exposure to locational differences in the price of global crude oil. Notably, NYMEX offers a cash settled Brent crude oil future for precisely the same reason. Today, ICE has a relatively small 15 percent share of total WTI futures equivalent open interest, while NYMEX retains the remaining 85 percent.

Nevertheless, it is clearly important that the CFTC, along with other regulators, have visibility into the entire WTI market given its oversight responsibility with respect to NYMEX. Thus, after introducing the WTI contract in 2006, ICE Futures Europe began sharing information with the CFTC through the CFTC's memorandum of understanding with the FSA. In the original information sharing agreement, ICE Futures Europe provides trader position data for the prompt 2 months in the WTI contract on a weekly basis. As the contract reaches expiration, this reporting frequency is increased to a daily basis each month. Recently, again working with the CFTC and FSA, ICE Futures Europe agreed to an enhanced information sharing arrangement. This arrangement allows the CFTC to receive daily position data, for all contract months at the client level. In addition, ICE Futures Europe has agreed to notify the CFTC if a trader exceeds position accountability levels similar to those on U.S. DCMs. To our knowledge, the level of information provided through the enhanced information sharing agreement represents a first of its kind in cross-border information sharing between regulators.

CFTC'S MUTUAL RECOGNITION SYSTEM

ICE Futures Europe operates in the United States as a foreign board of trade. As background, in the Futures Trading Act of 1982, Congress exempted foreign boards of trade from having to register as a DCM. This became the cornerstone of the CFTC's mutual recognition system. In 1996, the Commission issued a no-action letter allowing a German exchange, Eurex, to offer direct electronic access to U.S. customers. The basis of the Commission's ruling was the recognition that Eurex's regulator and regulatory scheme is comparable to that of the CFTC. In 1999, the Commission gave the International Petroleum Exchange no-action relief to enable U.S. based customers to access its electronic market. In 2006, pursuant the no-action letter granted to the IPE, ICE Futures Europe offered the WTI crude oil contract to U.S. based customers.

Through the market evolutions of the past 25 years, including increased globalization, the no-action process has proven highly effective tool for providing information to the U.S. regulator on foreign markets. The CFTC examines several key factors prior to granting relief. These include:

—the automated trading system (including the order-matching system, the audit trail, response time, reliability, security, and, of particular importance, adherence to the International Organization of Securities Commission principles for screen-based trading); the terms and conditions of contracts proposed to be listed;

—settlement and clearing (including financial requirements and default procedures); the regulatory regime governing the foreign board of trade in its home jurisdiction;

—the foreign board of trade's status in its home jurisdiction and its rules and enforcement thereof (including market surveillance and trade practice surveillance); and

—existing information sharing agreements with the foreign board of trade, and the foreign board of trade's regulatory authority.

Since adopting this policy, the CFTC has granted no-action relief to at least 20 foreign boards of trade. In 2006, the CFTC re-examined the no-action process and after a hearing, determined that the no-action policy was an effective tool for both regulatory cooperation and competition.

This mutual recognition system is now a backbone in the global regulatory network. As Benn Steil, Director of International Economics at the Council of Foreign Relations noted, "the U.S. activities of one beneficiary alone [of the no-action process], Eurex have had a tremendous effect in accelerating the move to more efficient electronic trading, in motivating exchanges to demutualize, . . . in reducing trading fees, and in stimulating new product development." This is in turn has lead to futures transactions that are faster and less susceptible to manipulation or other bad acts than they were a decade ago, which has greatly reduced the price of risk management and transactional costs to participants in the commodity markets.

It is important to recognize that there is no single agency today that can police all global markets, thus we must rely on foreign regulators if the United States is to remain part of the international marketplace. Other countries have similar policies in place, upon which U.S. exchanges rely. The Chicago Mercantile Exchange, NYMEX, and ICE Futures U.S. all rely on mutual recognition by foreign regulators to offer global access in those jurisdictions. Failure of the mutual recognition system would greatly impair the competitiveness of U.S. exchanges abroad and represent a major step back for U.S. markets. It is also important to note that the CFTC only can get information on foreign traders trading foreign contracts through information sharing agreements with foreign regulators.

THE PRICE OF OIL

ICE recognizes that the rising price of oil has many adverse effects on the U.S. economy and is painful for U.S. citizens. It is tempting to place blame for higher prices on the futures markets, but futures markets serve as the messenger not the fundamental driver of prices. The prices for almost all commodities, including wheat, corn, soybeans, precious and base metals have surged at the rates similar to crude oil and in some cases even more sharply and with greater volatility. It should be noted that in virtually all of these other commodity products, there are no foreign boards of trade offering a contract settling on a U.S. exchange contract to blame. It is also important to note that the price of many non-exchange traded commodities have increased, in some cases even more dramatically, than those traded on an exchange indicating that properly regulated markets, whether domestic or foreign, should not be the scapegoat for rising prices.

The crude oil market, more than most other commodity markets, is global. The United States imports approximately 58 percent of its crude oil from outside the United States. Because crude oil is a global market, regulating the trading of crude oil futures requires international regulatory cooperation, and it is misguided to assume that any one regulator can obtain the entire market picture without the cooperation of regulators in other countries trading other grades of crude oil.

In addition, attempts to artificially influence market prices through government action have historically failed, often with unintended consequences that have been damaging and difficult to repair. One such attempt suggests altering the margining requirements for futures contracts to approximate margining in the securities markets. This concept is misguided due to the economic and contractual differences between the purchase of a security and of a futures contract. When a stock is purchased, margin signifies a partial payment on an ownership stake in a company with the balance loaned by the customer's broker. It represents a financing arrangement between the broker and the customer. The stock is immediately delivered to the buyer and the transaction is complete from an exchange and clearinghouse perspective. In contrast, margining in futures markets, far from representing a financing arrangement, is the means by which the clearinghouse ensures that there are no losses suffered if and when a member defaults. As a result, futures margin rates are set based on complex mathematical models of contract price history and represent the largest 1 or 2 day price move at an extremely high confidence level. When a futures contract is traded, the buyer and seller take on obligations to take and make, respectively, delivery of the commodity at some later date. Margin represents a performance bond to ensure ultimate delivery or payment. Margins on futures contracts are central to the counterparty risk management systems for clearinghouses. Legislative interference with a basic market mechanism such as margin levels could lead to a number of unintended consequences. Dramatically higher margin rates for futures trading in the United States could shift significant exchange-traded volume back into the OTC market where firms would be exposed to the same counterparty risks roiling credit default swap and other markets today. Significantly higher margin rates would likely damage liquidity which would widen the bid-offer spread and increase execution costs for all. Furthermore, failure to adjust margins on a global basis could simply drive trading to overseas markets. Finally, and most tellingly, margin rates for ICE Futures Europe's crude oil contracts have already been raised 300 percent in the last year due to increased volatility, with no real effect on either the composition of the market or the price of oil.

Attempts to drive "speculation" from the market should also be avoided. It is important to note that speculation does not equal manipulation. Exchanges around the world are required to prevent, detect, and punish manipulation or attempts to manipulate markets. Speculation has always been an essential component of all markets whether prices are falling or rising. There is a common misconception that speculators only bet on prices rising—this assumption has no basis in fact, and often speculators have a net short bias. Ultimately, futures markets involve contracts in which one side of the market is attempting to predict where the price of a commodity will go in the future, and the other side of the market is attempting to sell or hedge its price risk with respect what the price of a commodity will be in the future. Importantly, neither of these market participants knows what the future will bring. Speculators are simply participants with a view about the future price of a commodity who are willing to put capital to work in assuming the price risk transferred from commercial participants. Speculators are a necessary component of the futures markets, providing liquidity and important pricing information to markets. Without speculators, futures markets would be established solely by commercial participants, in essence, pricing by cartel.

SOLUTIONS

Again, the utility function of futures markets is to send important price signals about the future price of commodities as determined by market forces. That said, Congress must insure that markets remain open, transparent and competitive. Global market participants must have regulatory certainty in order to transact confidently in the U.S. markets or they will seek other solutions. We agree with many of you here that the CFTC is under-funded and that Congress should increase the CFTC's budget. ICE strongly supports the budget increase as outlined in Chairman Durbin's bill. Second, the crude oil market is a global market, with many grades of crude substitutable for one another under traded contracts. Regulation of such a market requires global regulatory cooperation, and ICE strongly supports a study of the international regulation of energy markets. Finally, ICE supports the cooperative efforts that presently exist between the CFTC, the FSA, and other regulators around the world, and urges Congress not to disturb these relationships through over-reaching legislation. It is impossible to regulate a global market from a single jurisdiction, and no country can legitimately contend that it has the sole right to be the jurisdiction in which vibrant commodity markets exist to serve the needs of both domestic and foreign market participants. Over-reaching legislation could also trigger regulatory retaliation from other jurisdictions, impacting the ability of domestic exchanges to operate in other jurisdictions.

CONCLUSION

ICE has always been and continues to be a strong proponent of open and competitive markets in energy commodities and derivatives, and of appropriate regulatory oversight of those markets. As an operator of regulated futures exchanges in the United States, the U.K., and Canada, and as a publicly held company, ICE recognizes the importance of upholding the utmost confidence in its markets. However, with a mere 15 percent market share of global WTI, on a futures equivalent basis, we feel it is highly unlikely that the ICE Futures Europe's WTI market is the primary driver of WTI prices. Therefore, any expectation that WTI crude oil prices will fall as a result of increased restrictions on this relatively small portion of that market are likely to go unmet. Nonetheless, we recognize the severe impact of high crude oil prices on the U.S. economy and understand the congressional desire to "leave no stone unturned." As a result, we look forward to working with Congress and the CFTC to ensure that their concerns with regard to the ICE Futures Europe WTI contract are fully addressed while remaining fully compliant with obligations to the primary regulator, the FSA, and U.K. law.

Mr. Chairman, thank you for the opportunity to share our views and facts about our market operation with you. I would be happy to answer any questions you may have.

Senator DURBIN. Thanks, Mr. Vice.

And let me say to the panel, thank you for your patience in waiting and I am sorry that we are running short on time here. I see Senator Lugar is leaving, so I will just have maybe one or two questions.

Mr. Vice, this announcement today by the Commodity Futures Trading Commission about this new no action letter, which apparently has become at least a partial action letter—did you negotiate with the CFTC leading up to the announcement of this new regulation?

Mr. VICE. We did not negotiate with them. They made us aware of what they were planning because we do have obligations to our home regulator, the FSA. And pursuant to the information sharing and cooperation agreement with the FSA, as you might imagine, we and they have an interest in making sure that both regulators get what they need out of this.

Senator DURBIN. And is it your understanding that as a result of this, that you will be subject to the same type of disclosure, transparency, and regulation as those who trade on NYMEX today?

Mr. VICE. We are essentially subject to that already via the FSA, and beyond that, we do have——

Senator DURBIN. But that is the British authority. This is for the American authority.

Mr. VICE. Right. And via the information-sharing agreement, many of the core principles with regard to information the CFTC collects from NYMEX and U.S. exchanges, we are providing today via the FSA. We recently agreed to increase that reporting and extend it to all contract months and then, to answer your question, with the memorandum of understanding today, we will actually be applying and enforcing position limits, accountability limits on the WTI contracts.

Senator DURBIN. A level playing field.

Mr. VICE. Yes.

Senator DURBIN. Mr. Newsome, I do not know if this question goes to you or Mr. Duffy. If there is a Dubai exchange, will it be subject to the same standards of disclosure, transparency, and accountability to the CFTC?

Dr. NEWSOME. Two comments, Mr. Chairman. One there are currently two Dubai exchanges in existence, one of which NYMEX is a primary partner in. They do not list the WTI contract. If at some point in the future they do, they will absolutely provide the position limits and same large trader reporting that is subject to U.S.-regulated exchanges.

The other Dubai entity we are not a component of. They do not have a no action letter from the CFTC. They do list a WTI contract and are not providing anything to the CFTC.

Senator DURBIN. So this Dubai exchange that NYMEX and CME are interested in does not list WTI.

Dr. NEWSOME. Correct.

Senator DURBIN. A separate Dubai exchange does.

Dr. NEWSOME. Correct.

Senator DURBIN. I want to make sure it is clear. You do not know whether or not they will be covered by this CFTC standard?

Dr. NEWSOME. To my knowledge, they have not applied for a no action letter from the CFTC to date and therefore are not supplying any of the information that we supply or that ICE intends to supply.

Senator DURBIN. Mr. Cooper, the Enron loophole. There has been suggestion here that the new farm bill is going to close the loophole. Is that your impression?

Dr. COOPER. It closes it to a significant extent, but the key questions that Senator Klobuchar asked I think are really important. Prior to 2000, all these instruments were regulated, and the question is whether or not the presumption should be for regulation of these instruments and then let the CFTC make exceptions so that the trader bears the burden of proof, which we think is the right way. The way it is structured now the presumption is against regulation and then the CFTC bears the burden of proving it needs regulation.

Senator DURBIN. Does the farm bill change that?

Dr. COOPER. No, the farm bill does not change the presumption. And so you have now got this problem of having the CFTC to go through all of these contracts traded on all of these exchanges and prove that it needs to regulate. That is backwards from our point of view.

Senator DURBIN. Mr. Duffy, the whole concept of more disclosure and transparency and accountability to the CFTC—is that consistent with your vision? I know that you have a transaction with NYMEX that has been approved now. Is that consistent with your vision of how these markets should work?

Mr. DUFFY. Yes, and we are very encouraged by Chairman Lukken's comments and announcements from this morning as it relates to energy and metals. We have been on the record for many years now, Senator, stating that we believe that the energy and other exempt commercial markets should be under the same regulation as what the CME Group provides today. So, yes, we are very much in agreement.

Senator DURBIN. Mr. May, I met with your board recently, and it was a gloomy meeting. I am glad your testimony today is part of the record. I am sorry that you had to give it.

As you listen to these overall hearings and the speculation about speculation, you are a businessman. You do not come to this as some bleeding heart liberal. How do you view it?

Mr. MAY. Mr. Chairman, I think that a number of suggestions have been put on the table this morning. Some of them apparently have been addressed by recent activities of the CFTC. But there are some very clear loopholes that need to be addressed. There are some real issues with who is permitted to invest in these commodities in terms of pension funds. We really need to make sure that there is transparency and fairness in the market. I think this committee is interested in assuring that is the case. My absolute bottom line is that this needs to happen sooner rather than later.

Senator DURBIN. We met maybe 2 or 3 weeks ago in your office here in Washington. I will have to tell you. I do not know if this CFTC announcement was meant to coincide with this hearing. If it did, then maybe this hearing was worth the effort that we put into it.

But we are not going to stop. There is more that needs to be done in terms of this disclosure and transparency. I cannot answer the question about whether there is market manipulation, and honestly Mr. Lukken has a lot of markets he cannot even see at this point. He has no authority to look into, but he believes he will have more authority. And we are going to hold him to that standard.

ADDITIONAL COMMITTEE QUESTIONS

I can make this promise to you as chairman of this appropriations subcommittee, Mr. Lukken is going to have more soldiers to march into battle. There will be more people involved in market oversight and surveillance. We are going to give him additional resources for computer technology. There will be more cops on the beat, but as Senator Klobuchar alluded to in her questioning, the person at the top has to decide to use those tools to make sure that people know that we are not going to brook this kind speculation that might go overboard.

[The following questions were not asked at the hearing, but were submitted to the witnesses for response subsequent to the hearing:]

QUESTIONS SUBMITTED TO WALTER LUKKEN

QUESTION SUBMITTED BY SENATOR CHARLES E. GRASSLEY

Question. In 2007, the CFTC issued a "no-action" letter thereby declining to regulate the trading of the West Texas Intermediate (WTI) oil contracts on the Dubai Exchange. There appears to be a significant amount of trading in WTI contracts both on the Dubai Exchange and the Intercontinental Exchange in London. Given that, do you think CTFC has a responsibility to regulate WTI trading in these offshore exchanges? If not, why?

Answer. The CFTC should assert jurisdiction over all contracts designated in U.S. commodities and traded within the United States. The Dubai exchange fits that description and should be regulated.

QUESTIONS SUBMITTED BY SENATOR BEN NELSON

Question. The term "speculator" has certainly become a pejorative of late and I wanted to further explore the concepts of speculation and manipulation. I understand that some speculation in commodities can be a good thing for the market, providing liquidity and even providing some checks on prices in a functioning market. I also understand that market "speculation" isn't the same as market "manipulation." However, what we are seeing now with index speculation in such large sums entering the market in recent years and the steep rise in prices during the same time period raises serious concerns about this new form of speculation and what it means to the markets and those that rely upon them, as well as consumers and the economy as a whole. So my questions are these:

Where do you draw the line between speculation and manipulation—or the line between good speculation and bad speculation?

Answer. Speculation is trading to profit from anticipated price changes. Manipulation is intentionally acting to cause artificial price changes and to profit from those changes. Speculation in the futures markets aids the markets in their proper hedging and price discovery functions. If any type of trading, including speculation, distorts prices on, and disrupts the proper functioning of, futures markets, that is detrimental to efficient functioning of the markets.

Question. At what point is there too much speculation, or when does speculation become too out-of-balance or too removed from market fundamentals to be good for the market, inflating prices beyond where the fundamentals would put them? For example, if hundreds of billions of dollars have entered the market through index funds or other similar vehicles all falling under the category of "speculation," and the bulk of it is taking a long position in the market, doesn't that have a dramatic affect on the market by driving up prices and possibly inflating them beyond fundamental levels?

Answer. Section 4a of the Commodity Exchange Act ("CEA") states that "[e]xcessive speculation in any commodity under contracts of sale of such commodity for future delivery made on or subject to the rules of contract markets or derivatives transaction execution facilities causing sudden or unreasonable fluctuations or unwarranted changes in the price of such commodity, is an undue and unnecessary burden on interstate commerce . . ." Accordingly, speculation is excessive when it causes sudden or unreasonable fluctuations or unwarranted changes in prices. In accord with the directives in Section 4a, as well as the statutory Core Principle with respect to position limits for futures exchanges in Section 5(d)(5) of the CEA, the Commodity Futures Trading Commission ("Commission" or "CFTC") has set speculative limits on the positions of individual traders for many agricultural futures contracts and requires the exchanges to set position limits or accountability levels for other futures contracts.

Today, however, the concern is not that some individual traders are exceeding speculative limits, rather it's whether the total level or balance of speculation is actually causing price increases above that warranted by market fundamentals. Ultimately, the function of the market is to process various opinions to form a price at which a balance is reached in terms of those participants that believe prices will rise and those that believe they will fall. In a free market, if too many participants with a particular view of market fundamentals enter the market and push prices in a certain direction, participants with contrary views would be expected to enter the market on the opposite side to move prices back to where they believe they should be.

To better understand the dynamics of trading activity in the current markets, the Commission is engaged in a study of the futures markets. The Commission is looking at the effect of the influx of index funds into the futures markets, either directly or indirectly as the result of hedging by swaps dealers, as part of the study. The results of this study are expected on or before September 15, 2008.

In addition, in order to better understand the effects of speculative trading on commodity prices, the Commission has formed an interagency task force, enlisting the assistance of staff from the Departments of Agriculture, Energy and Treasury, the Board of Governors of the Federal Reserve, Federal Trade Commission, and the Securities and Exchange Commission. The Commission has also consulted a number of academic researchers. The Interagency Task Force released an interim report on the crude oil markets on July 22, 2008 and continues its work.

Question. What exactly is CFTC's definition of market manipulation?

Answer. Section 9(a)(2) of the CEA provides that it is unlawful for "[a]ny person to manipulate or attempt to manipulate the price of any commodity in interstate commerce, or for future delivery on or subject to the rules of any registered entity, or to corner or attempt to corner any such commodity . . ." Sections 6(c) and 6(d) of the CEA contain similar language. The CEA does not include a definition of manipulation, but courts and the Commission have developed case law on the subject. Sustaining a charge of manipulation requires establishing four elements by a preponderance of the evidence: (1) the party had the ability to influence market prices; (2) the party specifically intended to influence market prices; (3) an artificial price existed; and (4) the party caused the artificial price. In re *Cox*, [1986–1987 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶23,786 at 34,061 (CFTC July 15, 1987). To prove the intent element of manipulation or attempted manipulation, it must be shown that the party "acted (or failed to act) with the purpose or conscious object of causing or effecting a price or price trend in the market that did not reflect the legitimate forces of supply and demand." In re *Indiana Farm Bureau Cooperative Association*, [1982–1984 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶21,796 at 27,281 (CFTC Dec. 17, 1982).

Question. Does this technical definition of manipulation miss fail to address the realities of what is going on in the markets now? There may well be serious damage to the markets, consumers and the economy from large scale index speculation even though it does not fit the traditional definition of market manipulation because it lacks certain fundamental elements—not the least of which is an intent to manipulate.

Answer. As indicated above, intent has been held to be a key element of a manipulation violation under the CEA. Nevertheless, in addition to the Commission's role in policing the markets to ensure they are free from manipulators, the Commission also conducts active surveillance of the markets and their participants. The Commission's surveillance program is intended to detect and deter manipulation and market abuses, but it goes beyond preventing manipulation to preventing disruptions of the markets and other problems where the markets are not functioning properly. In connection with its ongoing surveillance efforts, the Commission is studying index trading and is prepared to act, if necessary.

Question. Does CFTC have the authority and capability to address the larger, systemic problems from this form of index speculation that may be driving price inflation across the board as opposed to the authority and capability for going after individuals who purposefully trying to manipulate prices? If so, what is CFTC doing to address these problems? If not, what authority does CFTC need?

Answer. The Commission has both the authority to police the markets for manipulation and the required tools to find and to manage "excessive speculation" as described in Section 4a of the CEA. The Commission's strong enforcement program is constantly obtaining and reviewing data and materials to make sure manipulators are brought to justice. Additionally, the Commission's surveillance program regularly reviews all reported data.

Specifically, the Commission has been actively gathering information about the role of index funds in the markets. In late May, the CFTC utilized its special call authorities to gather more detailed data from swap dealers on the amount of off-exchange index trading in the markets and to examine whether index traders are properly classified for regulatory and reporting purposes. Information requests have been issued, and the CFTC has begun receiving the first round of more detailed information on index funds and other transactions that are being conducted through swap dealers. With this data, the CFTC will provide findings to Congress as soon as practicable—and no later than September 15th—regarding the scope of commodity index trading in the futures markets and recommendations for improved practices and controls, should the Commission conclude that they are required.

Question. If this new form of index speculation is not a kind of market manipulation, how does CFTC classify it and does CFTC nevertheless consider it a significantly problematic aspect of the market and a component of current price run-ups such that it may need to be addressed?

Answer. At this time, nothing about the increased speculation in the commodities futures markets indicates that it has the same effect as a market manipulation. Our economic analysis to date indicates that supply and demand factors are the best explanation for the recent increase in crude oil prices, for example. However, the CFTC is aware of the concerns about the influx of index trading into the futures markets and is also aware of the current high prices of many commodities. As indicated above, the Commission is currently seeking additional data concerning speculative trading and is gathering more detailed data from swap dealers. After the data is received, the CFTC will review the data and determine if changes are necessary to the current way information is processed and reported.

Question. Why are index speculators such as Goldman Sachs classified as commercial traders when other speculators are classified as non-commercial? What impact has that had on the markets and prices as compared to benefits from traditional forms of speculation?

Answer. Some index traders do, in fact, hold positions directly in the futures markets and those positions are considered speculative positions and are subject to existing position limits and position accountability levels. Most index traders, however, do not participate directly in the futures markets. Rather, they participate indirectly as customers of swaps dealers. A swaps dealer, usually a bank, sells a contract to one of its clients, perhaps a pension fund, such that the swaps dealer will pay its client an investment return amount based on an index of several commodity futures prices. The swaps dealer then has a commercial risk that the prices of those commodities in the index will increase. Therefore, the swaps dealer now has a commodity price exposure to hedge, and swaps dealers often come to the futures markets to do that.

Since 1991, the Commission has viewed the positions of swaps dealers in the futures markets taken to offset their commodity price risks to their customers as bona fide hedging positions. This is consistent with congressional directives concerning modernization of both the criteria for hedge exemptions and the process for considering exemption requests. Specifically, during the CFTC reauthorization process in 1986, Congress directed the Commission to apply modern portfolio-based risk management concepts to its hedge exemption process, which allowed greater flexibility to the exemption and enabled financial institutions to have greater access to the regulated exchange-traded derivatives markets. See House Committee on Agriculture, Futures Trading Act of 1986, H.R. Rep. No. 624, 99th Cong., 2d Sess. 44–46 (1986) ("strongly urg[ing] the [CFTC] to undertake a review of its hedging definition . . . and to consider giving certain concepts, uses, and strategies 'non-speculative' treatment" including risk management by portfolio managers, and other trading strategies involving the use of financial futures including, but not limited to, asset allocation); Senate Committee on Agriculture, Nutrition and Forestry, Futures Trading Act of 1986, S. Rep. No. 291, 99th Cong., 2d Sess. at 21–22 (1986) (CFTC must consider "whether the concept of prudent risk management [should] be incorporated in the general definition of hedging as an alternative to this risk reduction standard").

Question. In your testimony you state that trading by index investors is not like "traditional speculative trading by hedge funds and other managed money." You go on to state that most of "this type of investment comes through major Wall Street swap dealers that sell their clients broad exposure to the commodity markets through an over-the-counter commodity index contract." Can you please explain this further? In particular, if there are hundreds of billions of dollars affecting the commodities markets through "swaps" and "over-the-counter" trades, how does this not raise serious concerns for the commercials utilizing the markets for hedging purposes and to consumers purchasing end products? If index investor trading is not like traditional speculative trading then doesn't that require CFTC to figure out what it is, what it is doing to the markets and how best to deal with it? What has CFTC done in that regard?

Answer. As explained above, many of the index traders are offering their clients broad exposure to commodities markets as a way to diversify the risk of their portfolio against other asset classes such as equities or real estate. The Commission has been actively gathering information about the role of index funds in the markets. In late May, the CFTC utilized its special call authorities to gather more detailed data from swaps dealers on the amount of off-exchange index trading in the markets and to examine whether index traders are properly classified for regulatory and reporting purposes. Information requests have been issued, and the CFTC has begun receiving the first round of more detailed information on index funds and other transactions that are being conducted through swaps dealers. With this data, the CFTC will provide findings to Congress as soon as practicable—and no later than September 15th—regarding the scope of commodity index trading in the futures markets and recommendations for improved practices and controls, should the Commission conclude that they are required.

Question. What is the purpose to the commodities market of "swaps" and "over-the-counter" trades between large entities or investment vehicles that are not hedging and will never have any physical connection to the commodities themselves? How does this improve liquidity or the functioning of the commodities markets?

Answer. The commodity futures markets provide a means of hedging risks taken on by swaps dealers in the course of their swaps business. Some of the business engaged in by swaps dealers is with large commercial participants who seek to use individually tailored swaps to more precisely hedge their market exposures or to transact in quantities that might be disruptive if executed directly on a futures market. For example, some airlines use swaps contracts rather than futures contracts to hedge their jet fuel purchases because a jet fuel futures contract does not exist. Other users of swaps contracts enter into them for speculative reasons. Like all speculators, entities that are not hedging a physical position or risk, are doing so for investment and profit purposes. All speculators provide market liquidity for hedgers using the same markets. Therefore, the buying of futures contracts by swaps dealers to hedge over-the-counter positions or the buying by a speculator in the market, provides short hedgers (like agricultural producers) with increased liquidity for trade execution.

Question. Commodity price increases in the past year have been extraordinary and some fear that a bubble has developed in the Commodities markets. Many point to the arrival of large numbers of new investors and a myriad of new investment vehicles, many of them involving derivative instruments that are traded outside the confines of regulated markets as significant contributors to these increases. I have read competing estimates for the amount of money coming into the commodities markets through these new investors and vehicles and welcome your estimate as well. However, there seems to be strong agreement that a lot of money has moved into these markets in the last few years. I have been hearing from many farmers and grain elevators regarding their concerns and their inability to utilize the futures markets for hedging and risk management purposes and, of course, I have heard from many drivers about the price of gas. I have also heard concerns about the cash market being below the futures markets, which some believe signal something other than market fundamentals behind the price increases.

It is my understanding that the CFTC has not found anything inappropriate in this situation to date, is that a correct understanding?

Answer. The CFTC has not found that the large increase in commodity prices over the past year is the result of systematic manipulation or other violations of the Commodity Exchange Act. That is not to say that violations have not occurred or been investigated. In fact, the Commission just recently announced the filing of a complaint against Optiver for alleged manipulation of the heating oil, crude oil and gasoline futures contracts traded on the NYMEX. This is in addition to the numerous manipulation, attempted manipulation and false reporting cases the Commission has brought in recent years and I have no doubt there will be more. The Commission has a strong enforcement program with a proven track record. In energy alone, the agency's Division of Enforcement has brought 42 cases against 72 respondents/defendants and assessed fines of more than $400 million since 2002.

In addition to our enforcement effort, our surveillance efforts are focused on detecting and deterring potential manipulation or abusive trading practices. The current situation of high prices and limited deliverable supplies makes our surveillance efforts all the more important. The Commission also recently announced several agriculture and energy initiatives targeted to ensure that the futures markets are operating efficiently.

Question. What specifically is CFTC looking for under this broad concept of "inappropriate" conduct, actions or market behavior; does it extend beyond simple market manipulation to other actions that can damage the markets, market participants and the national economy such as inflated prices or a bubble? If not, is CFTC able and prepared to expand its oversight and regulatory actions to address these broader issues?

Answer. Broadly speaking, the Commission seeks to protect market users and the public from fraud, manipulation, and abusive trading practices and to foster open, competitive, and financially sound markets. The Commission seeks to protect the price discovery and hedging functions of the futures markets. If the markets are not performing their price discovery function, then behavior that causes that failure is inappropriate. The Commission is studying whether the increased level of futures market activity is impacting the price discovery function in the markets. The Commission's mission is not to prevent traders from speculating or to administer prices, but it is to prevent traders from disrupting markets.

Question. In other words, what is your answer to the proverbial "missing the forest for the trees" problem—is it possible that CFTC is missing anything in its analysis?

Answer. While the CFTC's focus has been on deterring, detecting and penalizing those who violate the Commodity Exchange Act, new entrants in the markets like index funds require a broader view to determine whether there is a possible negative effect. Accordingly, the Commission has spent considerable time and resources looking at broad issues, including: the roles of new market entrants like hedge and index funds; structural changes and convergence in agricultural markets; globalization and foreign boards of trade; technology; and financial integrity. The Commission is working on these matters and, as I stated above, has enlisted the assistance of others as well. In addition to working with other Federal agencies, the CFTC has three advisory committees in the areas of energy, agriculture and global markets and meets with them regularly.

Question. In your testimony you discuss the Commission's lack of adequate resources and staff for the additional authority granted by the Farm Bill and for the unprecedented nature of today's markets. But this influx of index money and speculation didn't just begin in 2008, or 2007 for that matter.

How far behind is CFTC and why has it been allowed to fall behind?

Answer. For the fiscal year, 2009 the CFTC estimates that a budget of $157,000,000, supporting approximately 596 FTE, would provide the appropriate level of resources needed to perform our mission.

The $157,000,000 is based on the Commission's fiscal year 2009 OMB budget estimate (of $151,000,000 and 567 FTEs) which was formulated last summer and submitted to the OMB and the Congress in September 2007. Since that submission, Congress enacted the Farm Bill in May 2008, which conferred additional responsibilities to the Commission. Shortly after the bill became law, the Commission informed the OMB and the Congress that implementation of the new authorities in the Bill would require an estimated additional $6,000,000 and 29 FTEs for a total of $157,000,000 and 596 FTEs.

Every September, the Commission submits an OMB budget estimate to the OMB and the Congress. The OMB budget estimate is a detailed justification of the dollar and staff resources required for the budget year. The level of resources requested by the CFTC has generally been higher than the level provided for in the President's budget and the level eventually appropriated by the Congress. Congressional appropriations are the Commission's sole source of funding.

Question. When did this shortfall in funding and staff first become evident and what was done about it then?

Answer. The Commission has been under-staffed and under-funded for many years. The table below summarizes, for the twelve-year period 1997–2007, the CFTC's estimate of budgetary resources required as submitted to the OMB and the Congress. The table also includes the amount requested by the OMB and ultimately funded by the Congress.

[Dollars in millions]

Fiscal Year	CFTC Budget Estimate to OMB		The President's Budget		Final Appropriation	
	Amount	FTE	Amount	FTE	Amount	FTE
1997	$63.4	640	$56.5	600	$55.1	553
1998	63.8	640	60.1	600	58.1	560
1999	64.6	621	63.4	600	61.3	567
2000	67.7	621	67.7	621	62.8	567
2001	74.4	650	72.0	621	68.1	546
2002	81.0	600	70.4	510	[1] 87.5	509
2003	92.5	574	82.8	537	85.4	521
2004	110.5	574	88.4	489	89.9	517
2005	110.6	583	95.3	505	93.6	487
2006	112.1	572	99.4	491	97.4	493
2007	130.1	540	127.4	540	98.0	437
2008	143.7	557	116.0	475	111.3	465

[1] Provided for post 9/11/01 Emergency Supplemental of $17 million.

Question. If large portions of the trading are now being done off-exchange either via “swaps” or “over-the-counter” trades, then what good will adding more regulators do for the markets if so much of the trading that affects the markets is being done outside the regulated markets?

Answer. Additional staff would be employed by the Commission to fortify the enforcement and surveillance missions of the agency and to support those functions, including the Commission’s anti-manipulation authority over cash and off-exchange transactions (which it has used aggressively). As indicated above, the Commission is seeking more information from swaps dealers concerning their trading and, after analyzing the information we receive, we may make changes to the way the Commission collects and analyzes data.

But it also should be noted that, separate from swaps and over-the-counter trades, trading volume on the regulated futures exchanges has grown tremendously during the past several years. Since 2000, volume on U.S. exchanges has grown six-fold as traders increasingly seek the price certainty and clearing benefits of the futures markets regulated by the CFTC. Approximately $5 trillion of notional transactions flow through these U.S. exchanges and clearinghouses daily. We have no doubt that additional resources are necessary for the Commission to continue to effectively monitor and police these markets.

Question. Finally, I want to return to the issue of index speculation by looking at a commodity that is near and dear to the state of Nebraska and at the center of a few controversies right now—corn. Friday’s Commitment of Traders report indicated that the “traditional” funds were long 115,000 contracts of corn with the index funds long 427,000 contracts of corn. These combined fund longs are estimated to equal well over 2 billion bushels of corn (542,000 contracts). The index funds represent 78.8 percent or 1.6 billion bushels of this, while it is estimated that index funds today represent about 30 percent of the total open interest in corn and they are always long. By comparison, ethanol usage of corn is expected to be about 3 billion bushels or 23 percent of total corn usage, according to USDA. Also as of last Friday, index fund long was more than 167,000 contracts of soybeans, over 70,000 contracts of soybean oil and 188,000 contracts of Chicago wheat. We’ve seen corn prices almost double in the last year and certainly some of that is due to fundamental supply and demand concerns, which we are able to track and understand. What we don’t seem to have any knowledge or understanding of, however, is how much of this price is due to speculative demand—especially index speculation.

Question. Is it safe to say that if an estimated 3 billion bushels of corn demand from ethanol has an upward pressure on prices, that a potential 1.6 billion bushels of long index speculation would have an upward pressure on prices as well? Has anyone at CFTC estimated just what impact this is having on commodities prices and what have you found?

Answer. There are some critical differences in the demand for corn represented by the use of corn for ethanol and that represented by the purchase of futures contracts to buy corn. In the physical market corn is actually consumed. In the futures market, the long trader rarely takes delivery but, instead, usually offsets its long contract before delivery. The terms of index contracts require the dealer to roll out of the spot markets and into a deferred month by selling the spot month contract and simultaneously buying the next month’s contract, thus maintaining a position and never taking delivery. No corn is ever actually consumed through index trading.

The second important difference is that there is a finite amount of corn. Every bushel taken off the market and fed to livestock or used to produce ethanol leaves one less bushel available for sale. With decreased supply, if demand continues unabated, the price will rise. On the other hand, if a trader buys futures contracts, the number of contracts is unlimited as long as others are willing to sell.

This is not to say the financial markets for futures contracts are entirely divorced from the cash markets for physical grain. The two are linked by the ability to deliver on the futures contract, there is arbitrage between the two markets, and the cash markets use the futures markets as an important source of information about anticipated prices. Due to all of these factors, the issue you raise requires careful review. As discussed above the Commission staff has been studying various aspects of the effect of speculation on prices carefully and will report on the results.

Question. Does it make sense to consider this index speculation another category of “demand” for corn and other commodities and how would that affect the markets and CFTC’s role and responsibilities?

Answer. The role of index traders in today’s futures markets is of great interest to the public. The Commission is endeavoring to learn more about this group of traders. In addition, to provide additional transparency, the Commission has been able to publish information on the position of index traders in agricultural futures as a supplemental to the Commitments of Traders report. Publication of index traders' positions in the energy futures is a more difficult task but methods to provide that information are being considered.

QUESTIONS SUBMITTED BY SENATOR PAT ROBERTS

Question. Chairman Lukken, there has been a lot of negative talk about speculation in the marketplace. I agree, that if manipulation in the market exists, or if true prices are not reflected, then regulators must utilize the tools and authorities Congress has provided to go after those bad actors. However, as always, I'm concerned about the law of unintended consequences. What value does speculation bring to the futures markets? What are the potential impacts on both energy and agriculture futures markets if speculators were prevented from participating?

Answer. Futures markets require both speculators and hedgers. Speculators provide the market liquidity to allow hedgers to manage various commercial risks. Placing limitations on the amount of speculation in a futures market, whether by an individual trader or all traders, necessarily limits the amount of liquidity in the marketplace. Such limitations may restrict the ability of hedgers to manage risks, and may limit information flow into the marketplace, which could in turn negatively affect the price discovery process and the hedging function of the marketplace. As agricultural and energy producers are often short hedgers and as commercials generally tend to be short, a limitation on speculation tends to be a restriction on buyers. Ultimately, if long speculation is artificially driven from the market, the potential short-term advantage of lower prices could lead to production shortages, higher demand, and even higher prices for both energy and agricultural commodities.

Question. Several countries with increasingly high energy consumption growth rates like China are heavily subsidizing consumer energy costs. Reuters recently reported that for the first time ever, China has become a net importer of gasoline. They continue to consume without their consumers feeling the pain of global price increases. What affects do non-market based policies like this have on the price of crude oil?

Answer. Usually, when demand increases and supply remains constant, prices increases. This is the general situation today in the world market for crude oil. When commodity prices are subsidized, it has the effect of increasing demand for the commodity. In a worldwide market like that for crude oil, increases in consumption in one part of the world due to increased demand have the effect of raising prices to some degree everywhere else.

QUESTIONS SUBMITTED TO JAMES C. MAY

QUESTION SUBMITTED BY SENATOR SAXBY CHAMBLISS

Question. I am very sympathetic to the struggles our airline and other transportation industries are facing, which is why I really want to get into the detail of what the contributing factors truly are. In particular, I would like to know what specific information do you believe ICE Futures is not providing to the CFTC or their regulatory agency, the Financial Services Authority, to prevent manipulation?

Answer. The ATA believes ICE Futures and the British Financial Services Authority should be required to make information available to the CFTC on a daily basis, without separate requests from the CFTC, so that the CFTC can continuously monitor transactions made by persons in the United States regarding transactions, or based on transactions, relating to U.S. futures contracts, or transactions priced off U.S. futures contracts, for commodities for delivery in the United States.

ICE Futures, the Dubai Exchange, or ICE Futures London may comply, if they so choose, with specific requests from CFTC for information. However, such information would likely not be current and would likely focus on a particular time period or a particular trading entity and thus would not present the CFTC with an opportunity to comprehensively and routinely, monitor transactions affecting, or relating to, commodities with delivery points in the United States entered into by U.S. citizens or residents, or through U.S. based trading terminals.

The thorough, bipartisan Senate Permanent Subcommittee on Investigations joint report (June 25, 2007, "Excessive Speculation in the Natural Gas Market") said that the Enron and swaps loopholes allowed ICE to accept energy trades from persons in the United States, and elsewhere, and "operates with no regulatory oversight, no obligation to ensure its products are traded in a fair and orderly manner, and no obligation to prevent excessive speculation." Page 119, Senate Investigations Report. That subcommittee report noted that the "Enron loophole, which was inserted into the law in 2000 at the request of Enron and others, exempts electronic energy exchanges such as ICE from CFTC oversight and regulation."

In addition, that report noted that trading in the unregulated swaps market affects the regulated futures market because traders can replace futures contracts on NYMEX with swaps contracts on ICE. Page 120, Senate Investigations Report.

They concluded that "[e]liminating these loopholes would level the regulatory playing field between the NYMEX and ICE exchanges, increase energy price transparency, and strengthen the ability of the CFTC to analyze market transactions and police U.S. energy commodity markets." They further noted that it is "essential" that CFTC have "access to daily reports of large trades of energy commodities . . . to deter and detect price manipulation." Page 120, Senate Investigations Report.

Clearly, more recent agreements with officials in Dubai and at the Financial Services Authority will result in more reporting as long as those agreements continue in effect. Nonetheless, there are significant benefits to be gained by statutory changes to lock-in and assure strong and continuing CFTC oversight over, or at the least comparable reporting, position, and transparency requirements for, those foreign exchanges regarding transactions on behalf of U.S. residents, or made through U.S. terminals or other facilities, and involving U.S. contracts or commodities for delivery in the United States.

QUESTIONS SUBMITTED BY SENATOR CHARLES E. GRASSLEY

Question. Do you think that the CFTC has acted aggressively enough to determine the impact of institutional investors and speculators on commodity markets?

Answer. No, I do not. The CFTC has statutory authorities that it has only recently begun to utilize to monitor and regulate commodities markets. That said, the copious recordkeeping and reporting exceptions contained in the Commodity Exchange Act make it difficult for the CFTC to receive the ongoing, continuous flow of information about transactions affecting, related to, or based on, the U.S. futures markets. Thus, while more could have been done to date, the law limits the CFTC's ability to be aggressive in some cases. A bipartisan Senate Permanent Subcommittee on Investigations joint report (June 25, 2007, "Excessive Speculation in the Natural Gas Market") noted that the "Enron loophole, which was inserted into the law in 2000 at the request of Enron and others, exempts electronic energy exchanges such as ICE [the electronic Intercontinental Exchange] from CFTC oversight and regulation."

There have been many recent reports and testimony about the significant upward price pressure that passive, institutional investors bring to bear on the markets because they buy long, regardless of price signals, and keep "rolling over" their long positions. Assets allocated to commodity index trading is up $13 billion since the end of 2003, as prices went up 183 percent according to testimony of Michael Masters, Masters Capital Management/May 20, 2008, before the Committee on Homeland Security and Governmental Affairs. Citi Futures Perspective, May 12, 2008, noted regarding crude oil that there has been a 425 percent increase in open interest in the last five years which greatly exceeded the corresponding growth in the physical oil market.

This is happening not just in the oil sector. On April 22, 2008, American Farm Bureau Federation testimony noted "the role of speculative and commodity index-related trading in agriculture futures markets, while growing for some time, has reached historic levels and added to the uncertainty in these markets." Speculators "are now playing an exponentially greater role than ever before. . . . Market analysts report a continued, massive inflow of capital into the grain pits, much of it by long-only, passively managed index funds that buy futures and roll them forward according to a set schedule."

Mr. Fadel Gheit, managing director and senior oil analyst at Oppenheimer Equity Research noted at a June 23, 2008, hearing (House Subcommittee on Oversight and Investigation of the Committee on Energy and Commerce) that, " I do not believe the current record crude oil price is justified by market fundamentals of supply and demand . . . I believe the surge in crude oil price, which more than doubled in the last 12 months, was mainly due to excessive speculation and not due to an unexpected shift in market fundamentals."

Testimony of Michael Masters, Masters Capital Management, noted that the vast majority of index speculators do not trade based on the underlying supply and demand fundamentals of the individual physical commodities but simply buy on a continuing basis, "rolling over" positions as needed.

Question. Do you believe there is evidence that crude oil prices are being driven by speculators? If so, what do you believe is the CFTC's responsibility with regard to limiting the amount of institutional speculation?

Answer. Yes, I do think evidence exists showing the recent upward pressure caused by excessive speculation regarding on oil prices. As I mentioned in my earlier answer, Mr. Fadel Gheit, managing director and senior oil analyst at Oppenheimer Equity Research noted at a June 23 hearing, that, "I do not believe the current record crude oil price is justified by market fundamentals of supply and demand . . . I believe the surge in crude oil price, which more than doubled in the last 12 months, was mainly due to excessive speculation and not due to an unexpected shift in market fundamentals."

"Speculation has contributed to rising U.S. energy prices." That simple conclusion is stated in a June 2006 bipartisan report of the U.S. Senate Permanent Subcommittee on Investigations called "The Role of Market Speculation in Rising Oil and Gas Prices: A Need to Put the Cop Back on the Beat." I agree with that conclusion that the cop, the CFTC, needs to be put back on the beat and must carefully monitor transactions to prevent price manipulation just as the Securities and Exchange Commission words to prevent stock price manipulation.

In addition, Mr. Roger Diwan, a partner at PFC Energy, testified on June 23, 2008, (House Subcommittee on Oversight and Investigation of the Committee on Energy and Commerce) that "these index funds . . . probably represent the single largest components on oil futures and their sizes have been calculated to be close to $280 billion." He noted how the open interest strongly correlated with the increases in oil prices, stating that, "the flow of money to the futures market that became the key element to predict prices, with a correlation close to 80 percent."

According to a June 15 Bloomberg article, Robert Aliber is quoted as saying "You've got speculation in a lot of commodities, and that seems to be driving up the price." Dr. Aliber is a professor of economics emeritus at the University of Chicago Graduate School of Business and co-author of "Manias, Panics, and Crashes: A History of Financial Crises."

The CFTC should focus on the clear intent of Congress to protect market participants from "excessive speculation" and "manipulation" in addition to all the provisions designed to punish fraud, conspiracies to corner markets, misleading statements, and the like. Investments related to hedging one's physical position, or future physical position, designed to reduce risk have not been the problem. On the contrary, they are the very reason such exchanges were formed. Michael Masters noted that automatic institutional investments made with little, if any, consideration as to price, and not done to limit risk, in the hopes that the market always goes in one direction can distort the price discovery functions of the markets and should be monitored and regulated by the CFTC.

Question. Does CFTC currently have all the tools necessary to respond to the speculation in commodities by hedge funds, investment banks and pension funds? Does Congress need to act to provide additional authority to the CFTC? If so, please provide specific recommendations for additional authority.

Answer. The CFTC does not have all the authorities needed to respond to the speculation. Several bills before the Congress contain provisions which would help CFTC to reduce reckless and excessive speculation not consistent with normal rules of supply and demand for the underlying commodity; the "spot price" of that commodity.

We would recommend law changes to allow for CFTC to better monitor, through greater transparency, and exercise authority over, swaps transactions to prevent excessive speculation in energy products. The CFTC should not permit foreign boards of trade (FBOT) to provide its members or other participants subject to CFTC jurisdiction direct access to electronic trading in the United States or to order matching systems unless the FBOT meets specified requirements related to transparency, information sharing and position limits; except for bona fide hedge trading.

The CFTC should be able to quickly exercise oversight over any disturbance in a commodity market that disrupts its liquidity and price discovery function from accurately reflecting a commodity's supply and demand ("major market disturbance") and should be able to identify each large over-the-counter transaction or class of such transactions in order to detect and prevent potential price manipulation of, or excessive speculation in, any contract listed for trading on a registered entity.

The CFTC should have the clear authority to require recordkeeping by anyone either in the United States or entering trades into the trade matching system of a foreign BOT from the United States regarding U.S. traded commodities.

Further, the CFTC should be instructed to: (1) routinely require detailed reporting from index traders and swap dealers in markets under its control; and (2) review the trading practices for index traders in markets to ensure that index trading is not adversely impacting the price discovery process.

The CFTC should disaggregate and make public on a regular basis: (1) the number of positions and total value of index funds and other passive, long-only positions in energy markets; and (2) data on speculative positions relative to bona fide physical hedgers in energy markets

Several bills before the Congress require the CFTC to hire additional enforcement personnel and we certainly support those efforts. The CFTC should clearly distinguish between bona fide legitimate hedgers and speculators and ensure that position limits apply to all traders who are not doing legitimate, bona fide, hedging.

Question. Goldman Sachs and Morgan Stanley appear to be two of the largest energy trading financial institutions. Should CFTC regulate oil analysts with institutional speculators who forecast oil markets? If an investment bank with large positions in the commodity market makes a prediction that benefits the positions of the investment bank, is the price manipulation?

Answer. There have been news accounts that discuss the potential for price manipulation by persons interested in a certain market outcome who then try to drive the press or the public in that direction for the purpose of making increased profits. As with stock prices, these activities can influence prices in a manner that is inconsistent with a true assessment of the value of the commodity or the stock. The CFTC should carefully monitor these activities and establish clear standards for proper behavior to prevent price manipulation designed to mislead the public for private gain. A bipartisan Senate Permanent Subcommittee on Investigations joint report (June 25, 2007, "Excessive Speculation in the Natural Gas Market") is instructive regarding the ability of a company to manipulate futures prices in the energy markets.

Question. In 2007, the CFTC issued a "no-action" letter thereby declining to regulate the trading of the West Texas Intermediate (WTI) oil contracts on the Dubai Exchange. There appears to be a significant amount of trading in WTI contracts both on the Dubai Exchange and the Intercontinental Exchange in London. Given that, do you think CTFC has a responsibility to regulate WTI trading in these offshore exchanges? If not, why?

Answer. Let me start my answer by bringing to your attention what happens when trading in energy commodities is not regulated by the CFTC. The perfect example is natural gas trading. An energy trading company called Amaranth recently took advantage of the so-called Enron loopholes such that the CFTC was unable to adequately regulate trading in energy futures leading to excessive speculation and price manipulation. A bipartisan Senate Permanent Subcommittee on Investigations joint report (June 25, 2007, "Excessive Speculation in the Natural Gas Market") noted that the "Enron loophole, which was inserted into the law in 2000 at the request of Enron and others, exempts electronic energy exchanges such as ICE [the electronic Intercontinental Exchange] from CFTC oversight and regulation." That report shows the dangers of limiting CFTC ability to regulate energy trading by U.S. residents or those using U.S. trading terminals related to commodities for delivery in the United States.

Our commodity futures markets should offer a level playing field to all foreign and domestic investors using U.S. terminals regarding commodities for delivery in the United States. The Commodity Futures Trading Commission (CFTC) should evenly enforce the same rules for all, ensure transparent pricing, and assure the availability of timely, reliable, and accurate information to all traders using U.S. facilities to trade U.S. energy futures.

QUESTIONS SUBMITTED TO MARK COOPER

QUESTIONS SUBMITTED BY SENATOR PAT ROBERTS

Question. Mr. Cooper, several of your fellow panelists testified that retaining liquidity in the market is a priority for maintaining efficiency, and that raising margin rates could drive liquidity to less transparent oversees markets. Yet, your testimony advocates for increases in margin requirements. I've heard a lot about the impacts higher prices have had on margin calls recently. Grain elevators and co-ops already struggle to meet existing margin calls and often times max out their credit limits securing enough capital to do so, or they discontinue offering futures contracts to producers. Can you explain to me how your proposal to raise their rates will put my constituents' minds and businesses at ease?

Answer. Rising volatility and value of commodities has squeezed physical (commercial) players out of the market because they must finance their hedging activities. Exchanges should set lower margins for real physical/commercial traders.

Question. Mr. Cooper, Mr. Duffy, Dr. Newsome and Mr. Vice, several countries with increasingly high energy consumption growth rates like China are heavily subsidizing consumer energy costs. Reuters recently reported that for the first time ever, China has become a net importer of gasoline. They continue to consume without their consumers feeling the pain of global price increases. What affects do non-market based policies like this have on the price of crude oil?

Answer. Non-market factors have a huge influence on the price of crude, both policies that subsidize consumption and OPEC policies that manage supply. Chinese policies of under valued currency and under paid labor are used to subsidize under priced energy consumption. The Chinese know well that if they did not subsidize energy consumption, they would have to raise wages, which would increase the cost of exports. The Chinese pay for cheap oil with cheap labor because they use the trade surplus from manufactured exports to subsidize energy consumption. They export the burden of a tight energy market to nations that do not subsidize energy consumption.

QUESTIONS SUBMITTED BY SENATOR SAXBY CHAMBLISS

Question. Dr. Cooper, I hear concerns that all trades are not being properly reported and that the CFTC doesn't have adequate data to monitor participation by speculators in the market—hence the call for more reporting requirements and monitoring by the CFTC. However, if the data available is truly insufficient, then I am genuinely interested to know what information is being used to support the assessment that speculation is contributing $40 to the price of a barrel of crude oil?

Answer. The data and information on the economic cost of production and market models of the supply-demand balance are adequate to make a reasonable projection of what the price of oil should be at economic equilibrium in today's market. There is general agreement among oil industry economists, oil industry executives and governmental energy modelers on the fact that the price of oil should be less than $80 per barrel. With oil in the range of $130 to $140 per barrel, the observed price is $40 to $60 higher than that calculated market equilibrium price.

The data and information that is lacking deals with how trading practices and policies have allowed the speculative bubble to come about. The CFTC insisted for years that it had enough data and that regulatory oversight by exempt entities was adequate, until two months ago. Now it admits that it did not have enough data to answer the critical questions and that foreign regulation of exempt exchanges was inadequate. The CFTC has only begun to investigate the problem, but every day that the abuse goes on costs the American public about $1 billion.

Question. In your written testimony you state that the CFTC misclassifies large speculators, such a Goldman Sachs and Merrill Lynch, as commercial traders, not speculators. Is it not true that Goldman Sachs and Merrill Lynch often trade both on behalf of those who are commercial market participants, in other words those who can actually take delivery of crude oil, as well as speculators—and the CFTC recently announced that they are going to be looking at the books of these traders to differentiate positions held by speculators and commercial participants?

Answer. The admission that it needs to look more carefully at who, exactly, is trading through these brokers underscores the fact that the CFTC's practices were to lax in the past and misrepresented the reality to policymakers. The actual commercial traders should be identified and treated differently, but the CFTC allowed huge quantities of speculation to be misclassified as commercial activity by treating all Merrill Lynch activities as commercial.

QUESTIONS SUBMITTED BY SENATOR CHARLES E. GRASSLEY

Question. Do you believe that further oversight of commodities trading is needed in light of the increased pressure on margin calls and market volatility that has led to local elevators and major grain trading companies not being able to offer forward contracts to producers?

Answer. Yes. By imposing prudential regulation of commodity future markets the CFTC will dampen excessive speculation, which will enable physical traders to reenter the market.

Question. Recently CTFC announced investigations into possible price manipulation in oil and cotton markets. Would you support them opening investigations into other commodities including corn and wheat? Why or why not?

Answer. The CFTC should be vigilant to prevent manipulation in all commodity markets. The investigation of potential manipulation in any commodity markets should be vigorous and continuous. However, the current problem of excessive speculation goes well beyond manipulation. The trading practices that are pumping up commodity prices across the board should be addressed by reform of prudential regulation, reform that will affect all commodities.

QUESTIONS SUBMITTED TO MARK COOPER AND JAMES C. MAY

QUESTIONS SUBMITTED BY SENATOR CHARLES E. GRASSLEY

Question. Do you think that the CFTC has acted aggressively enough to determine the impact of institutional investors and speculator on commodity markets?

Answer. The CFTC has been slow and slovenly in its oversight over these markets. The CFTC insisted for years that it had enough data and that regulatory oversight by exempt entities was adequate, until two months ago. Now it admits that it did not have enough data to answer the critical questions and that foreign regulation of exempt exchanges was inadequate. The CFTC has only begun to investigate the problem, but every day that the abuse goes on costs the American public about $1 billion.

Question. Do you believe there is evidence that crude oil prices are being driven by speculators? If so, what do you believe is the CFTC's responsibility with regard to limiting the amount of institutional speculation?

Answer. The CFTC's obligation is to prevent excessive speculation, whatever its causes. It should declare an emergency and adopt whatever measures it needs to burst the speculative bubble that afflicts the oil market. The practice of institutions engaging in long-only index trading is contributing to the speculative bubble and should be terminated.

Question. Does CFTC currently have all the tools necessary to respond to the speculation in commodities by hedge funds, investment banks and pension funds? Does Congress need to act to provide additional authority to the CFTC? If so, please provide specific recommendations for additional authority.

Answer. The Congress needs to enact legislation to accomplish two things. There were some loopholes created by the Commodity Futures Modernization Act that only Congress can close. Among my recommendations, these include closing the Enron loophole firmly, instituting minimum criminal penalties for market manipulation, banning some trading practices, etc. There are also a number of practices that the CFTC adopted administratively (such as the foreign board of trade exemption and the swaps exemption) that the Congress should close because the CFTC has failed to address these problems. Since the CFTC could have taken remedial action, but it has failed to do so, Congress should.

Question. Goldman Sachs and Morgan Stanley appear to be two of the largest energy trading financial institutions. Should CFTC regulate oil analysts with institutional speculators who forecast oil markets? If an investment bank with large positions in the commodity market makes a prediction that benefits the positions of the investment bank, is the price manipulation?

Answer. Whether or not these practices fit the narrow definition of manipulation, these practices constitute conflicts of interest and must be regulated. The case law and practice on manipulation at the CFTC ignores a wide range of trading practices that contribute to excessive speculation. The Congress needs to address these practices with legislation because, legally, existing case law makes it difficult for the CFTC to reach these practices and, administratively, the CFTC has been slow and reluctant to act to protect the public.

Question. When testifying before the Agriculture Committee, Acting Chairman Lukken and Commissioner Chilton discussed several new initiatives to improve trade collection and dissemination efforts to bring more transparency in the areas of agriculture and energy markets. Do you think the steps taken by the CFTC in recent weeks go far enough to bring greater transparency and scrutiny in energy and agriculture trades? If not, what suggestions can you offer?

Answer. The sudden discovery that the CFTC has inadequate information, that foreign boards of trade are inadequately regulated and that categorizing all swaps trading by large banks as commercial may distort the picture of the market underscores what a bad job the CFTC has done in preventing excessive speculation. Legally, the CFTC will have difficulty reforming some of the practices that are causing the problem because it has defined its task so narrowly and the case law will not easily support actions against the broader range of abuses that have developed. Practically, we doubt the genuineness of the commitment of the current Commission to vigorous action to protect the public. The Congress cannot rely on the Commission to protect the public. It must outlaw certain practices and order the commission to regulate others. I recommended fifteen specific policies in my testimony.

QUESTIONS SUBMITTED TO TERRENCE A. DUFFY

QUESTION SUBMITTED BY SENATOR PAT ROBERTS

Question. Mr. Cooper, Mr. Duffy, Dr. Newsome and Mr. Vice, several countries with increasingly high energy consumption growth rates like China are heavily subsidizing consumer energy costs. Reuters recently reported that for the first time ever, China has become a net importer of gasoline. They continue to consume without their consumers feeling the pain of global price increases. What affects do non-market based policies like this have on the price of crude oil?

Answer. CME does not operate crude oil futures markets so we do not possess the expertise in that particular area that NYMEX has to offer. That said, our experience with the markets we do operate, especially agricultural commodities, provides a basis for our informed judgment that non-market policies are having a significant impact on supply and demand in global commodity markets. As we explained in our written testimony, there are several factors that have combined to create volatility and increased prices in the grains and oilseeds markets, including weather/disease/pestilence; increasing per capita consumption in emerging markets; increased demand for grain and oil seeds as feedstock for biofuels; reactionary governmental trade policies; and financial market turmoil, including the weakened dollar. Of these factors, several are the result of governmental policies, specifically policies prioritizing biofuel development, protectionist trade policies such as those that reserve certain nations' internal agricultural production exclusively for domestic consumption, and international monetary policy that is set by the respective national banks and governments. Having confirmed the interplay of such governmental policy on the price-supply dynamics in our agricultural commodity markets, we would assume that similar impacts can readily be at play in crude oil markets which are increasingly characterized by government controlled production and cartelization of supply, and Congress should not be surprised by such policy driven adverse impacts on prices in the crude oil markets.

QUESTION SUBMITTED BY SENATOR SAXBY CHAMBLISS

Question. There have been several issues raised with regard to changing how margin levels are set and whether CFTC should play a greater role in that process. Specifically, some have compared the margin levels applied to stock trading to those applied to commodity futures trading. While this comparison has been made in the context of energy futures and I recognize that you are not in the energy futures business, I know that you are very familiar with the differences in stocks and commodity futures and wonder if you could explain how clearing houses establish margins for commodity futures contracts and why this differs from margins applied to stock trading?

Answer. The discussion of mandated margin increases during recent congressional hearings makes it abundantly clear that many legislators wrongly assume the concept of margin in futures markets is similar to that in equity markets. Indeed, legislative proposals to require mandated increases in futures margins are premised on a seriously flawed understanding of the role margin plays in futures markets and how that role differs from the concept and function of margin in equity markets. In the securities market, margin serves as an extension of credit or a down payment on the cost of a security. However, the notion of "credit" has nothing to do with the concept of margin as used in futures markets. In futures markets, margin is not an extension of credit. Rather, margin is the equivalent of a performance bond designed to ensure that contractual obligations are met and that clearing houses can fulfill their responsibilities. Margins are not intended to create incentives or disincentives for trading decisions. Failure to understand this critical difference in the notion of margin as used in futures trading can have highly destructive implications for U.S. futures markets and those who rely on them.

QUESTIONS SUBMITTED BY SENATOR CHARLES E. GRASSLEY

Question. In a recent hearing in the Senate Commerce Committee, Michael Greenberger, a law professor at the University of Maryland and former head of the

CFTC's Division of Trading & Markets, suggested that if the CFTC required all U.S. crude trades to be subject to CFTC regulation and trading limits, oil prices would drop by 25 percent overnight. Do you agree with his contention?

Answer. CME group does not operate oil and gas futures markets, so we do not profess to have the specialized experience with those markets to definitively answer this question regarding crude oil prices. That said, from what we observe with regard to the run up in commodity prices in general and our agricultural commodity markets in specific, the primary factors contributing to that phenomenon relate to fundamentals of supply and demand, not the regulation of speculative trading by CFTC or the conduct of trading activity on markets that are not regulated by the CFTC. We have no reason to expect that adoption of Mr. Greenberger's suggestion would result in a reduction in the price of crude oil by 25 percent overnight.

Question. In 2007, the CFTC issued a "no-action" letter thereby declining to regulate the trading of the West Texas Intermediate (WTI) oil contracts on the Dubai Exchange. There appears to be a significant amount of trading in WTI contracts both on the Dubai Exchange and the Intercontinental Exchange in London. Given that, do you think CTFC has a responsibility to regulate WTI trading in these offshore exchanges? If not, why?

Answer. CFTC has taken steps in recent weeks to significantly bolster its regulatory reach under its "no-action letter" regime with regard to the ICE London exchange. These enhancements include increased reporting requirements to improve transparency and imposition of position limits and accountability standards that mirror what CFTC requires of NYMEX which trades competing WTI contracts in this country. CFTC's expansion of its regulatory regime in this regard is appropriate and welcome since it fairly levels the regulatory playing field among competitors, while enhancing the agency's understanding of the broader international trading activity that can affect the proper functioning of our own domestic futures markets. In addition, the manner in which CFTC negotiated these improvements in its "no action" requirements with the foreign board of trade and its London-based regulator reflects the need to respect the legitimate interest foreign regulators have in the fair treatment of their own domestic trading platforms by foreign regulators. CME very much understands that the United States has that same interest in judiciously accommodating foreign competitors and the legitimate reciprocal concerns of foreign regulators since U.S. exchanges such as CME's world-class platforms need to be able to access foreign markets in a non-discriminatory manner too. Any foreign regulator that insisted on our compliance with its regulatory regime that conflicted with U.S. law or imposed discriminatory burdens on us as a foreign competitor would present an untenable obstacle to our access to those foreign markets. As a result, U.S. policy must embrace the notion of respectful and productive accommodation of differing international regulatory regimes to facilitate commerce that is still properly and adequately regulated to attain U.S. public policy objectives.

QUESTIONS SUBMITTED TO DR. JAMES NEWSOME

QUESTIONS SUBMITTED BY SENATOR CHARLES E. GRASSLEY

Question. In 2007, the CFTC issued a "no-action" letter thereby declining to regulate the trading of the West Texas Intermediate (WTI) oil contracts on the Dubai Exchange. There appears to be a significant amount of trading in WTI contracts both on the Dubai Exchange and the Intercontinental Exchange in London. Given that, do you think CFTC has a responsibility to regulate WTI trading in these offshore exchanges? If not, why?

Answer. First, the CFTC staff no-action letter to the Dubai Mercantile Exchange (DME) permits the DME to provide direct access to qualified users in the United States for the electronic trading of specified products. Such staff no-action letters generally are issued following a review of the regulation of the home-country regulator for the exchange and these no-action letters typically include various conditions that must be met in order to maintain the no-action relief. Second, NYMEX notes that the DME has not yet listed the WTI futures contract for trading and no future date has been announced for the listing of this contract.

More generally, Section 4(a) of the Commodity Exchange Act requires futures contracts to be traded on or subject to the rules of an exchange that is regulated by the CFTC. However, this broad requirement by its terms does not apply to contracts on exchanges "located outside the United States, its territories or possessions. . . ." NYMEX believes that a foreign board of trade that is permitted to offer products by direct access to U.S. customers pursuant to CFTC staff no-action letters and that lists futures based on commodities with U.S. delivery points should be subject to some level of CFTC oversight. These offshore exchanges 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. In addition, NYMEX believes that offshore exchanges offering contracts linked to commodities with U.S. delivery points should be required to impose position limits. Complete transparency to the CFTC should be a fundamental requirement for offshore exchanges offering direct access for the electronic trading of products linked to U.S. markets.

Question. Do you believe that speculators could be at least playing some role in the higher prices of oil? If not, what do you believe are the causes?

Answer. NYMEX's Research Department has conducted extensive analysis on the role of speculators in our markets. These evaluations began in 2004 and included reviewing data from 2007 through to the middle of 2008 for our core crude oil and natural gas futures contracts. We found no evidence to support harmful impacts on price or price volatility by non-commercial participants. Our analysis instead disclosed that non-commercial participants are price takers. In other words, they do not initiate movements in price or otherwise set prices, but rather follow price movements that are generated by commercials. In addition, our data indicate that trading by non-commercials or speculators has had a moderating or braking effect on price volatility in the products that were the subject of the study.

Other findings also support our conclusion that speculators are not influencing the futures prices. First, non-commercial participants historically have represented a smaller percentage of the energy futures markets than commercial participants. Second, noncommercial participation consistently has been relatively balanced between longs (buys) and shorts (sells), so there has not been, for example a disproportionate push on the long side of the market, which would cause the price to increase. Third, non-commercials generally are not in a position to influence final settlement prices because they do not own the physical commodity and therefore, must liquidate their open futures positions prior to expiration of trading of the applicable expiring contract month.

Lastly, with hundreds of commercial participants and instantaneous price dissemination, any short term "speculative" price impact that creates a discrepancy between the futures price and the price level that would be anticipated on the basis of market fundamentals in the underlying physical commodity market would be expected to be met in reasonably short order with an equally strong "commercial" reaction. Thus, if short-term prices in a futures market should happen to move in a direction inconsistent with actual market fundamentals, a vast number of participants, including energy producers, wholesalers and end-users (as well as government agencies) would respond to ensure that prices return rapidly to where the industry consensus believes they should be to reflect supply and demand fundamentals.

NYMEX believes that market fundamentals generally explain the volatility and level of prices in the oil futures markets. Most recently, the U.S. Department of Energy's Energy Information Administration (EIA) and International Energy Agency (IEA) in their recent respective market reports have noted the uncharacteristic changes in the Organization for Economic Cooperation and Development (OECD) inventories during the second quarter this year. On the supply side of the equation, EIA reported an over 1 million barrel per day drop from the "average build" for OECD countries during the second quarter. EIA also indicated that there were changes in world inventories during the first half of the year—600,000 barrels per day decrease during the first quarter and 280,000 barrels increase during the second quarter. EIA and IEA data typically are revised a few times following the initial release, indicating the complexities in ascertaining the correct level of inventories and also highlighting a measure of uncertainty regarding core market fundamentals that have an impact on price levels.

On the demand side, the strongest source of projected energy demand is from the less transparent developing countries such as China, India, and the Middle East. There is considerable difficulty in assembling accurate and timely information on non-OECD petroleum consumption in these countries. However, the EIA Short-Term Energy Outlook projects that world oil demand will grow by 1.2 million barrels per day in 2008, up a healthy 1.4 percent, with China accounting for 35 percent of this demand growth. We caution anyone against oversimplifying the challenge of accurately assessing or projecting the level of demand in these developing countries.

Finally, over the long term, there has been steady upward pressure on petroleum demand pushed each year by the millions of people making the transition in less-developed countries to the beginnings of middle-class circumstances. However, a global recession could have the effect of softening or suspending this upward pressure.

Question. An estimated 30 percent of West Texas Intermediate trading is now done through ICE Futures Europe. NYMEX has recently gotten involved in the foreign exchange by partnering with the Dubai Mercantile Exchange. If a trade involves a WTI contract, why shouldn't these trades be subject to CFTC regulation?

Answer. As a note, NYMEX has not entered into a formal partnership with the DME but instead does own a modest ownership share in a holding company that owns the DME. We agree that trading of WTI futures contracts offered by direct access to U.S. customers by foreign boards of trade generally should be fully transparent to the CFTC. It should also be generally subject to the same market surveillance regulatory regime as the linked U.S. market, such as position limits/accountability levels, large trader reporting and emergency authority. Prior to the listing of the WTI crude oil contract by ICE Futures Europe, 100 percent of trading in that contract was under CFTC jurisdiction, fully transparent and regulated at the highest tier of regulation.

Question. If these trades are exempt from CFTC regulatory supervision, what will prevent an even greater percentage of WTI contracts to be traded on a foreign exchange, exempt from CFTC oversight?

Answer. In fact. there is nothing to prevent the shift of trading volume away from the NYMEX WTI crude futures contract to ICE Futures Europe. NYMEX staff repeatedly advised CFTC staff that this shift of liquidity could well occur if the regulations governing the NYMEX and ICE markets were not comparable to redress the unlevel playing field. The CFTC staff now has conditioned their no-action letter (on direct electronic access) to ICE Futures Europe so as to impose similar market surveillance requirements on ICE Futures Europe that are imposed on NYMEX as a designated contract market.

Question. In a recent hearing in the Senate Commerce Committee, Michael Greenberger, a law professor at the University of Maryland and former head of the CFTC's Division of Trading & Markets, suggested that if the CFTC required all U.S. crude trades to be subject to CFTC regulation and trading limits, oil prices would drop by 25 percent overnight. Do you agree with this contention?

Answer. I strongly disagree with this contention. While noting Mr. Greenberger's rather short stint as head of the CFTC's Division of Trading and Market, it should also be noted that he has no training, experience or expertise in the economic analysis of futures markets. Moreover, despite his grand and sweeping assertion, Mr. Greenberger to date has not been able to point to a single econometric study or other analysis by a legitimate economist demonstrating any such price impact resulting from his proposed legislative solutions. As noted above, futures prices are generally driven by the fundamental forces of supply and demand. It is frankly preposterous to think that requiring all oil trading to be regulated will cause a 25 percent drop in price. The location and manner of oil trading ultimately does not and cannot change the underlying market fundamentals of the global oil market.

QUESTION SUBMITTED BY SENATOR PAT ROBERTS

Question. Several countries with increasingly high energy consumption growth rates like China are heavily subsidizing consumer energy costs. Reuters recently reported that for the first time ever, China has become a net importer of gasoline. They continue to consume without their consumers feeling the pain of global price increases. What affects do non-market based policies like this have on the price of crude oil?

Answer. It has been widely reported that a number of countries have been providing significant subsidies for consumer energy costs. All other things being equal, the impact is a rise in the price of oil. Noting the market for crude oil is global in scope, such subsidies raise the demand for the underlying refined product which, in turn, raises the demand for crude oil which, in turn, raises the price of crude oil. From the perspective of interpretation, it means that the demand for the refined product as well as crude oil does not reflect accurately consumer interests because some consumers are being shielded directly from the market price for the refined product and indirectly from the price of crude oil. Certainly, the impact on non-subsidized consumers is unambiguously higher prices for crude oil and refined products. While consumers in non-subsidized countries generally would respond to increasing prices, such as by cutting back on their energy consumption, consumers in the subsidized countries may make no changes in their demand for energy regardless of the extent of price increases.

QUESTIONS SUBMITTED TO CHARLES A. VICE

QUESTION SUBMITTED BY SENATOR PAT ROBERTS

Question. Mr. Cooper, Mr. Duffy, Dr. Newsome and Mr. Vice, several countries with increasingly high energy consumption growth rates like China are heavily subsidizing consumer energy costs. Reuters recently reported that for the first time ever, China has become a net importer of gasoline. They continue to consume without their consumers feeling the pain of global price increases. What affects do non-market based policies like this have on the price of crude oil?

Answer. These policies have a huge effect of the price of crude oil. India, China and many other developing countries, to some extent, subsidize the gasoline purchases. Critically, these same countries are a large part of the new and growing demand for oil. Without the proper market incentives, these countries will not take steps to become more efficient and thus will distort demand and exacerbate crude oil prices. Not only is this bad for the global economy, but it is particularly detrimental to the subsidizing governments. In India, the cost of the gasoline subsidy grew to 3 percent of the countries GDP.[1] Finally, it is important to note that many of these countries began to cut their fuel subsidies this summer, which coincided with the demand destruction that lead to the recent fall in crude oil prices.

QUESTIONS SUBMITTED BY SENATOR CHARLES E. GRASSLEY

Question. In 2007, the CFTC issued a "no-action" letter thereby declining to regulate the trading of the West Texas Intermediate (WTI) oil contracts on the Dubai Exchange. There appears to be a significant amount of trading in WTI contracts both on the Dubai Exchange and the Intercontinental Exchange in London. Given that, do you think CTFC has a responsibility to regulate WTI trading in these offshore exchanges? If not, why?

An estimated 30 percent of West Texas Intermediate trading is now done through ICE Futures Europe. NYMEX has recently gotten involved in the foreign exchange by partnering with the Dubai Mercantile exchange. If a trade involves a WTI contract, why shouldn't these trades be subject to CFTC regulation?

If these trades are exempt from CFTC regulatory supervision, what will prevent an even greater percentage of WTI contracts to be traded on a foreign exchange, exempt from CFTC oversight?

Answer. It is important to note that pursuant to the Commodity Futures Trading Commission's recent amendment to ICE Futures Europe's no action letter, the ICE will be placing speculative limits and will be meeting the same reporting requirements as U.S. based exchanges on its contracts that settle on the price of a contract traded by a U.S. designated contract market. This is in addition to the stringent oversight provided by the Financial Services Authority.

That said, it should also be noted that the CFTC's current "no action" regulatory regime works. As background, in 2006, the CFTC convened public hearings to consider the issue of the regulation of Foreign Boards of Trade in the United States. Consideration of the issue at that time was largely triggered by the launch of the ICE WTI Crude futures contract. An overwhelming majority of participants in those hearings thought that the CFTC "no action" regime had been very successful. The CFTC reaffirmed its no action regime thereafter[2], recognizing the benefits of regulatory cooperation and mutual recognition.

The basis of this approach is that markets, particularly oil markets, are global. Participants are based all over the world and cooperation between regulators is crucial in this context. The concept that each exchange be subject to the jurisdiction of one primary regulator has avoided duplication and conflicting regulations that would have made it unduly burdensome and expensive for participants to conduct their trading activities within the current arrangements. Other regulators with an interest in the activities of the exchange can exercise secondary oversight and jurisdiction through consents to jurisdiction, and through information sharing with the correspondent regulator.

Question. Do you believe that speculators could be at least playing some role in the higher prices of oil? If not, what do you believe are the causes?

Answer. At the outset, all investment is inherently speculative. Commercial firms speculate on the price of commodities when they invest in new production and when they hedge their risks from these investments. The real issue is whether this specu-

---

[1] Backlash as India puts up Fuel Price, Financial Times, July 4, 2008. http://www.ft.com/cms/s/0/8bd96c88-3208-11dd-9b87-0000779fd2ac.html?nclick__check=1.

[2] CFTC Release: 52 52–2 issued October 31, 2006.

lation reflects the underlying supply and demand. Numerous experts and industry observers have come to the conclusion that the recent price spike in oil was driven by supply and demand. For example, the International Energy Agency, in its Medium-Term Oil Market Report, states that global oil product demand is expected to grow by 1.6 percent per year on average over the next five years, primarily driven by growth in developing countries. The report notes that demand growth remains heavily concentrated in developing countries, where total consumption will nearly reach parity with mature economies by 2015. Asia, the Middle East and South America will account for nearly 90 percent of global demand growth over the next five years. On the supply side of the equation, oilfields worldwide are declining in production, especially given the underinvestment in energy infrastructure that has been caused by prior price collapses. Just to hold world production steady, over 3.5 million barrels per day of new production is needed. However, this new production, if it is possible, will come at a steep price. Costs of new production today are double the cost of new production four years ago.

In addition, the effect of the devaluation of the dollar cannot be discounted. The price of oil is highly correlated to the value of the dollar as shown by the recent drop in the price of oil, which has coincided with a rise in the valuation of the dollar. As Benn Steil noted in his testimony before the Senate Committee on Homeland Security and Governmental Affairs, that while "the prices of oil and wheat measured in dollars have soared over the course of this decade, they have, on the other hand, been remarkably stable when measured in terms of gold—gold having been the foundation of the world's monetary system until 1971." [3] Thus, the effect of the dollar has a large impact on the price of oil.

Question. In a recent hearing in the Senate Commerce Committee, Michael Greenberger, a law professor at the University of Maryland and former head of the CFTC's Division of Trading & Markets, suggested that if the CFTC required all U.S. crude trades to be subject to CFTC regulation and trading limits, oil prices would drop by 25 percent overnight. Do you agree with his contention?

Answer. No. As pointed out in the Joint Analysis Prepared by Majority and Minority Staffs of the Senate Permanent Subcommittee on Investigations of Michael Greenberger Testimony before Senate Committee on Commerce, Science and Transportation on June 3, 2008, Professor Greenberger's statement is untrue ("Senate PSI Response").[4] Professor Greenberger's statement refers to trading on exempt commercial markets ("ECMs"). As the Senate PSI Response points out, there is little to no trading of crude oil on ECMs. In addition, the Subcommittee points out that the prices for agricultural commodities have risen, even though these commodities do not trade on ECMs.

CONCLUSION OF HEARING

Senator DURBIN. I thank everybody for attending today. I think this was an important hearing and we will follow through. Thank you.

[Whereupon, at 1:05 p.m., Tuesday, June 17, the hearing was concluded, and the subcommittee was recessed, to reconvene subject to the call of the Chair.]

○

[3] Testimony of Dr. Benn Steil before the Senate Committee on Homeland Security and Governmental Affairs (May 20, 2008). http://www.cfr.org/content/publications/attachments/Steil__Senate%20Testimony__3%2020%2008.pdf.

[4] Senate PSI Response, pg. 6. http://hsgac.senate.gov/public/__files/PSIJtSTAFFANALYSISGREENBERGERTESTIMONYONJUNE32008.pdf.