TESTIMONY
OF
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BEFORE THE
SUBCOMMITTEE ON GENERAL FARM COMMODITIES
AND
RISK MANAGEMENT
OF THE
HOUSE COMMITTEE ON AGRICULTURE

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I am Terrence A. Duffy, executive chairman of CME Group Inc. Thank you Chairman Boswell and Ranking Member Moran for inviting us to testify today. You asked us to discuss the implementation of provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act relating to position limits.

CME Group is the world's largest and most diverse derivatives marketplace. We are the parent of four separate regulated exchanges, including Chicago Mercantile Exchange Inc. ("CME"), the Board of Trade of the City of Chicago, Inc. ("CBOT"), the New York Mercantile Exchange, Inc. ("NYMEX") and the Commodity Exchange, Inc. ("COMEX") (collectively, the "CME Group Exchanges"). The CME Group Exchanges offer the widest range of benchmark products available across all major asset classes, including futures and options on futures based on interest rates, equity indexes, foreign exchange, energy, metals, agricultural commodities, and alternative investment products.

CME Clearing, a division of CME, is one of the largest central counterparty clearing services in the world, which provides clearing and settlement services for exchange-traded contracts, as well as for over-the-counter derivatives contracts through CME ClearPort®. Using the CME ClearPort service, eligible participants can execute an OTC swap transaction, which is transformed into a futures or options contract that is subject to the full range of Commodity Futures Trading Commission (the "Commission" or "CFTC") and exchange-based regulation and reporting. The CME ClearPort service mitigates counterparty credit risks, provides transparency to OTC transactions and enables the use of the exchange's market surveillance monitoring tools.

The CME Group Exchanges serve the hedging, risk management and trading needs of our global customer base by facilitating transactions through the CME Globex® electronic trading platform, our open outcry trading facilities in New York and Chicago, as well as through privately negotiated CME ClearPort transactions.

The theory that speculators in futures markets cause unwarranted price volatility and excessively high and/or low prices is not new; Congress has dealt with that notion since the late 1800s. The Commodity Exchange Act ("CEA"), however, does not limit speculation, but only "excessive speculation." This is an implicit recognition that futures markets cannot operate without the participation of speculators.

The so-called "speculators," such as index funds and swap dealers, who are the focus of recent intense criticism, are not engaged in traditional speculative activity, i.e., trying to beat the market. Rather, swap dealers use futures markets to facilitate the hedging of more complex and specific risks accepted in connection with swap transactions with commercial customers and others. Denying or limiting their access to the futures markets will simply impede hedging activity by commercial market participants. Index funds aggregate the buying and selling decisions of many thousands of investors, most of whom are doing what they have been taught for decades to do: diversifying their investment portfolios and hedging inflation risks to their investment returns in order to maximize their retirement savings and their individual wealth.

Position limits are not a costless palliative. Position limits, when improperly calibrated and administered, can easily distort markets, increase the costs to hedgers and effectively increase costs to consumers. Unfortunately, many demands for speculative limitations assume that severe limits on speculation will bring prices to some favored level. On the contrary, position limits on futures contracts will not and do not control cash market prices. There is a complete disconnect between the implied promise to drive prices down or up, whichever the most vocal constituency desires, and the ability of position limits to deliver on that promise.

<u>Introduction</u>

We disagree with those who contend, in contravention of the clear academic evidence and of the clear intent of Congress, as expressed in Dodd-Frank Wall Street Reform and Consumer Protection Act (P.L. 111-203, July 21,2010)("DFA" or "Dodd-Frank"), that speculative positions must be limited in order to eliminate price volatility and/or high prices or low prices for essential commodities.

Some of the proponents for limits are well intentioned, but have no credible evidence to support their claims. Some contend for example that strict limits on silver futures will allow the price of silver to go up to levels that they think is appropriate. Other proponents of strict position limits contend that limits on oil positions will cause the price of gasoline to fall to levels that are "better" for the economy or their constituents. The *Wall Street Journal* reported on December 8, 2010, that:

> "[T]he latest data also show an increase in speculation doesn't necessarily bring with it an increase in prices. Natural gas, for example, is down 21% this year despite a surge in speculative bets. In opposite circumstances with sugar, prices rallied despite a withdrawal of speculative bets." *The Wall Street Journal --- Investors Pile Into Commodities*, Carolyn Cui and Susan Pulliam.

All of the serious academic literature, including all of the studies produced by the CFTC's economists demonstrate that position limits in futures trading are not the means to deal with real supply and demand issues that are prevalent in markets for many physical commodities. It is my firm belief that efforts to focus on position limits rather than the underlying economic issues are certain to divert attention from the real supply and demand dynamics and do more harm than good. Worse yet, position limits in derivative markets that preclude investors from seeking economic exposure to particular asset classes drives those investors to speculate in physical commodities, which has a significant and often detrimental impact on the flow of commodities in commercial channels. We have already seen the beginnings of such distortions in metals and energy markets in anticipation of the imposition of limits on derivatives. This is not a development that anyone should favor, but one that is the logical result of even the threat of position limits based on bad economics.

CME group is not opposed to position limits and other similar measures in all circumstances; we employ limits in most of our physically delivered contracts. However, we use limits and accountability levels, as contemplated by the congressionally-approved Core Principles for Designated Contract Markets, to mitigate potential congestion during delivery periods and to help us identify and respond in advance to any threat to manipulate our markets. CME Group believes that the core purpose that should govern Federal and exchange-set position limits, to the extent such limits are necessary and appropriate, should be to reduce the threat of price manipulation and other disruptions to the integrity of prices. Such activity destroys public confidence in the integrity of our markets and harms the acknowledged public interest in legitimate price discovery.

CME Group is therefore vigilant in seeking to deter and prevent price manipulation or other illegitimate distortions of market prices. Speculation, however, is not manipulation, nor is it an abusive practice. As CME Group observed in its response to the Commission's January 2010 energy position limits proposal, speculation is essential to the orderly functioning of futures markets—it provides market liquidity which promotes more effective commodity price discovery and allows for the efficient transfer of price risk. See CME Group Comments, 10-002 Comment CL-02714, at 2 (Apr. 26, 2010) ("CME Comments"). The Commission's responsibility and challenge is not to restrict speculation per se, but to act when necessary to prevent "excessive speculation" from burdening interstate commerce through what the Commodity Exchange Act ("CEA") calls "unreasonable" and "unwarranted" fluctuations in the price of a commodity. To this end, Congress has granted to the Commission the authority to impose speculative position limits under Section 4a of the CEA, as amended by DFA.

CME Group understands the extensive demands being made on the Commission's limited resources. However, the Commission must gather critical data regarding swap markets and individual traders' swap positions. Without a thorough understanding of such data, the Commission runs the risk of inappropriately setting position limits. CME Group appreciates the great challenge this presents to the Commission.

I. Statutorily Required Basis for Imposing Position Limits

Section 4a(a)(1) provides in pertinent part:

"For the purpose of diminishing, eliminating, or preventing such burden [of unwarranted or unreasonable price fluctuations resulting from excessive speculation], the Commission shall . . . fix such limits on the amount of trading which may be done or positions which may be held . . . as the Commission finds are necessary to diminish, eliminate, or prevent such burden." (emphasis added)

By its terms, DFA requires the Commission to make a finding that position limits "are necessary to diminish, eliminate, or prevent" burdensome excessive speculation before imposing such limits. Dan Berkowitz, CFTC General Counsel, confirmed that Section 4a(a)(1) sets forth a conditional mandate during the CFTC's July 2009 hearings on energy position limits. In response to Chairman Gensler's question, "What does the word 'shall' mean in 4a?," Berkowitz replied, "If the Commission finds that position limits are necessary to prevent, diminish, or eliminate such burdens, then there is a directive that it shall establish position limits." Transcript of July 28, 2009 CFTC Hearing on Energy Position Limits at 35-36 (emphasis added). The above quoted language from Section 4a(a)(1) was not deleted or in any way altered by DFA. New CEA subsection (a)(2) ("Establishment of Limitations") even reaffirms that any position limits must be established "[i]n accordance with the standards set forth in paragraph 1 of this subsection," which include the requisite "necessary" finding. Core Principle 5, Section 5(d)(2)(5) of the CEA as amended by DFA, also recognizes that "accountability levels" are an alternative to rigid position limits:

> (5) POSITION LIMITATIONS OR ACCOUNTABILITY.—
>
> (A) IN GENERAL.—To reduce the potential threat of market manipulation or congestion (especially during trading in the delivery month), the board of trade shall adopt for each contract of the board of trade, as is necessary and appropriate, position limitations *or* position accountability for speculators. (emphasis supplied)

Moreover, the Commission must publish the statutorily required finding and the information in support thereof in any notice of proposed rulemaking to comply with the Administrative Procedure Act ("APA"). The APA requires that the notice of a proposed rule include "sufficient detail on its content and basis in law and evidence to allow for meaningful and informed comment." See, e.g., *Am. Med. Ass'n v. Reno*, 57 F.3d 1129, 1132 (D.C. Cir. 1995). Absent a finding with supporting evidence that position limits are "necessary," this APA requirement cannot be met because the public will not know the Commission's specific reasoning for the essential finding that triggers its proposed rulemaking.

DFA indicates that such limits would be "unnecessary" where burdensome excessive speculation does not exist or is unlikely to occur in the future. CME Group's comment letter on the Commission's energy position limits proposal discussed at length the absence of any credible empirical evidence of the existence of burdensome excessive speculation or its likely future occurrence. See CME Comments at 17-24. The weight of empirically sound analysis and research demonstrates that movements in commodity prices are attributable to fundamental market conditions rather than speculative trading. CFTC studies, for example, have found that supply and demand factors were largely responsible for the 2008 rise in oil prices and that, far from harming the market, speculators serve as an important source of liquidity for other participants. See, e.g., CFTC Interagency Task Force on Commodity Markets, *Interim Report on Crude Oil* at 3-4 (July 22, 2008); Michael Haigh et al., *Market Growth, Trader Participation and Pricing in Energy Futures Markets* (Feb. 7, 2007), available at http://web.uvic.ca/econ/research/seminars/robe.pdf. Like CFTC staff, the Government Accountability Office ("GAO") has not identified a causal relationship between speculation in the futures market and changes in commodity prices. See GAO, GAO-09-285R, *Issues Involving the Use of the Futures Markets to Invest in Commodity Indexes* at 5 (Jan. 30, 2009). The conclusions of these governmental studies and reports are consistent with those of academic and private sector economists. See, e.g., Paul Krugman, *The Oil Nonbubble*, N.Y. Times, May 12, 2008, http://www.nytimes.com/2008/05/12/opinion/12krugman.html ("[T]he rise in oil prices isn't the result of runaway speculation; it's the result of . . . the growing difficulty of finding oil and the rapid growth of emerging economies like China.").

To the extent there are any legitimate concerns with the potential for excessive speculation to cause unwarranted or unreasonable price fluctuations, CME Group believes that futures exchanges effectively address such concerns through their existing market surveillance programs. CME Group provided a detailed account of the futures exchanges' capabilities in its April 26, 2010 comments filed with the CFTC. See CME Comments at 8-12. Briefly stated, the exchanges independently have the ability to establish position limits as warranted by the characteristics of their traded contracts, and to employ position accountability provisions as appropriate given particular market constructs and market conditions. This flexible regulation is a much more appropriate and effective means of addressing potentially manipulative or disruptive positions than are blunt position limits that fail to account for variability in specific contract months, market conditions, and market participation. Insofar as the existing exchange programs are and have been proven to be effective, CME Group believes the Commission would lack the statutory basis for establishing new Federal position limits on certain contracts involving exempt and agricultural commodities.

II. Mechanics of Imposing Position Limits

Assuming the Commission is able to find that position limits "are necessary to diminish, eliminate, or prevent" burdensome excessive speculation, CME Group offers the following views on how to impose those limits:

A. The Imposition of Limits Should be Deferred Until the Commission Can Properly Determine and Ensure Compliance with Appropriate Limits

Dodd-Frank sets forth several seemingly inconsistent timing requirements for the exercise of the Commission's position limit authority. New CEA § 4a(a)(2)(B) directs the Commission to impose limits for certain contracts, within 180 days for exempt commodities and within 270 days for agricultural commodities, respectively, of Dodd-Frank's enactment. Meanwhile, new CEA § 4a(5)(A) requires that limits for swaps that are economically equivalent to futures and options be established simultaneously with the limits under Section 4a(a)(2)(B). The statute, however, also vests the Commission with discretion to establish limits "as appropriate," thereby indicating that the Commission is not bound by the aforementioned dates. CME Group believes that DFA requires the Commission to defer imposing limits until doing so would be "appropriate"—that is, when it has the data needed to accurately set and enforce those limits and when it is in a position to impose limits simultaneously on futures (and options on futures) and swaps.

B. Position Limits Should Be Set with Due Regard for Legislative Objectives and Considerations

Under Dodd-Frank, the Commission is required to take into account several factors when setting position limits. New CEA § 4a(a)(3) provides that, to the maximum extent practicable, the Commission should use its discretion to establish limits to: (i) diminish, eliminate, or prevent "excessive speculation"; (ii) deter and prevent market manipulation, squeezes, and corners; (iii) ensure sufficient market liquidity for bona fide hedgers; and (iv) ensure that the price discovery function of the underlying market is not disrupted. Additionally, new CEA § 4a(a)(2)(C) states that the Commission must act to avoid shifting the price discovery function to FBOTs in establishing limits. In mandating these considerations, Congress recognized that limiting trading positions has the potential to reduce liquidity and adversely affect the hedging and price discovery functions of U.S. commodity markets. The Commission is obliged to give due weight to each consideration in setting any position limits and may not focus solely on imposing limits to diminish, eliminate, or prevent "excessive speculation."

C. The Commission's Exemptive Authority Should Be Interpreted Broadly To Accommodate All Non-Speculative Positions

New CEA § 4a(a)(7) gives the Commission authority to exempt from any position limit rule, with or without conditions, "any person or class of persons, any swap or class of swaps, any contract of sale for future delivery or class of such contracts, any option or class of options, or any transaction or class of transactions." Under this provision, the Commission's statutory power to exempt any person or class of person from position limits is greater than it has ever been before.

CME Group believes that DFA authorizes the Commission to use its broad new exemption authority under § 4a(a)(7) to grant exemptions to market participants who use futures, options, or swaps when economically appropriate to the reduction of the risks they face in their enterprises. Although it is impossible to enumerate the breadth of exemptions that should be permitted in order to ensure that entities are able to effectively manage exposure that is highly correlated to fluctuations in the price of exempt and agricultural commodities, an application for exemption should be judged on its merits in terms of the specific risks to be hedged, the relevant price relationships, the proposed position sizes, and the operational procedures for establishing and lifting the hedge.

If the Commission were to narrowly construe its § 4a(a)(7) exemptive authority to exclude non-speculative trading activity, then market participants could be forced to either actually speculate on those price risks (i.e., not establish any positions to mitigate the risk), and potentially increase costs to consumers, or hedge their risks through transactions that lie outside the CFTC's position limit authority. Either strategy would undermine the Commission's mission to promote liquidity and protect the price discovery function of its regulated markets. The Commission should thus broadly interpret its exemptive powers and grant exemptions to market participants who are not seeking to establish positions in the futures market for speculative purposes but rather to serve their legitimate commercial and financial hedging needs.

III. Conclusion

CME Group appreciates the opportunity to offer the foregoing comments respecting the implementation of DFA's provisions respecting position limits on certain contracts involving exempt and agricultural commodities. We hope that the views expressed herein prove to be helpful and we are available to answer any questions the Committee may have.