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Testimony

Written Testimony of CFTC Chief Economist Jeffrey Harris before the Senate Energy Subcommittee of the Committee on Energy and Natural Resources

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Chairman Dorgan, Ranking Member Murkowski, and other Subcommittee Members, thank you for inviting me to testify before the Energy Subcommittee. My name is Jeffrey Harris and I am the Chief Economist at the Commodity Futures Trading Commission (CFTC or Commission). I am testifying today in my capacity as Chief Economist and not on behalf of the CFTC. My testimony today will focus on the CFTC's staff report on the commodity swap dealers and index traders issued Thursday September 11, 2008.

The CFTC recognizes that a secure, reliable, and sustainable energy future is of great importance to the American people. We are acutely aware that high commodity prices have been, and continue to be, painful for American consumers. We are also aware that speculative activity can affect the price discovery and risk management roles of the markets we regulate. With that context, let me summarize what the Commission is doing to insure that the markets that we regulate are serving the public interest.

The CFTC continuously monitors and analyzes trading in the markets we regulate. We collect and analyze data on a daily basis, and monitor positions, price movements and activity in these markets. The CFTC data includes positions and trading of noncommercial traders like hedge funds and other managed money traders. As noted in the Interim Report on Crude Oil produced by the Interagency Task Force on Commodity Markets, staff did not find evidence from this data to support the view that noncommercial trading has been systematically driving price changes in the crude oil market.

Despite these findings, the CFTC continues to analyze the data for evidence of such a connection. During the last year, the CFTC has been systematically reviewing satellite markets that complement and compete with the centralized and regulated futures markets in the United States, in order to determine whether satellite markets are having an impact on regulated futures markets. As you know, a combination of Congressional and Commission action has resulted in increased regulation of trading on exempt commercial markets and increased transparency and reporting of trading on foreign boards of trade that seek access to trade contracts linked to any U.S. regulated contract.

More recently, the agency has been reviewing the role of swap dealers and index traders and whether their connection to the futures markets is having an impact on the price of commodities. In May, the

CFTC announced that it would use its special call authority to gather new and detailed data from swap dealers on the amount of index trading occurring in the OTC markets. Last week, the CFTC released its staff report, which compiled substantial information on index funds and other transactions that are being conducted through swap dealers.

CFTC Report on Swap Dealer and Index Trader Activity

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

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

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

- How much total commodity index trading is occurring in both the OTC and on-exchange markets?
- How much commodity index trading is occurring by specific commodity in both the OTC and on-exchange markets?
- What are the major types of index investors?
- What types of clients utilize swap dealers to trade OTC commodity transactions?
- To what extent would the swap clients have exceeded position limits or accountability levels had their OTC swap positions been taken on exchange?

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

Findings:

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

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

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

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

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

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

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

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

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

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

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

In light of the preliminary data and findings, the Commission made the following preliminary recommendations.

Preliminary Recommendations:

1. **Remove Swap Dealer from Commercial Category and Create New Swap Dealer Classification for Reporting Purposes:** In order to provide for increased transparency of the exchange traded futures and options markets, the Commission has instructed the staff to develop a proposal to enhance and improve the CFTC's weekly Commitments of Traders (COT) Report by including more delineated trader classification categories beyond commercial and noncommercial, which may include at a minimum the addition of a separate category identifying the trading of swap dealers.

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

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

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

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

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

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

8. **Review of Swap Dealer Commodity Research Independence**: Many commodity swap dealers are large financial institutions engaged in a range of related financial activity, including commodity market research. Questions have been raised as to whether swap dealer futures trading activity is sufficiently independent of any related and published commodity market research. Accordingly, the Commission has instructed the staff to utilize existing authorities to conduct a review of the independence of swap dealers' futures trading activities from affiliated commodity research and report back to the Commission with any findings.

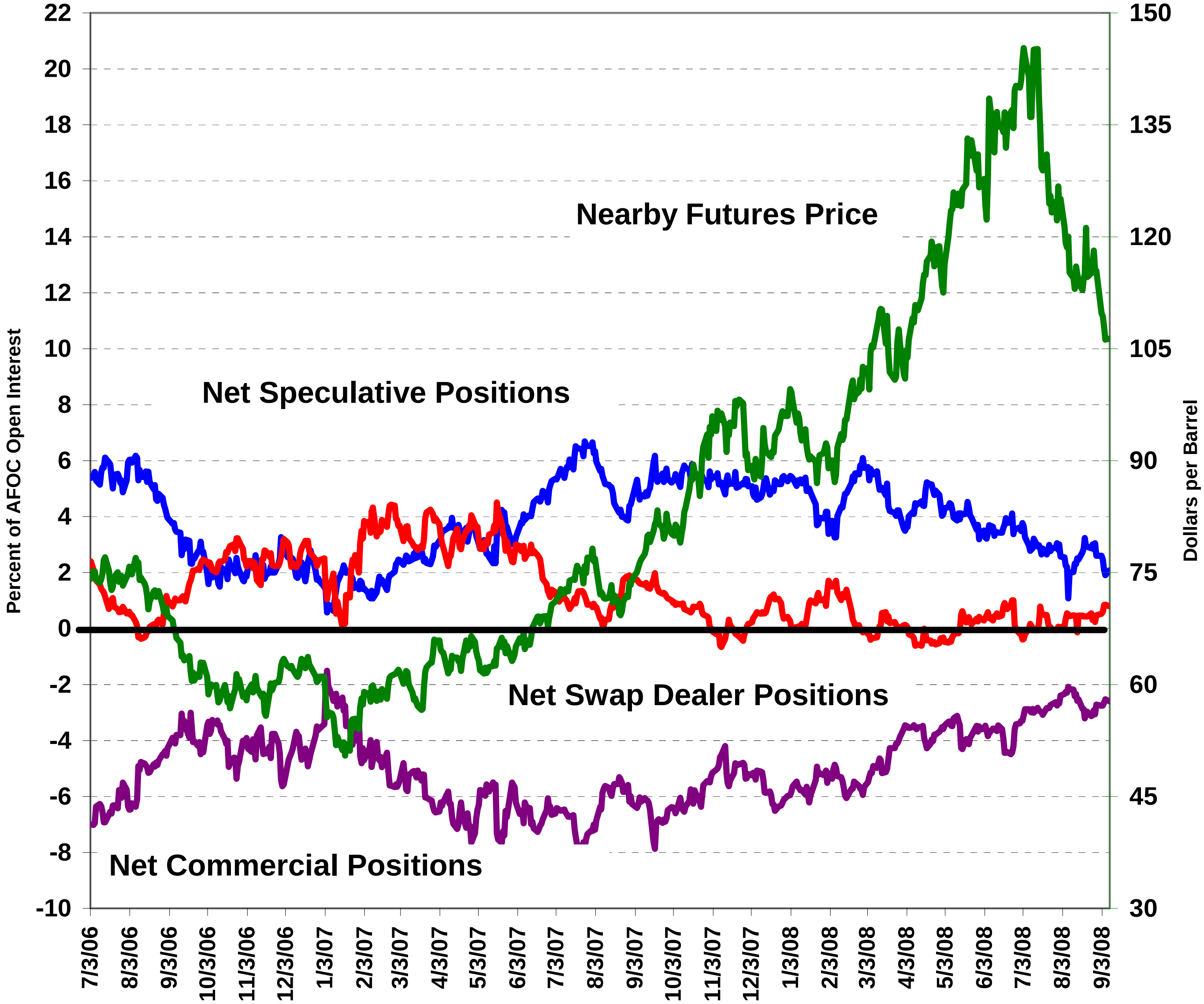
In sum, this special call data and analysis has given the CFTC a snapshot of the OTC market. While the report's findings are useful and instructive, the data collection and analysis need to continue if the agency is to get a clearer, moving picture of this vast marketplace. The Commission's recommendations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

Office of Chief Economist Recent Analysis of Crude Oil Markets Using Large Trader Data

In addition to the special call data and analysis, the Office of the Chief Economist (OCE) continues to examine and analyze trading in the regulated futures markets. OCE staff played a central role in producing the July 2008 Interim Report on Crude Oil, working with the Interagency Task Force on Commodity Markets. Utilizing the detailed data included in the CFTC's Large Trader Reporting System, we continue to monitor and analyze various groups of traders, including index traders, hedge funds, and other non-commercial traders.

In the market for crude oil, we have witnessed a significant run-up in prices through mid-July 2008, with prices falling substantially during the past two months. Figure 1 below displays this price pattern along with the net positions of commercial entities, swap dealers (who bring index fund positions to these markets), and speculators in the crude oil futures markets. As displayed in Figure 1, while oil prices were rising dramatically during the first half of 2008, net speculative positions have been largely falling. This pattern mirrors the data collected by the special call to swap dealers and commodity index funds showing that commodity index net long positions in NYMEX crude oil contracts declined by approximately 11 percent during this same six-month interval.

Figure 1: NYMEX WTI Crude Oil: Daily Speculative, Commercial and Swap Dealer Net Positions as a Percentage of AFOC Open Interest
July 3, 2006 through September 8, 2008



AFOC = All Futures and Delta Adjusted Options Combined   Negative percentages represent net short positions.
"Net Commercial Positions" excluded "Net Swap Dealer Positions"

The Office of the Chief Economist continues to work with the Interagency Task Force on Commodity Markets and expects to update and supplement the findings produced in the July 2008 Interim Report in the near future.

Conclusion

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