August 5, 2009 CFTC Hearing on Price Discovery, Position Limits and Hedge Exemptions

Written Testimony of Mark D. Young, Kirkland & Ellis LLP on behalf of the Futures Industry Association

Chairman Gensler and Members of the Commission, I am Mark Young, a partner in the law firm of Kirkland & Ellis LLP. I am appearing today on behalf of our client, the Futures Industry Association. It is a double honor to be here. It is an honor to represent FIA and an honor to return to the Commission where I started as a staff attorney in the Office of the General Counsel in 1977.

I have great memories of my five years working at the Commission. During that time, I was involved in many important chapters in the Commission's early history from the Hunt silver manipulation and the March 1979 Wheat emergency to private rights of action for market participants and the modest disagreement the Commission once had over GNMA options jurisdiction with the Securities and Exchange Commission. One of the best parts of working at the Commission was the quality and dedication of my colleagues on the professional staff, both lawyers and economists. I am sure those working for the Commission today feel the same way.

Interest of the FIA

The Futures Industry Association has a considerable stake in the issues being addressed in these hearings. FIA is a principal spokesman for the commodity futures and options industry. FIA's regular membership is comprised of approximately 30 of the largest FCMs in the United States. Among its associate members are representatives from virtually all other segments of the futures industry, both national and international. Reflecting the scope and diversity of its membership, FIA estimates that its members effect more than eighty percent of all customer transactions executed on United States contract markets. FIA members also effect a substantial volume of futures and options transactions for customers on exchanges that are not located in the United States.

Summary of FIA's Position

During the first two days of hearings, the Commission has addressed a range of issues arising under current law and prospective legislation. FIA has prepared its testimony today based on the two different regulatory contexts in which these issues may arise.

First, under current law, if the Commission decides to set new position limits for energy or other commodities of finite supply, it should do so in a manner that will not compromise price discovery and the other public interests served by futures markets or cripple competitively U.S. futures exchanges and firms. Position limits no matter how well meaning create real market migration risk and pushing price discovery of agricultural, energy or metals markets to overseas or other trading venues would be contrary to the purposes of the Act. The Commission also should either continue the existing conditional exemptions for swaps dealers or

utilize its flexible position limit powers to fashion appropriate exemptions as warranted for swaps dealers and index traders reflecting the economic reality of their market activities which plainly differ from those of traditional speculators. FIA also supports Commission efforts to make its Commitment of Traders Report more granular and informative.

Second, with an eye on prospective legislation, FIA would support new legislative standby authority for the Commission to impose position limits on U.S. market users that enter into OTC derivative or foreign board of trade positions that are settled against prices of regulated futures contracts. FIA also would support legislation to enhance the transparency of OTC derivatives market activity for the Commission's market surveillance purposes as well as for its Commitment of Traders Report. If such legislation is adopted, the application of OTC position limits to a swaps dealer's counterparties would strengthen the dealer's status as a hedger and the appropriateness of retaining the dealer's exemption from position limits.

In adopting these positions, FIA's primary concern is that restrictive position limits would lead to market migration. We know that many in Congress and even some members of the Commission do not believe that position limits could cause market liquidity migration. Respectfully, FIA's member firms disagree strongly. Repeatedly we are told by our members, in the most emphatic terms, that futures markets and their inherent price discovery function are moveable. Human nature tells us that those who are well-capitalized and looking for commodity market price exposure -- as a hedge against expected inflation, for example -- would, all other things being equal, choose a market without rigid limits, rather than a market with such limits. No one is saying this is certain to happen, but enough people are saying this could happen that migration risk should not be relegated to the "boy who cried wolf" category.

The Integrity of Commodity Price Discovery: A Congressionally-Defined Public Interest

Commodity prices discovered through futures trading touch every sector and person in our national economy. For that reason, FIA believes the Commission's paramount mission is to protect the integrity of the price discovery process through vigorous market surveillance. If that integrity is compromised through price manipulation or other market integrity disruptions, futures markets will not serve the public interests Congress has identified.

Congress has built the modern Commodity Exchange Act on a foundation of public interest "findings" and "purposes" that recognize the importance of futures price discovery. In Section 3(a) of the Act, Congress found that the commodity transactions subject to the Act "are affected with a national public interest by providing a means for managing and assuming price risks, discovering prices, or disseminating pricing information through trading in liquid, fair and financially secure trading facilities." 7 U.S.C. § 5(a). FIA strongly supports Commission policies that promote these national public interests through "trading in liquid, fair and financially secure trading facilities."

In Section 3(b) of the Act, Congress has also made two statutory purpose findings "to serve" and "to foster" the public interest. First, it is the purpose of the Act "to serve these public interests" through a system of self-regulation subject to Commission oversight. 7 U.S.C. § 5(b). Second, Section 3(b) of the Act specifies: "to foster these public interests, it is further the purpose of this [Act] **to deter and prevent price manipulation or any other disruptions to**

market integrity; to ensure the financial integrity of all transactions subject to this [Act] and the avoidance of systemic risk; to protect all market participants from fraudulent or other abusive sales practices and misuses of customer assets; and to promote responsible innovation and fair competition among boards of trade, other markets and market participants." 7 U.S.C. § 5(b) (emphasis added)[1]

Four points derived from these core provisions of the Act are relevant to this hearing. First, Congress acknowledged that the transactions subject to the Act allow both those who "manage and assume price risks," i.e., hedgers and speculators, to play an important role in serving the public interest. Second, Congress emphasized that deterring and preventing price manipulation was a fundamental statutory objective. Third, one purpose of the Act is to promote fair competition among boards of trade and other markets, presumably including U.S. and foreign boards of trade as well as OTC markets. Last, Congress recognized the significance of liquidity to regulated futures markets which serve the public interest in "price discovery" through "liquid, fair and financially secure trading facilities."[2]

How the Commission Protects the Integrity of Price Discovery

The Commission's market surveillance efforts, coupled with those of the exchanges, are designed to protect futures price discovery. Large trader reports, special calls, daily and inter-day price analysis, jawboning, audit trails, accountability levels, position limits and weekly briefings combine to give the Commission (and the exchanges) the best picture possible of who is in the market, doing what and when. If problems exist, the Commission has a wealth of statutory authority to address them including emergency authority, injunctive power and strong enforcement remedies. In conducting market surveillance, the Commission must be price neutral. The Commission doesn't seek high prices or low prices, just fair prices that are discovered through "liquid, fair and financially secure trading facilities" in the words of Section 3(b) of the Act.

Over the years, people have criticized futures market prices as too low and too high, as the Commission well knows. Recently, the criticism has been that prices are too high and have been driven in that direction artificially by new kinds of market participants. To date, no credible consensus has formed on this issue of causation.

The Task Force on Commodity Futures Markets of the Technical Committee of the International Organization of Securities Commissions issued a report in March 2009 (IOSCO Report) in which it analyzed the reviews on this issue conducted by the International Monetary

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1 The phrase "excessive speculation" appeared in the Act's purposes clause for decades. See 7 U.S.C. § 5 (2000). In 2000, as General Counsel Dan Berkovitz pointed out in his testimony on page 20, Congress modernized the purposes of the Act with the language quoted in the text and removed any mention of "excessive speculation."

2 As recently as last year, Congress emphasized the centrality of price discovery to the Commission's statutory mission by empowering the Commission to bring within much of the Act's regulatory structure electronically-traded, bi-lateral contracts it found to be "Significant Price Discovery Contracts." See the CFTC Reauthorization Act of 2008, 122 Stat. at 2197-2200 (June 18, 2008)

Fund staff, the European Commission, Her Majesty's Treasury and the U.S. Inter-Agency Task Force chaired by CFTC staff. The Task Force concluded:

> "the reports reviewed by the Task Force do not support the proposition that the activity of speculators has systematically moved commodity market cash or futures prices up or down on a sustained basis."

IOSCO Report at 6.

That is not surprising because futures markets historically have been found not to set or determine prices, that normally happens in the cash markets as Doctor Petzel explained in his testimony last week and as the IOSCO Report describes at page 6. Futures markets instead discover prices based on trading judgments made by market participants world-wide. When those prices are considered to be fair and reliable benchmarks, businesses rely on them as a reference point for commercial transactions in a wide array of commodities.

Excessive Speculation and Position Limits

During the first two hearings, the scope of the Commission's position limit authority has been discussed. Section 4a of the Act affords the Commission great flexibility in terms of imposing position limits or fashioning appropriate exemptions. Nothing in Section 4a requires the Commission to impose position limits. (Otherwise the Commission would have been operating in violation of its statute almost since its inception.) And nothing in Section 4a limits the Commission's discretion to adopt appropriate exemptions from position limits for those non-speculators who may not qualify as bona fide hedgers.

What Section 4a of the Act does require is a finding that position limits are "necessary to diminish, eliminate, or prevent" the burden of "excessive speculation." 7 U.S.C. § 6a(a). In turn, the statute defines "excessive speculation in any commodity" as speculation "causing sudden or unreasonable fluctuations or unwarranted changes in the price of such commodity." *Id*. Thus, when the Commission finds speculation to have caused price fluctuations that are "sudden or unreasonable" or price changes that are "unwarranted" in any commodity, the Commission shall conduct a public rulemaking to set appropriate limits to "diminish, eliminate or prevent" those conditions.[3]

The breadth of the Commission's flexible powers under Section 4a is underscored by the following provision:

> Nothing in this section shall be construed to prohibit the Commission from fixing different trading or position limits for different commodities, markets, futures, or delivery months, or for different number of days remaining until the last day of trading in a

[3] The three words "diminish, eliminate or prevent" further illustrate the Commission's flexibility in setting limits. Surely there is a vast difference in a limit that, for example, diminishes "unwarranted" price changes and one that eliminates "unwarranted" price changes.

> contract, or different trading limits for buying and selling operations, or different limits for the purposes of paragraphs (1) and (2) of subsection (b) of this section, or from exempting transactions normally known to the trade as "spreads" or "straddles" or "arbitrage" or from fixing limits applying to such transactions or positions different from limits fixed for other transactions or positions. The word "arbitrage" in domestic markets shall be defined to mean the same as "spread" or "straddle". The Commission is authorized to define the term "international arbitrage".

7 U.S.C. § 6a(a). Interestingly, the provision's last sentence even confirms that the Commission's field of vision in setting position limits should include international considerations.

In one area the Commission's authority is circumscribed. Under Section 4a(c) of the Act, the Commission must exempt "bona fide hedging transactions" from its position limits. 7 U.S.C. § 6a(c). But that required exemption does not mean the Commission may exempt only bona fide hedging transactions from the Commission's position limits. Requiring one form of exemption logically does not preclude others.[4] Hence, we believe the Commission could adopt other targeted exemptions from its speculative position limits for swaps dealers, index funds and others. Those exemptions would likely involve setting position limits on a class or individualized basis for different types of market participants. Thus, the statute gives the Commission considerable flexibility in this area to mold appropriate speculative limit exemptions for those found not to have engaged in commodity speculation as that term is commonly understood.

During the first two hearings, there was much discussion about whether the Commission or the exchanges should set position limits. As with other areas of market surveillance, FIA has always understood position limit setting to be a shared responsibility for the CFTC and the DCMs to protect the integrity of the price discovery process. Self-regulation is an important part of that process, as Section 3(b) of the Act confirms. Accordingly, FIA recognizes that DCMs have, since the Commission's inception, played a vital role in setting appropriate position limits. But FIA does not have a position on whether the Commission should either set position limits for all commodities of finite supply or review, and possibly change, limits set initially by exchanges. What is more important from our perspective is whether both the Commission and the exchanges have adequate authority to adapt their position limits to new market dynamics and participants. FIA believes the position setting powers of the Commission and the DCMs are sufficiently flexible for this purpose.

[4] Section 4(c) of the Act offers the Commission yet another exemption vehicle to allow qualifying traders to exceed the speculation position limits when doing so would be consistent with the public interest. 7 U.S.C. § 6(c).

Position Limits Could Harm the Price Discovery Process

Both the Commission and the DCMs appreciate that setting position limits is a critical and difficult assignment. If too high, mischief may ensue, leading to price distortions or worse in the delivery period. If too low, the markets will be choked off from vital liquidity which, among other things, will distort price discovery and hurt hedgers. Compounding this difficulty is the availability today of multiple ways in which market participants that want exposure to price risk may achieve that exposure -- OTC derivatives through dealers, electronic trading on foreign exchanges and even physical commodity transactions. These three venues for obtaining price exposure must be part of the Commission's position setting considerations.

DCMs now set position limits for the last three trading days before the delivery period and accountability levels for energy commodities. If position limits replace or supersede DCM-set accountability levels for energy and other commodities of finite supply, FIA would be concerned that this switch could endanger the integrity of the price discovery process. At least under current law, the Commission lacks the authority to extend the position limits it would impose on speculators trading on DCMs to OTC derivatives, physical transactions and trades on foreign exchanges. (In the case of foreign exchanges, many foreign regulators do not believe that speculative position limits are necessary or advisable to protect their market's price discovery process.) As a result, imposing a rigid, inflexible position limit solely on U.S. futures trading could cause those seeking additional commodity price exposure to shift to one or all of these three other platforms.

That shift would have serious ramifications for the price discovery process. Assume a foreign exchange decides to list a cash-settled energy or agricultural commodity contract that settles daily on the price of the futures contract traded on a U.S. DCM. Trading on the DCM is subject to a position limit. Trading on the foreign exchange is not. The foreign regulator of the foreign exchange decides that position limits are not warranted because other mechanisms exist to prevent price manipulations and disruptions. Well-capitalized market participants that want price exposure in the commodity in excess of the CFTC limit may shift their positions to the foreign exchange. As more and more market participants follow suit, the focal point for price discovery shifts too, from the U.S. to overseas. Arbitrage may smooth out pricing disparities in the two markets, but the foreign exchange becomes the price leader, the U.S. exchange the price follower.

FIA member firms believe this hypothetical to be entirely realistic. They are naturally concerned about their loss of business. From the Commission's perspective, however, the blurring of the Commission's vision when price discovery actually occurs on a foreign exchange must be even more troubling. Ceding price discovery responsibility for wheat, corn or natural gas to foreign regulators can not be squared with the public interests and purposes Congress identified in the CEA, as we described above.

Moreover, price discovery could shift to OTC markets which are more difficult for the Commission to oversee. Worse yet, market participants that want more long price exposure than allowed by Commission-set limits and who believe that market fundamentals will drive prices higher could adopt a buy and hold strategy in the cash market which could actually

alter supply and demand dynamics and roil the futures price discovery process. As Doctor Petzel testified last week, some of this kind of market behavior is already being seen in some markets.

FIA knows that many disbelieve this possibility. They do not believe that U.S. price discovery leadership is ever in jeopardy from Commission-set new position limits. Already we are seeing, however, reports of market participants reacting to even the threat of position limits by moving their trading activities to one of the three trading environments where now position limits can not be extended.[5]

FIA does not believe these market realities render the Commission powerless to impose position limits when and where justified. Instead, we believe the Commission should obtain new standby statutory authority to extend any position limits it adopts to U.S. traders that enter into OTC and FBOT transactions that are settled against the price of futures contracts traded on DCMs. When limits on these contracts are determined to be needed, the Commission should negotiate with foreign regulatory bodies to either ensure harmonized position limits (along the lines of the WTI crude oil limits for the New York Mercantile Exchange and ICE Futures Europe) or other appropriate measures. This approach also comports with the statutory purpose of fair competition among boards of trade. 7 U.S.C. § 5(b).[6]

This proposal would not include physical cash transactions. But the Commission and the DCMs have historically been able to obtain information about cash positions through their market surveillance and large trader reporting systems. Those powers should be adequate to prevent price manipulation and thereby protect the integrity of the price discovery process.

Transparency and Market Surveillance Should Be Enhanced

FIA understands that the exchanges have testified in favor of the imposition of monthly and aggregate position limits on energy commodities. FIA would defer to their self-regulatory judgments. But by doing so FIA does not want to minimize the value and importance of enhanced transparency and market surveillance tools for the Commission as a means to prevent and deter price manipulation and other market disruptions. FIA favors allowing the Commission full transparency through the reporting of all U.S. trader positions in finite supply commodities which are linked to the price of a regulated futures contract, whether that position was established OTC or on an foreign board of trade. As questions exist about the Commission's current authority to obtain this information, FIA has and would support legislative proposals to grant the Commission expanded transparency authority.

FIA also favors Commission action to regularize its special call procedures for swaps dealers and investment managers. Obtaining this information on a regular basis should expand the Commission's market surveillance capacities to prevent price manipulation or other

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[5] See "UNG goes OTC," http://ftalphaville.ft.com/blog/2009/07/27/63816/ung-goes-otc/.

[6] Consistent with the fair competition statutory purpose, the Commission and its foreign counterparts also should cooperate and negotiate a mutually acceptable outcome when a U.S. exchange tries to challenge the dominance of a foreign exchange by trading a cash-settled contract linked to the foreign exchange's settlement price. The NYMEX Brent Oil contract is one example.

market disruptions. Through this regular data, the Commission also could make its Commitment of Trader reports more granular in terms of the aggregate positions -- net long and net short -- held by swaps dealers and index traders. That kind of data would likely be considered to be useful by many market participants.[7]

Dealer Hedge Exemptions Should Be Retained

FIA filed an extensive comment letter on this subject on June 16. We are attaching that letter to this statement for inclusion in the hearing record. The Commission's first two hearings on this subject have only strengthened our conviction that these exemptions should be retained. Dealers that act as risk aggregators for OTC positions and then lay off residual price risk in the futures markets fit well within the traditional concept of a price risk-offsetting hedger. And, as the witnesses for JP Morgan and Goldman Sachs confirmed, the dealer's proprietary futures trading would continue to be subject to the speculative position limits like any other speculator's trading.

If anything, the case for retaining the exemption becomes more compelling if the Commission obtains regular reports about the OTC trades linked to futures prices by the dealer's counterparties, and more compelling still if the Commission is granted statutory authority to impose position limits on exchange and OTC positions in linked contracts. If market users like index funds are subject to position limits for commodity index swaps, the fear that the dealer is being used to mask position limit evasion is fully addressed. In short, if the market user is subject to the limit there is no evasion and surely no reason to attribute the market user's gross futures equivalent OTC position to the dealer's net futures position.

In fact, if the Commission characterized the dealer as a speculator it could be viewed as inflating speculative trading activity, rather than reflecting accurately the level of speculation. Counting the counterparty's swaps position as a long speculator and the dealer's offsetting futures as a long speculator does not comport with the economic reality of these transactions.

If the Commission disagrees, it is still free to fashion an appropriate exemption, including a targeted position limit for swaps dealers, just as it is for index traders and funds. Section 4a simply does not say that the Commission is limited to only granting position limit exemptions for bona fide hedgers. Section 4(c) also grants the Commission general exemption powers from virtually all provisions of the Act, including Section 4a limits, when an exemption would be consistent with the public interest. 7 U.S.C. § 6(c). FIA believes the Commission should consider exercising any of its multiple exemption powers in appropriate circumstances for non-speculative trading activity.

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[7] Many observers inadvertently confuse the different categories in the Commitment of Traders Reports and believe that Commission market surveillance and position limit enforcement are somehow dictated by the categories assigned in the COT Reports. For example, many seem to believe that hedgers are excused from Commission market surveillance because they are not subject to position limits and are separately accounted for in the COT report. The Commission should restate again that the COT Report and its classifications of market participants are for public use and do not limit the Commission's market surveillance activities which focus on hedgers and speculators alike.

Conclusion

Many misinformed observers have criticized the operation and regulation of the U.S. futures markets in recent years. FIA respectfully disagrees. We are proud of the record compiled by the U.S. futures markets and proud of our role in assisting the Commission's development of a sound regulatory framework for U.S. futures trading. The recent credit crisis is a good example. In that difficult time, the futures markets proved once again to be an open and reliable venue for those that wanted to manage or assume price risks. All trades were open, transparent and cleared. All customers were paid. No futures market participant sought government assistance. This record is a great compliment to the many decades of regulatory effort by this Commission.

In line with that history, the Commission's first two hearings have increased public awareness of the complex regulatory challenges the Commission faces every day. FIA strongly supports public and informed discussion of important regulatory issues. We would hope that when the Commission releases its new staff report on data gleaned from the swaps dealer special calls that the Commission would consider holding another public hearing on that report to better inform the public and to obtain comments from interested members of the public.

Thank you for granting FIA the opportunity to testify on August 5.