COMMODITY MARKETS OVERSIGHT COALITION

An Alliance of Derivatives End-Users & Reform Advocates

Testimony of
Mr. James Collura
Vice President, New England Fuel Institute
On behalf of the
Commodity Markets Oversight Coalition

U.S. House of Representatives
Committee on Agriculture
Subcommittee on General Farm Commodities and Risk Management

Washington, DC
December 15, 2010

Honorable Chairman Boswell, Ranking Member Moran and members of the committee; thank you for the opportunity to testify before you today on the importance of position limits for commodity dependent businesses and consumers, and the broader economy and market stability.

I currently serve as Vice President of New England Fuel Institute (or "NEFI"), a not-for-profit home energy trade association that represents more than 1,200 mostly small, family owned- and operated-businesses. In 2007, in response to what was perceived as increasingly unpredictable and volatile commodities futures markets, and out of concern over possible excessive speculation in these markets, NEFI partnered with the Petroleum Marketers Association of America (or "PMAA") to form the Commodity Markets Oversight Coalition.[1] I am delivering testimony today as a spokesman for this coalition.

The Commodity Markets Oversight Coalition (or "CMOC") is an informal coalition whose participating members represent an array of business interests, including commodity producers, processors, distributors, retailers, commercial and industrial end-users, as well as groups representing average American consumers. The CMOC advocates in favor of government

[1] The Petroleum Marketers Association of America is a national federation of 47 state and regional trade associations representing over 8,000 independent petroleum marketing companies, including convenience store/gas stations, gasoline and diesel fuel retailers and suppliers, and home heating oil dealers.

policies that promote stability and confidence in the commodity markets and that preserve the interests of *bona fide* hedgers, consumers and the broader economy.[2]

On July 21, 2010, President Barack Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act.[3] Title VII of the Dodd-Frank Act, which was endorsed by members of the CMOC, included the most substantial new regulations of the U.S. derivatives markets in more than a decade. Members of this committee, under the leadership of Chairman Peterson, Chairman Boswell and Ranking Members Lucas and Moran, are to be commended for their years of hard work that resulted in the passage and enactment of this monumental piece of legislation.

Obtaining the consensus necessary to assemble and retain support for Title VII of the Dodd-Frank Act was certainly no easy task. Many proposed reforms of the U.S. derivatives markets were met with great skepticism, if not outright opposition, from various special interests and market participants from small businesses, farmers and energy end-users to massive Wall Street banks and trading houses.

Despite efforts by opponents to misrepresent or create doubt about many of the derivatives reforms in the bill, Congress included various regulatory initiatives necessary for market transparency and accountability and to prevent fraud, manipulation and excessive speculation. But rather than taking a detailed and proscriptive approach to the most controversial provisions, the Congress ceded much discretion to financial regulators such as the Commodity Futures Trading Commission (or "CFTC"). One clear example of this delegation of Congressional authority is the law's directive to CFTC to establish speculative position limits for regulated and currently unregulated markets such as over-the-counter swaps markets.[4]

The Dodd-Frank Act requires that these limits be established "in the spot month, in each other month, and in the aggregate across all months" and provides the CFTC with discretion in

[2] The coalition, when formed in August of 2007, was referred to as the "Energy Markets Oversight Coalition," but was changed to the "Commodity Markets Oversight Coalition" to reflect its members' interests in reforming derivative trading in a broad range of commodities, including agricultural and energy commodities.
[3] Pub.L.111-203
[4] *Ibid.*, §737

defining exemptions for *bona fide* hedgers. The new law requires that the CFTC establish speculative position limits for what are defined by statute as currently "exempt commodities," such as energy and metals, within 180 days of enactment, and for agricultural commodities within 270 days of enactment.[5]

We commend CFTC Commissioner Gary Gensler and his fellow Commissioners for their commitment to timely enactment and enforcement of new regulatory initiatives under this Act and for engaging stakeholders in a thoughtful and transparent rulemaking process. Tomorrow, the CFTC will hold the eighth in a series of public meetings. Tomorrow's meeting will include discussion and review proposed rulemakings for position limits. Despite this transparent and inclusive process, the Commission has recently come under pressure to delay the formulation and imposition of position limits by the deadline required by law. Our coalition opposes any such delay.

Imposition of position limits is not a new idea

The Dodd-Frank Act does not *provide* the CFTC with the authority to establish speculative position limits; it actually *expands* existing authority under the Commodity Exchange Act of 1936. Section 4(a) of that Act required the CFTC to set limits on market positions that traders can take in any commodity in order to prevent a single market participant from controlling price movements. The goal was to prevent an "undue burden on interstate commerce" that would result from excessive speculation and, as a consequence, cause "sudden or unreasonable fluctuations or unwarranted changes in the price" of commodities.

Like the Dodd-Frank Act, the 1936 statue was enacted following a time of crisis for the economy, a catastrophic upheaval in U.S. financial markets, volatility and uncertainty in commodity futures markets and a debate over prudent regulation to remedy these problems and their causes. Farmers, arguing that speculation can indeed become excessive and manipulative, and therefore distort fundamentals and the price discovery function of futures markets, fought hard for position limits authority and won the day.

---

[5] The Commodity Futures Modernization Act of 2000 (Pub.L.106-554) created a new classification for commodities to be exempt from many trading rules under the Commodity Exchange Act, called "exempt commodities," which includes any commodity other than an excluded or agricultural commodity.

In 1936, federal regulators acted quickly to impose position limits on agricultural markets that resulted in sixty years of relatively reliable and orderly commodities futures markets for agricultural, and eventually, energy commodities. However, in the 1990s the commodity markets began to change dramatically as a result of digitalization, globalization and the internet. Traditional open-outcry exchanges on LaSalle Street in Chicago and Wall Street in New York found themselves in competition with new electronic and off-shore trading platforms. In an effort to remain competitive in energy commodity futures, options and swaps, many exchanges abandoned hard speculation limits in favor of softer "accountability limits."

However, shortly after his confirmation as CFTC Chairman, Gary Gensler acknowledged that accountability limits have time and time again proved insufficient in preventing traders from taking large positions in violation of these limits and with relative inaction by the exchange. In fact, the CFTC found that in the 12 months between July 2008 and June 2009, individual month accountability limits were exceeded for crude oil, gasoline, heating oil and natural gas by 69 different traders. Some traders even exceeded limits every day during the trading period.[6]

There are well documented cases in which individual traders violated accountability limits and their actions had major consequences for market hedgers and consumers. This includes the $6 billion collapse of Amaranth Advisors in 2006, one of the largest hedge fund collapses in U.S. history. A Senate Permanent Subcommittee on Investigations report in June 2007 found that "Amaranth controlled 40 percent of all outstanding contracts on NYMEX for natural gas in the winter season (October 2006 through March 2007), including as much as 75 percent of the outstanding contracts to deliver natural gas in November, 2006."[7]

Amaranth occasionally held five or more times the "accountability limit" for natural gas, and according to the report, the NYMEX failed to take immediate action and in many instances where traders violated limits, never took any action. When the NYMEX finally ordered

---

[6] Statement by CFTC Chairman Gary Gensler, Public Meeting on Establishing Position Limits, CFTC Headquarters, Washington, DC, January 14, 2010.
[7] *Excessive Speculation in the Natural Gas Market*, Senate Permanent Subcommittee for Investigations Staff Report, June 25, 2007.

Amaranth to draw down its position, they simply moved their holdings onto an off-shore exchange where the CFTC and the U.S. exchanges had access to little or no data. But the size of the Amaranth position relative to the market eventually came back to haunt it, when in September, 2006 its position collapsed.

The record surge in natural gas prices at the height of the Amaranth position and the subsequent collapse demonstrated that without hard position limits one trader alone can move these markets. This event led many industries to recognize the problems associated with exempting energy commodities from position limits and catalyzed the establishment of our coalition in August of 2007. It also proved that “too big to fail” exists in the commodities derivative markets and that commodity speculation can be at times excessive. It also exposed in dramatic fashion the inadequacies of so-called “accountability limits” and lack of oversight and transparency in the commodity markets. More frightening still was evidence that a growing majority of trading was now occurring on so-called “dark markets,” or markets that reported little or no data and were subject to little or no oversight and regulation.

As policy makers deliberated on appropriate reforms, the market continued to deteriorate for end-users. The following year, energy prices surged to unjustified levels. In the summer of 2008, and despite declining demand and historically high inventories, crude oil topped $147 per barrel. Consumers faced unprecedented gasoline and home heating costs. Food prices similarly surged to record levels. As food became unaffordable and aide declined, riots broke out in at least 30 food important dependent countries. Manufactures, airlines, truckers and other transporters saw fuel prices surge, which caused inflation in the cost of goods and services for every American. But like almost every speculative bubble, this one eventually burst, leaving many farmers, manufacturers and other end-users stuck with unaffordable commodity pricing contracts.

Shortly after his confirmation as CFTC Chairman last year, Gary Gensler acknowledged the need for immediate action to restore confidence and stability. The Commission began drafting proposed rules to address trading loopholes and exemptions, and to establish position limits for energy and metals. The Commission held a round of hearings in the summer of 2009 to solicit

input from commodity hedgers, speculators, consumers and academics. Several members of this coalition delivered testimony before the Commission at this time.[8]

In January 2010, the CFTC proposed a rule for the establishment of speculative position limits for energy contracts, modeled largely after existing position limits that existed for agricultural commodities.[9] During the comment period ending April 26, 2010, the CFTC received an unprecedented number of submissions, well more than 8,000 in all, the vast majority of which indicated support for strong and meaningful limits on speculation. Several CMOC member groups were among those comments, and many expressed reservations at the relatively "high bar" formulae recommended by the Commission.

Understandably, several Commissioners expressed reservations about establishing limits that could be considered too aggressive in light of the Commissions lack of authority over certain trading environments. At least two Commissioners feared in April that position limits would drive trade to "dark" over-the-counter and off-shore environments. The CFTC repeatedly called on Congress to give it authority over these markets, so that broad and uniform limits could be placed on all speculative positions and in all markets. On July 21, 2010, the agency got its wish when the Dodd-Frank Act became law.

The CFTC has enjoyed 75 years of authority to establish speculation limits in commodity markets. After nearly two years of debate and passage of the most sweeping reforms in the history of the U.S. derivative markets, they now have the authority to establish said limits across the board to all traders and in all markets. We see little merit to the argument that the CFTC has not sufficiently considered the imposition of such limits. We are discouraged that, despite ample evidence of excessive speculation in commodities markets that some continue to doubt, question or outright deny that speculation was ever and could ever be excessive.

2. Hard speculation limits will not disrupt markets

---

[8] Held on July 28 and 29, and August 5, 2010. <www.cftc.gov/PressRoom/Events/Events2009/index.htm>

[9] Notice of Proposed Rulemaking for Federal Speculative Position Limits for Referenced Energy Contracts and Associated Regulations, Commodity Futures Trading Commission, 75 FR 4143, Washington DC, January 26, 2010.

Many CMOC participating groups represent vital commodity-dependent industries that have a steadfast belief in open, transparent and competitive markets. We believe that any new rules and regulations must be well reasoned, justified and not excessively burden market participants, or unnecessarily impede market liquidity. Speculators provide the market with this liquidity, but excessive speculation drives commodity prices to levels not justified by the market forces of supply and demand, results in pricing bubbles that harm commodity hedgers, end-users and the broader economy.

We also believe that the commodity derivatives markets, when they were first established more than 150 years ago, did not have as their primary constituents Wall Street speculators and investors looking to make a fast buck, nor was the CFTC established by Congress to serve such constituents to the detriment of hedgers and consumers.

Commodity exchanges were established to provide legitimate commercial businesses and end-users with a means to hedge risks associated with commodity prices. When unrestrained speculation is allowed to dominate markets and their hedging and price discovery functions, as we have clearly seen, it violates the Commodity Exchange Act's prohibitions on such activity. The CMOC rejects the contention of some in the financial services industry that limits to prohibit excessive speculation could be more disruptive to our markets more than excessive speculation itself.

Last week, the InterContinental Exchange (ICE), the Chicago Mercantile Exchange (CME) and the New York Mercantile Exchange (NYMEX) denied that timely imposition of limits would disrupt markets. Reuters reported on December 8th that the "top U.S. futures exchanges expressed confidence that a revised plan to clamp down on commodities market speculation will not unduly burden the market" if it uses the previous (January, 2010) proposed rule as a starting point.[10] We believe the earlier proposed rule was insufficient to address "the burdens of excessive speculation" due to its very high limits. However, it is a starting point and because

[10] Wallace, John and Steve Orlofsky, "ICE, CME More Optimistic on CFTC Position Limits," Reuters News Service, December 8, 2010.

the CFTC now has authority to apply limits to previously exempt markets and participants, our coalition would be supportive of lower limits.

Some argue that establishing limits expeditiously in order to meet what they consider to be negotiable or arbitrary deadlines under the Dodd-Frank Act will drive market activity off-shore to trading environments that are free from such limits (as we saw earlier with the Amaranth case). This argument is a red herring, as the Dodd-Frank Act anticipates this response and establishes new registration requirements for foreign boards of trade (FBOTs) that seek to allow access from within the U.S., provided they meet a list of comparable regulatory criteria, including the imposition of speculative position limits.[11] The stated intent of the Congress was to prevent limits imposed by the CFTC to "cause price discovery in the commodity to shift to trading on the foreign board of trade."

In addition, regulators in Europe and elsewhere are currently in the process of drawing up their own plans to impose speculative position limits in addition to the many other transparency requirements and other regulatory initiatives prescribed by the Dodd-Frank Act. If the CFTC were to fail to apply aggregate position limits to implement the Dodd-Frank Act, the impetus for regulatory reform in other jurisdictions could be jeopardized. As we learn of the extraordinary measures that he Federal Reserve Bank took to provide European banks with hundreds of billions of dollars of loans on extremely favorable terms,[12] we are reminded of the high cost of relying completely on financial industry self-regulation. Weak position limits or a return to position accountability would provide industry with *de facto* self-regulation.

On November 1, 2010, our coalition submitted preliminary comments regarding the implementation of various regulatory initiatives under the Dodd-Frank Act. We announced then our opposition to any delay in the formulation and imposition of speculative position limits. We also suggested that additional stability and restraint on speculation could be achieved were the CFTC to develop limits specifically for index funds and to distinguish them as separate and

[11] Pub.L.111-203, §738 and §737(a)(4)
[12] Harding, Robin with Tom Braithwaite and Francesco Guerrera, "Europe's banks tapped Fed," *Financial Times*, December 2, 2010.

distinct from more traditional speculators.[13] These so-called "passive investors" and their rolling contracts in energy and food commodities places commodities in a perpetual state of contango, where out-month futures prices are perpetually higher than spot prices. Such an investment strategy ignores market fundamentals and distorts the price discovery nature of the markets. These large funds have transformed commodities markets from a means to hedge fluctuating prices into a new asset class for pure financial accumulation.

We also agree with a recent suggestion by CFTC Commissioner Bart Chilton that separate limits might also be considered for high-frequency trading (HFT) or so-called "computer algorithm-based trading" or "algo-trading" in commodity markets. Today, HFT accounts for one-third of all trading activity in U.S. futures markets and it is growing fast. Futures regulators and the Congress need to address this trend, especially in light of the "flash crashes" that have been witnessed in the securities markets, for which HFT has been considered at least partly responsible (including the 1000 point plunge in the Dow on May 6, 2010). Such "flash crashes" in the commodity trading markets could have devastating consequences for U.S. businesses and consumers.

3. Limits will restore confidence in commodity markets

Establishing and imposing timely and meaningful speculative position limits as required by the Dodd-Frank Act will send a signal of confidence and stability to all market participants that end-users will again be able to rely on transparent, orderly and functional commodity markets. Continued inaction is not an option. Our coalition and the businesses and consumers we represent rely upon the CFTC to do their best to protect against fraud, manipulation and excessive speculation and to ensure a fair, transparent and accountable marketplace. Decisive action will be a strong and long overdue step in the protection of market integrity and the stability of the broader economy.

As the 111th Congress comes to a close, we commend it - and especially the Chairs and members of the Agriculture, Banking and Financial Services Committees - for the hard work, political

---

[13] *General Comments to the CFTC on the Implementation of Title VII of the Dodd-Frank Act,* Commodity Markets Oversight Coalition, November 1, 2010, p. 6.

courage and leadership that made derivatives reform possible. Generations of Americans will be forever grateful for what you've done. But now this legislative legacy is in the hands of regulators. We trust that they will implement and enforce new authority, and that the new Congress will continue to provide them with the political support and financial resources necessary to do so.

Thank you again for the opportunity to testify. We would be pleased to answer any questions that you might have.