UNITED STATES OF AMERICA

COMMODITY FUTURES TRADING COMMISSION

ENERGY POSITION LIMITS AND HEDGE EXEMPTIONS

Washington, D.C.

Tuesday, July 28, 2009

ANDERSON COURT REPORTING
706 Duke Street, Suite 100

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

C O N T E N T S

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

Break Presentations:

LAURA CAMPBELL

SEAN COTA
Petroleum Marketers Association of America

BEN HIRST
Air Transport Association

TODD PETZEL
Offit Capital Advisers, LLC

* * * * *

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

P R O C E E D I N G S

(9:04 a.m.)

CHAIRMAN GENSLER: Good morning. I call to order this meeting of the Commodity Futures Trading Commission. I would like to start by thanking my fellow Commissioners and our distinguished witnesses here today, and in particular thank you, Senator Sanders, and I know Congressman Stupak will be testifying and testifying in a few moments.

The CFTC has the duty to protect the American public from fraud, manipulation and excessive speculation. The work we do has meaningful implications on the day-to- day lives of American people. Futures markets affect the decisions families make around the dinner table. Gasoline prices, for example, can determine whether a family takes a summer vacation. Natural gas futures contracts can affect utility bills. And lack of convergence in the wheat market can shorten a grocery list.

Immediately upon becoming Chair of the

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

CFTC I called the staff into my office and directed them to research and outline every authority available to the agency to protect the markets and the public. Every option must be on the table. The CFTC has significant statutory authority to set strict position limits in energy markets. The Commodities Exchange Act states that the CFTC, "Shall impose limits on trading and positions as necessary to eliminate, diminish or prevent the undue burdens that may come as a result of excessive speculation." While we currently set and enforce position limits on certain agricultural products, we do not do so for energy markets. The exchanges currently use accountability levels to monitor the size of positions in energy markets. These should not be confused however with position limits. Whereas position limits are strict restrictions on the size of a position a speculator can take, accountability levels are merely a way to provide the exchanges with additional oversight totals when a speculator's position exceeds a certain

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

size. If a position limit is a stop sign, accountability levels shouldn't be confused with a yield sign. They are a way to alert the exchanges of growing positions. In fact, in the last 12 months nearly 70 times different energy traders exceeded accountability levels.

Let me be clear. The CFTC recognizes the importance of speculators to the effective options of the futures markets, markets that benefit the American public. We are concerned with the undue burden that may be created by excessive speculation. Speculators allow farmers, grain elevator owners, oil producers and oil users to hedge their risks and have a marketplace where prices are determined in a fair and orderly way. The Congress long ago gave the CFTC an important tool to prevent markets from becoming too concentrated -- position limits and they directed us to use them. In 1980 the CFTC reiterated its goal to prevent market concentration and in a rule making by this Commission we stated that, "A trader's net position has a continued effect on

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

price and if sufficiently large can become a perceptible market factor." By limiting the ability of one part or group to obtain extraordinarily large positions, speculative limits diminish the possibility of accentuating price swings of large positions must be liquidated abruptly. To the extent that financial parties such as money managers, hedge funds and swap dealers participate in the futures markets, position limits have the potential to increase liquidity I believe by reducing the positions of the largest trader. Position limits can enhance liquidity by promoting more market participants rather than having one party that has such concentration as to decrease liquidity in fact.

I believe we must seriously consider setting position limits in these markets. This series of hearings will help inform the Commission on the merits of possible new rules to set limits to protect the American public. I was pleased in this regard to read in the written testimony of the Chicago Mercantile Exchange that it supports

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

adaptation of a hard limit regime. This is a significant development by a major exchange expressing support for hard position limits. This announcement represents tangible progress and I welcome it. Nevertheless, several very important questions remain. What formula should be used to determine where position limits are set? Who should set them, the CFTC or the individual exchanges. Should noncommercial exemptions be provided for financial risk management?

On the first question I look forward in this hearing to our panelists and what they believe is the appropriation position levels and what quantity measures should be used in setting such limits. On the question of who should set position limits, this is one that's been debated for nearly seven decades. Senator Capper, one of the co-authors of our original legislation to regulate commodities, pressed then vice president of the Chicago Board of Trade, Seibel Harris, on this very question in the 1936 hearings. Harris was arguing that the exchanges should the limits.

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

Then Senator Capper asked, "I take it that your position all hangs on this point, that you want the board of trade to make all the rules and regulations governing the grain trade rather than an impartial agency of the government that will function in the interests of all parties interested." I believe it should be the CFTC that sets the rules and regulations for the futures markets. We need consistent across-the-board regulations for all competing exchanges. The CFTC is the most able to strike a balance between competing interests and the responsibility to protect the American public.

The third question is whether and how to grant noncommercial hedgers exemptions from position limits. Congress has made it clear that position limits should apply to bona fide hedgers. There are three different types of categories currently that are set with regard to exemptions for agriculture commodities, commercial parties with physical inventory, commercial parties with physical anticipatory needs, and then lastly those

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

who fall under Section 147 of our rules. These parties neither have inventory nor commercial parties with anticipatory needs. Thank you for joining us as well.

It is this third category of hedge exemptions, the exemptions for noncommercial entities such as swap dealers, that currently risk swallowing up the rule. To prevent market participants from moving to the over-the- counter market or onto foreign exchanges, the Commission I believe also must urgently work with Congress to secure additional authorities including aggregate position limits. The CFTC should be empowered to establish these limits across markets to ensure that traders cannot avoid position limits by moving to a related exchange or market including international markets.

I look forward to hearing from everyone who is participating today. I believe that we have a diversity of points of view that will provide a thoughtful discussion on this very important subject. I will also note that the

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

written comments on the topic of this hearing will be accepted from the public until August 12, 2009, and included in the record. Based upon what we learn in these hearings, we will further review CFTC rules to determine what the best course of action is most appropriate.

I will now turn to Commissioner Dunn for his opening statement, and after each of the Commissioners have an opening I will turn to our esteemed panelists.

COMMISSIONER DUNN: Thank you, Mister Chairman. It's unusual for us to be on this side of the dais with the Senator and the Representative. It feels kind of good.

I commend you, Mister Chairman, for calling these hearings and providing the setting for an open and meaningful dialogue on excessive speculation and the impact that that may have on the futures markets. Since the Commission issued the concept release on whether to eliminate bona fide hedge exception during my tenure as acting chair, I've been keenly aware of the need to study

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

this issue and look forward to listening to the witnesses who will testify over the course of the three scheduled hearings.

The term excessive speculation is as old as the futures markets. Despite its age, a hard and fast definition of excessive speculation has alluded both Congress and the Commission. Instead of defining excessive speculation and preemptively addressing any impact it may have on the futures markets, Congress and the Commission have chosen to react to market events that may or may not be caused by excessive speculation. This is akin to treating a symptom of an illness without diagnosing the disease and finding a cure.

An historical review of the acceptable role of speculators in futures markets could lead to the justified conclusion that the legislators and regulators have been schizophrenic in their approach to this subject. In reality, Congress and the Commission are both membership bodies in a constant state of flux whose prevailing beliefs can only reflect the composition of the current

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

body. Additionally, the futures industry is composed of a dynamic group of entrepreneurs whose business and marketing strategies are continually changing to reflect and anticipate market needs.

The hearings we begin today will allow us to ask important questions needed to diagnose the situation we face. Are the futures markets working effectively and with the integrity that the public has a right to expect? Are our current regulations and rules out of synch with the underlying proposed mandates by Congress for the futures markets? If so, what role has excessive speculation played in preventing the futures markets from operating correctly? What tools does the Commission have at its disposal and how is it utilizing them to address this alleged problem? Are new tools needed? If they are, what are they and how will any changes impact the futures industry?

Thankfully the Chairman has gathered a diverse group to testify on this subject and I look forward to a lively, robust and educational

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

discussion. I appreciate the efforts that the Commission's staff has put into this hearing and also the efforts of those testifying. Your commitment of time and effort will be instrumental in helping this Commission decide what steps are necessary. My commitment to you is to listen with an open mind to your thoughts on this subject and to work with my fellow Commissioners to ensure that we have a functioning futures industry. Thank you in advance for all of your participation.

CHAIRMAN GENSLER: Thank you, Commissioner Dunn. Commissioner Sommers?

COMMISSIONER SOMMERS: Thank you, Mister Chairman, and thank you Senator Sanders and Congressman Stupak for being with us today.

The U.S. futures markets have been continually examined over the past 18 months as prices for crude oil and many agricultural products reached record highs. The question on everyone's mind is whether speculative trading is responsible especially through the influx of new

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

traders into the market such as pension and endowment funds seeking exposure to commodities through passive long-term investment in commodity indexes and swap dealers who seek to hedge price risks resulting from their over-the-counter activity.

Those participating in the debate have acknowledged that speculation is a necessary component of healthy markets. It is speculators who take on the risk that hedgers seek to shed and provide the liquidity that is the lifeblood of futures trading. There is a sense by some though that excessive speculation has pushed prices beyond levels warranted by supply and demand and that something must be done to rein it in. One of the primary tasks of market regulators is to foster the high level of market integrity necessary to preserve the important risk management and price discovery functions the futures markets perform. So we must ask ourselves how do we ensure that the markets are working as they should?

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

Congress recognized in the Commodity Exchange Act that market functions can be compromised when excessive speculation causes sudden or unreasonable fluctuations or unwarranted changes in the prices of commodities and therefore authorized the Commission to set limits on the amount of trading that can be done by market participants. Congress also recognized the need for certain market participants to exceed such limits for the purpose of bona fide hedging. Determining what constitutes excessive speculation however is how straightforward and there are differing views on the types of risks that should be eligible for hedging.

The issues surrounding position limits and hedge exceptions are enormously complex. Every market has its own characteristics. So what works for the soybean markets for example may not be appropriate for natural gas markets. Trading linked to commodity indexes, exchange traded funds and exchange traded notes presents a whole different set of questions. Should positions

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

related to such trading be governed by their own set of rules given the passive nature of the activity? How do we determine the appropriate level of passive investment in the markets? Should it be based on percentages, numerical limits or some other methodology? Should hard position limits be imposed in all physical commodities? And if so, should they be imposed on exchange trading without similar limits in place for the OTC markets? I'm especially concerned that doing so will have the perverse effect of driving large positions of the market away from centralized trading and clearing at the very same time we are urging all standardized OTC activity to be traded on exchange or cleared. Likewise, I can concerned that without global standards trading will move to other financial centers around the world.

The Commission has undertaken various initiatives to inform this debate including collecting detailed information from swap dealers and index traders which we plan to publish on an

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

ongoing basis, and I believe these hearings are another important step in developing the record. It is critical for us to have input from all sides of the marketplace to inform the debate as the Commission struggles to answer many of these complicated questions. This is a very challenging time, but we just do everything we can to fulfill our mission and preserve the critical price discovery and hedging functions of the U.S. futures markets. Thank you, Mister Chairman, for holding these hearings and to all the panelists for their contributions over the next week.

CHAIRMAN GENSLER: Thank you, Commissioner Sommers. Commissioner Chilton?

COMMISSIONER CHILTON: Thanks, Mister Chairman. I really want to thank both the Senator and Congressman for not only being here but for your tireless efforts on these issues. Some people must think you're crazy. They are so difficult, and I know it takes a lot of our staff resources. Warren does a great job for you, Senator, Justin does a great for you, Congressman.

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

I see Dawn Stumps here from Senator Chambliss's office from our Committee or Jurisdiction and we appreciate her being here and her tireless work. You've been great leaders on these issues and we very much appreciate it.

I just want to make two points. One, these are new markets in that we have new participants. So they're older markets but they have new participants in them. The impact of new speculators, the pension funds, the endowments, et cetera, I don't think anybody is saying that they're evil or that they don't provide the needed liquidity, but it's a new way for us to look at them. Are they having an impact in the aggregate? Some people will say absolutely yes, some people will say no. I tend to think personally that the billions of dollars in these markets is having some upward impact on prices and its our job to be inquisitive and try to figure out the right balance here.

Secondly, with regard to individual traders, these accountability levels, you have the

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

position limits as everybody knows in the final few trading days, but these accountability levels that my colleagues were discussing, they're not very effectual. They're sort of like suggested speed limits on a dark desert highway. They're not really adhered to. So at some level, an individual trader's position in the markets, it seems to me that there should be a limit. I don't know what that limit is. I don't know if it's a percentage of open interest, if it's the number of contracts as the Chairman was talking about, but you got to say at some point it's too much. In addition to the energy commodities, I also think we should be looking at the metals complex here. I commend the Chairman for saying we should look at commodities of finite supply. Metals is a finite supply. People invest their hard-earned investments there and I think we need to be looking at that and doing the same types of things that we end up doing if we end up doing and I don't want to prejudge what we're doing on metals as we do on energy.

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

There's a second part to this and this is my final point. That is that what we're doing is using all of the available tools that we have right now, but quite frankly, and I look to the Senator and the Congressman, we need more. So if we do this alone, you could actually have the perverse impact of shifting some of this to the OTC market and we don't want to do that. I don't think we're going to do that. We're going to be thoughtful. We're getting the best and brightest minds here to figure this out and not be draconian in how we go forward. But we need regulatory reform also. We need to ensure that what we do here doesn't make things less transparent. Make no mistake about it, there are tens of billions, hundreds of billions of dollars that are traded OTC all the time and those trades can have an impact on price discovery on what people pay at the pump because they're impacted the regulated markets that we do see. So that's an important second component of this. If we just do the types of things that we're talking about potentially

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

doing today, that's only half of the story.

So let me thank you again and I couldn't be more pleased to have everybody here and I very much thank the Chairman for his leadership on these issues and I look forward to the hearing.

CHAIRMAN GENSLER: Commissioner Chilton, I thank you and I agree if I might say that as these hearings that we're looking at, the energy markets we do as the Commission I believe it to the markets and the American public to look at other commodities of finite supply including the metals and silver, and I know you've been very thoughtful on that regard.

It's our great honor today to have two esteemed members of Congress, and if I can just briefly introduce both Senator Sanders and Congressman Stupak. I wanted to personally thank you and thank you on behalf of the Commission not only for coming but your leadership on behalf of the American public on these very challenging but real issues in our marketplace, how we make the marketplace fair and orderly but at the same time

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

protected against any burdens that might come to the marketplace by large or excessive speculation.

Senator Sanders and I first met many years ago. I think you were still in the House at the time. We had lively debates at the time. We had lively debates even through my confirmation process. But I view us as allies trying to protect these markets and the American public. You have in front of the Senate now a bill that talks about the CFTC and tries to give us even additional authorities, and I applaud that because I know that we do need additional authorities. Congressman Stupak, it's amazing that you're even here with all that you're doing in terms of the energy markets and the recently passed cap and trade bill, but in that bill and many bills earlier last year worked with Chairman Peterson of the House Agriculture Committee on how we can enhance our oversight and regulatory regime of the energy markets and we thank you for that and look forward to working even more closely with you moving forward. With that I turn the mike over to

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

Senator Sanders and we look forward to your thoughts.

SENATOR SANDERS: Mister Chairman, thank you very much for inviting me and allowing me to be here, and Commissioners, thank you very much as well. It's a pleasure to be here with Congressman Stupak who I've worked with for many, many years.

As you indicated in your opening remarks, Mister Chairman, while the terminology that we use today may be complicated and may be esoteric, they have real life impacts. I come from a very rural state and in my state when the price of gasoline gets to $4 a gallon and you have people who make $10 an hour traveling 100 miles to their jobs and back, trust me, it impacts their lives very severely. In my state, the weather gets 20 below zero in the wintertime. A lot of our people including many older people on fixed incomes hear with heating oil and when that price soars, these people make the choice of whether they stay warm in the winter or they buy the prescription drugs they need or the food they

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

need. So the work you are doing is enormously important and I applaud you very much for having this hearing today.

Mister Chairman, as you know, when President Obama first nominated you as Chairman, I had reservations about whether you were the right person at the right time for this job. That's not a secret. But since you have taken over the reins of the CFTC, I have been impressed by some of the statements you have made and the initial steps you have taken to begin to tackle excessive oil speculation in particular and the reform of our financial markets in general. First, your legislative proposal to regulate over-the-counter derivatives will go a long way to putting a lid on excessive speculation, but I believe more must be done to regulate what Warren Buffett correctly called "financial weapons of mass destruction." Clearly the plan you have presented to Congress is a significant step in the right direction.

I'm also pleased that instead of waiting around for Congress to act, you are currently

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

considering all of the options that the CFTC currently has at its disposal to ensure that the price of oil and other commodities are based on the fundamentals of supply and demand, not by those on Wall Street out to make a quick buck. And I applaud your decision to make the futures market more transparent so that for the very first time the American people will know how much big banks and hedge funds are trading in oil and other commodities. So thank you for the start that you have begun.

But I am here today to tell you that as important as these steps are, they will all be for naught unless they are followed up by aggressive action on the part of the CFTC to prohibit excessive speculation in oil and gas trading. The bottom line is that we have got to make sure that Americans are no longer ripped off at the gas pump by some of the same Wall Street gamblers responsible for the worst economic crisis since the Great Depression, and that's the charge that you have and that is an enormous charge. Frankly,

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

the American people are tired and they are disgusted and they have felt the ramifications of excessive speculation and bubble economics caused by Wall Street greed. They are tired of record-breaking Wall Street profits and excessive compensation packages while millions of Americans continue to lose their jobs, their savings, their homes and their hope for the future. They are tired of hedge fund managers and firms like Goldman Sachs making a fortune betting that the subprime mortgage market will continue to get worse or that more companies will go bankrupt. The American people are tired of financial policies that benefit the very few at the expense of the many. And they are sick of a Wall Street that is allowed to make a fortune betting that the price of oil will go up while millions of Americans pay that price at the gas pump.

Mister Chairman, we all learned in Economics 101 that when supply is low and demand is high, prices are supposed to go up, and when supply is high and demand is low, prices are

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

supposed to go down. That is a concept that most Americans can understand and do understand. But when it comes to the recent run-up in oil and gas prices this summer and the astronomical prices we saw last summer, those economic textbooks can be thrown out the window. Right now the supply of oil in the United States is at an all-time high and demand for oil in this country is lower today than it was a decade ago, yet instead of seeing prices go down, crude oil prices have more than doubled since Christmas Eve. From April to June 24 of this year, gasoline prices increased 54 days in a row, the longest streak on record dating back to 1996. While gas prices have gone down some since that time, they are now headed back up. This summer's high gas prices could not come at a more inopportune time. I don't have to tell you what Americans are experiencing today as the result of the severe recession we are currently experiencing. Clearly we have all of us, Congress and you, a responsibility to do everything we can to prevent the manipulation of oil and gas prices

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

so that they reflect the basic economic supply-and-demand curve, not excessive speculation. This would not only help Americans struggling to fill up their gas tanks this summer, but it would also help my constituents in Vermont and Bart Stupak's constituents in Michigan who need to purchase heating oil to stay warm in the winter.

To begin to address these problems I've introduced S. 1225, the Energy Markets Manipulation Prevention Act, to require the CFTC to use its emergency powers to prevent the manipulation of oil prices and empower the CFTC with new authority to prohibit excessive speculation in the oil market. As you know, last July the House of Representatives passed similar legislation by a vote of 402 to 19. That is bipartisan to say the least. But that legislation unfortunately did not become law. In addition, my legislation would also require the CFTC to do the following. Number one. Immediately classify all bank holding companies and hedge funds engaged in energy futures trading as noncommercial

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

participants and subject them to strict position limits. I think the American people would have a hard time understanding why large financial firms are being treated by the CFTC in the same manner as truckers, airlines and fuel dealers, people who actually deal with oil on a day-to-day basis, but that is exactly what is going on today. I'm not sure many people know that. Over the past several years, the CFTC has granted "bona fide hedging exemptions" to Wall Street firms like Goldman Sachs and Morgan Stanley, allowing them to trade as much oil and gas as they want in the futures market. As a result, we now have a situation in which the overwhelming majority of oil trades on the futures market are being conducted not by oil companies, not by airlines who consume huge amounts of oil, not by truckers, not by fuel dealers, but by speculators. This has got to change. Classifying hedge funds and financial firms as speculators and subjecting them to strict position limits could go a long way toward stabilizing the price of gas and oil.

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

Number two. Eliminate the conflicts of interest that arise when a large Wall Street financial institution has employees under one umbrella responsible for predicting the future price of oil while the same company owns and controls physical oil assets and trades in energy derivatives. We have seen this time and time again. Goldman Sachs and other companies predict the price of oil is going to go up, lo and behold, the price of oil goes up and the same companies make a fortune. That's wrong and we've got to deal with that.

Number three. This legislation that we have introduced would also immediately revoke all staff no action letters for foreign boards of trade that have established trading terminals in the United States for the purpose of trading U.S. commodities to U.S. investors. Mister Chairman, the Intercontinental Exchange, ICE, operates a trading terminal in Atlanta, Georgia, that allows U.S. investors to buy and sell west Texas intermediate crude oil, but because ICE claims

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

that its headquarters in London, the CFTC has allowed it to be regulated by the British Financial Services Authority. While steps have been taken to address this matter, in my view ICE and other foreign boards of trade that have set up trading terminals in the United States should fall completely within the jurisdiction of the CFTC.

Mister Chairman, I understand that there are still some who may not believe that excessive speculation is responsible for driving up oil and gas prices, but let me just mention some past recent history to maybe delude you of that supposition. We know that in 2000 and 2001 energy traders at ENRON for thrown in jail for manipulating electric prices on the West Coast. Everybody knows that. We know that in February 2004 the CFTC fined BP $303 million for driving up the price of propane by purchasing "enormous quantities of propane and withholding the fuel to drive prices higher." We all know that. And we know that in 2006 the Amaranth hedge fund went bankrupt after federal regulators found that it

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

had artificially increased natural gas prices by controlling 75 percent of all the natural gas futures contracts in a single month. In other words, the idea of speculators acting illegally to drive prices up is not a new concept. That is exactly what has been happening in recent years. Given that, why would anyone believe that speculators at this very moment are not now manipulating the price of oil when supply is high and demand is low? I think the American people believe that.

Mister Chairman, in conclusion I think the American people were stunned that companies like Goldman Sachs made huge profits in the second quarter of this year and will be rewarding their executives with huge bonuses just as if the financial crisis never happened. We are back to where we were again where speculation and bubble economics is the rule of the game. So what I'm here to tell you today, to ask you, is don't let that happen again. Your job is not to protect oil speculators, people who make a quick buck

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

speculating in oil and gas, your job is to protect the American people and I look forward to working with you to make sure that that happens. Thank you very much, Mister Chairman, and thank you members of the Commission.

CHAIRMAN GENSLER: Thank you very much Senator Sanders. Congressman Stupak?

CONGRESSMAN STUPAK: Thank you, Mister Chairman, and thank you members of the Commission for having me here today. I agree with many of the things that my friend Senator Sanders said. I recognize that some individuals remain skeptical of the claim that anything other than supply-and-demand fundamentals dictate the price of the market. So I'd like to review if I may a number of recent studies and events that prove otherwise, that really that excessive speculation is dictating prices.

According to CFTC data, from January 2008 through the end of June 2008, index speculators poured $55 billion into major commodity indexes, pushing up the price of crude

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

oil from $99 per barrel to $140. Gasoline prices spiked at around $4 a gallon and reaching $5 per gallon in my rural district. That same market collapsed over the course of the next 6 months with prices plummeting to $30 a barrel by December 2008 as investors withdrew $73 billion from the market. This was not a coincidence. The dramatic drop in oil prices was occurring at the same time index investors fled the market.

Now take from January of this, January 2009 through May 2009, and you can see prices rise from $35 a barrel to $70 a barrel as index investors came back into the market and put $35 billion into major commodity indexes. I have three charts up here illustrating the fact that supply-and-demand fundamentals are not driving this oil market. This year, domestic oil supplies are at a 20- year high, oil demand is at a 10-year low, yet in June oil was trading at more than $70 per barrel, up from the $35 per barrel in January representing a price increase of more than 100 percent in the first 6 months of this year. All

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

of this comes in the midst of the worst global economic decline since the Great Depression, but oil prices keep going up even though demand is down. The driving factor contributing to an increase in the price of oil this year was the surge of funding from index investors back into the oil markets. According to an independent analysis of CFTC data on oil future positions, index investors increased their crude oil holdings to the equivalent of 600 million barrels in June that is up more than 30 percent from the end of December 2008.

There have been a number of reports and studies over the past few years implicating excessive speculation as the cause of volatility and price increases in the commodities futures market. In October 2007, the Government Accountability Office, GAO, released its report on the ability of the CFTC to properly monitor these markets to prevent manipulation. The GAO found that the volume of trading in energy commodities have skyrocketed specifically after the ENRON

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

loophole was created in 2000. The GAO also found that while trading has doubled since 2002, the number of CFTC staff monitoring these markets has actually declined. On June 23 at one of my Oversight Investigation Subcommittee hearings on the effect that speculators have on energy prices, Fidel Gate, managing director and senior oil analyst at Oppenheimer said in his testimony, "I firmly believe that record oil prices in excess of $135 per barrel is inflated. I believe based on supply-and-demand fundamentals that crude oil should not be above $60 a barrel." In 2000, physical hedgers, businesses such as airlines, trucking companies in the need to hedge to ensure a stable price for fuel in the future months accounted for 63 percent of the oil futures market, speculators were 37 percent. By April 2008, physical hedgers' share of the same market dropped to 29 percent and speculators were not controlling an astonishing 71 percent of the market. The market was taken over by swap dealers and speculators, a considerable majority of whom

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

had no physical stake in the market. Excessive speculation is a significant factor in the price Americans are paying for gasoline, diesel and home heating oil. Even the executives of U.S. oil companies recognize this. On April 1 in testimony before the House Select Committee on Global Warming, John Lowe, executive vice president of ConocoPhillips said, "It is likely that the large inflow of capital into the commodities funds is temporarily exaggerating upward oil price movements." At a May 21, 2008 hearing in the Senate Judiciary Committee, Shell president John Hoffmeister agreed that the price of crude oil has been inflated, saying that the proper range of oil prices should be, "Somewhere between $35 and $65 a barrel." The federal Energy Regulatory Commission released its "State of the Market" report on April 16, 2009. The report indicated that excessive speculation within the natural gas market was a principal reason for the price increase in natural gas. And while I know we are focusing on energy in this hearing, the Senate Homeland Security and

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

Government Affairs Subcommittee on Investigations released a report on June 23, 2009, indicating that excessive speculation was the blame for the distortion of wheat futures prices in relation to the settling cash market price.

On October 24, 2008, the Energy and Commerce Committee requested company-by-company data underpinning the CFTC staff report on swap dealers and index traders with specific information on individual companies' swap positions and related futures positions for crude oil, heating oil, natural gas and gasoline. This data was requested and was followed-up by questions raised by Commissioner Bart Chilton and others regarding the accuracy and conclusions of the September 2008 staff report. I understand that the CFTC will issue a new report possibly contradicting previous assumptions on the role speculator played in the energy markets. I look forward to seeing the CFTC's revised analysis.

Although the data provided by the CFTC on swaps did not distinguish between commercial

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

and noncommercial positions, it was possible to draw insights not presented in the CFTC staff report. By identifying the core business activity of each company, airlines, investment banks, oil producers and utilities, one can estimate the role each entity played in the combined swaps in futures markets. This chart shows that the speculators such as the banks and hedge funds held 60 percent of the open interest in natural gas markets on June 30, 2008, and 75 percent of the west Texas intermediate crude oil market. Physical hedgers and middlemen took a much smaller share of both natural gas and oil markets. I encourage the CFTC to look closer at this data, update it with more recent positions and see if the conclusion is the same.

If the dollars and swaps and related futures positions equals power in the marketplace, the banks and hedge funders are determining prices and physical hedgers have become small players in the process. This data points to excessive speculation dictating the pricing of commodities

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

in June 2008. The prices paid by physical hedgers whose bid and ask price are linked to supply and demand are being swapped by speculators who have overtaken this combined market. In a number of reports, market experts and regulators agree that reform of the derivatives market is necessary. Physical hedging, long used to provide liquidity, transparency and set market prices is no longer possible due to manipulation of financial traders. The recent statement by Treasury Secretary Geithner advocating derivatives reform, and Mister Chairman, your support for aggregate position limits on all commodities and these hearings by the CFTC are a welcome step toward reining in excessive speculation in the marketplace. I caution the CFTC against regulating only so-called standard contracts as loopholes for customization will circumvent any regulations in place to prevent manipulation in the market. The Commodities Exchange Act recognized the dangers of excessive speculation. Section 4 of the Act states excessive speculation in any commodity

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

under contract for sale of such commodity for future delivery made on or subject to the rules of contract markets or derivative transactions, execution facilitates causing sudden or unreasonable fluctuations or unwarranted changes in the price of such commodity is an undue and unnecessary burden on interstate commerce. As a result, Section 4(a) requires the CFTC to use the authority to aggregate position limits or take other actions necessary to curb excessive speculation. However, there are significant loopholes that exempt energy trading from these protections against excessive speculation. The swaps exemption in 2(g) and 2(h)(1) of the Commodities Exchange Act, the Foreign Boards of Trade no action letters swap loophole which allows a swap dealer to circumvent position limits designed to prevent excessive speculation. Finally, state attorneys general are handcuffed by applying -- gaming laws to swap dealers through a preemption of state law contained in the Commodities Futures Modernization Act.

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

Legislation I have introduced and included in the American Clean Energy and Security Act, otherwise known as ACES, which recently passed in the House of Representatives and is now pending before the Senate contains strong provisions to comprehensively address excessive speculation in the energy markets. I encourage the Commission to look thoroughly at each of these issues and take action within its existing authority to begin address the problems -- swap transactions for energy commodities. The Farm Bill only closed the ENRON loophole for future trades on electronic exchanges. Most bilateral swap trades remain in the dark. These bilateral trades must be subject to CFTC oversight. Foreign boards of trade, petroleum contracts offered through Intercontinental Exchange, ICE or on ICE futures are cleared on a foreign board of trade in London. Data provided by the CFTC indicates that more than 60 percent of the trades of west Texas crude originate in the United States. These contracts for west Texas crude have a delivery

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

point in the United States. ICE is a foreign board of trade in name only. ICE futures agreed to provide CFTC with information and set position limits on their trades. However, this step is not enough. The CFTC does not have the authority to regulate foreign markets that act as price-setting markets dominated by U.S. energy trading. The CFTC just enforce standards on all markets to eliminate loopholes. Similar to ICE, the Dubai exchange raises the same issues, and because of the CFTC's inability to enforce regulations on trades bound for the U.S., this loophole remains open for excessive speculation to impact energy prices. The CFTC should exert jurisdiction over these exchanges when they are using computer terminals in the United States and when they are trading energy commodities that provide for a delivery point in the United States.

Swaps loophole bona fide hedging exemption. The Commodity Exchange Act allows exemptions from position limits for businesses to hedge their legitimate anticipated business needs.

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

However, in 1991 the CFTC authorized the first bona fide hedging exemption to a swap dealer, J. Aron Company, which is owned by Goldman Sachs with no physical commodity exposure and therefore no legitimate anticipated business need. Since 1991, 15 different investment banks have taken advantage of this exemption even though they do not have a legitimate anticipated business need. Since 2006, NYMEX has granted 117 hedging exemptions for west Texas intermediate crude contracts many of which are for swap dealers without physical hedging positions. Swaps are currently excluded from requirements for position limits designed to prevent excessive speculation. An estimated 85 percent of futures purchases tied to commodity index speculation come through swap dealers. Because there are no requirements for position limits, these swaps have grown considerably, driving crude prices higher. By eliminating this exemption, swaps would be subject to position limits to prevent excessive speculation. The CFTC created this exemption and can undo it. The CFTC

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

must clarify that legitimate anticipated business needs does not mean economic speculators.

Strong aggregate position limits. CFTC should set aggregate trader position limits on energy contracts over all markets. With the growing number of markets, speculators can currently comply with exchange specific position limits on several exchanges while still holding an excessive number of total contacts taken together. By setting strong aggregate position limits over all markets, the CFTC would be able to curb excessive speculation by making sure traders are not amassing huge positions in a commodity in an attempt to play one exchange off the other. Carbon market regulation.

Carbon market regulation. The ACES or the climate change bill that we passed in the House of Representatives and sent to the Senate creates an economy wide cap and trade program for carbon dioxide and other greenhouse gas emissions. Companies will hedge their risks and lock in prices for these carbon credits in a new carbon

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

futures market. The CFTC should have the authority to regulate any carbon futures market with strong regulations from the start to prevent price volatility from excessive speculation. I introduced these protections in the ACES legislation and I believe the CFTC should apply strong rules on aggregate position and bona fide hedging exemptions to any carbon futures market. Last week one of my dealers up north has already given to me what they anticipate the carbon market is going to look like. They are already starting to hedge what it's going to be. Is it going to be $15, $25, $50 or $100. Depending on where it is, that's how much more my constituents will pay for their residential electricity. So I urge you before this market gets going to put in strong regulations.

By closing all these loopholes and setting strong aggregate position limits, the CFTC would be better able to monitor trades in real time to present market manipulation. Eliminating unreasonable inflation of energy prices caused by

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

excessive speculation protects American consumers. We cannot continue the status quo that allows excessive energy speculation. I look forward to your work. Thank you for holding these hearings and thank you for having me here.

CHAIRMAN GENSLER: Senator, Congressman, I can't thank you enough on behalf of the Commission. Personally if I might say, Senator Sanders, I very much appreciate your kind words because I know we've had a great dialogue. I look forward to meeting each of you probably on the Hill in your offices because you've raised so many things in your bills, but I just want to say for the record and the public I think that there's much we agree on in each of the statutes -- legislative initiatives about trying to close loopholes, making sure that we put in place position limits that are consistently applied across the markets, that we even look at the conflicts of interest that Senator Sanders has embedded in his bill in terms of energy traders on Wall Street and the conflicts just as we do in the

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

securities markets, whether the commodities markets should have some of those similar concepts to avoid conflicts. As Congressman Stupak has laid out with very thoughtful analysis as well, you mentioned at one point that we need more resources down here at the Commission and I look forward to working with Congress on that, but also many of your attributes that you said about how we close these various loopholes of 2(g) and 2(h) and swaps loopholes and so forth. I thank both of you for being part of this process. I wanted to say that these slides here hopefully if I could just make sure we'll have a chance to also put them on our website so that the public can see them, so that will all be available at some point a www.cftc.gov.

The next stage of what we're going here is we're going to go through a little bit of background on the legislative history of the position limits and hedge exemptions. Our general counsel Dan Berkovitz has a report which he is going to summarize, but that too will be in our

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

record. Just before that I was going to go through a few bits of data that was referred to in some of our openings. It's a PowerPoint. Is there a physical copy for the Commissioners? I was going to do a quick run through of a few pages. This document and I believe with a few text notes will be on our website as well and is available on some back table there.

The Commodity Futures Trading Commission sets speculative position limits on corn, oats, soybeans, soybean oil, meal and cotton, and then limits -- on energy and metal products just in the spot month. This is in the last 3 days of the month to avoid manipulation and congestion, and there is an accountability regime that will be discussed I'm sure by the exchanges and by Mr. Berkovitz that are set for single month and all months combined.

With regard to accountability levels, we just took a look as the Commission in the last 12 months through June 30 how often were these accountability levels -- individual traders who

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

had passed that. Overall, there were 69 instances, 69 unique traders, that went over the single month limit and 46 times all months combined. To give you a sense of who they were, we can't disclose individual names in a public hearing like this, the commercial or physical hedgers are about 20 of the 70 total or 13 of the 46, a little over a quarter of the total, but the risk management or swap money managed which is largely hedge funds and other noncommercials make up roughly three- quarters or 70 to 75 percent of the times that people are above accountability levels either in a single month or all months combined.

These are looking at the four large energy contacts. We did not have for this hearing the time to look at every energy contract, but it gives you an indication of the four major contracts on NYMEX. We have on ICE Futures Europe just in the last 3 months -- had the full authorities and been getting the daily data on the linked contracts. I think it would show a similar

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

story, but this is for NYMEX contracts here of crude oil, natural gas, heating and RBOB or gasoline. The number of traders just to use an example on crude oil that went past the 10,000 single month limit was 43, but 23 on all months combined. You can see that on average it's roughly 80 to 85 days that they're over. Of the 69 individual traders that were over, there are some that are over just occasionally, 5 to 10 days, there are some in fact that are over every day of the year. So it's a wide diversity between them. The average position you can see on the right-hand schedule is 20,000 in a single month, about 33,000 in the all months combined on crude oil, and then the other statistics going forward.

We took a look at in terms of this how often did traders in these four major contracts go over 10 percent of the total open interest, how many times did traders go over the 20 percent? This is just in the 12-month period. We weren't looking at an earlier period. We're not suggesting this is necessarily what's going to

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

happen in the next 12 months. It's just one period of time to see what are these accountability levels. You can see that twice in the crude oil markets, 13 times in natural gas, 4 in heating oil, and in gasoline. A trader in these 12 months was greater than 10 percent of the open interest, but in natural gas you can see that they actually grew, four times it was over 20 percent, and there were three instances where traders were over 30 percent of the open interest with the maximum being 33 percent and 14 percent crude oil to give you a sense of just this 12-month period of time of the largest concentration in these marketplaces.

This is same analysis for the first deferred futures. So rather than the nearby contractors going out one more contract, generally the most liquidity is in the first two contracts. I believe that in the set of data that might be on the web, we might include one more contract if I recall.

In terms of the speculative position

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

limits, the position limits that are set by the exchanges are in the last 3 days of the spot month. We also took a look at how many exemptions are there from that. There are no exemptions from accountability limits because accountability levels are not really a limit, but in terms of position limits themselves, this gives you a flavor for the limits. So on crude oil where the limit is 3,000 contracts, there are 37 exemptions and they average roughly 5,700 contracts. So on order of magnitude, the exemptions of 1,000 in the other contracts and 3,000 in crude oil the main market participants are generally two and a half times that limit in the three contracts and about twice that in crude oil. I should note that of this 35 to 40 exemptions, that's the whole category so that includes commercial anticipatory hedges as well as risk management hedges, but roughly half in each category are risk management meaning the swap dealers and financial participants, about half are inventory hedgers or commercial anticipatory hedges. These numbers

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

might slightly differ from what the exchange has, but I think they're approximately the same.

We also took a look at the position exemptions that we as the Commission grant, and you can see in the individual categories there are three different types of exemptions that are granted. Some are automatically, and these are the original ones from the 1936 act that are physical inventories that occur, and depending on the contract, between eight and 13 of these. There are also exemptions that we have to grant that we have to write a letter on under our rules. I think it's 1.48 is the rule, and these are physical anticipatory commercial and it's between three and six, except for cotton is zero. Then risk management exemptions are swap dealers while soybean meal is smaller generally between 11 and 14. I believe this was the subject of Chairman Levin's Permanent Subcommittee investigation as well. We talked about these in the wheat markets. So that's just a little background. I'm going to turn it over to our General Counsel Dan Berkovitz

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

who has done I think a really commendable job looking at the legislative history. This is meant for the public as well as the Commission to look at how did we come about in 1936 to have position limits in our statute, what was the debate at the time and the history and amendments since then. He's going to try to summarize. We're going to give him 10 minutes because there's a lot to summarize, but to summarize that. Then the Commissioners will ask questions and we'll try to see if there's need for a second round of questions, we'll go twice. We'll turn it over to you, Dan.

MR. BERKOVITZ: Thank you, Mister Chairman and Commissioners. As you noted, since its enactment in 1936, the Commodity Exchange Act has stated that excessive speculation in any commodity traded on a futures exchange causing sudden or unreasonable fluctuations or unwarranted changes in the price of such commodity is an undue and unnecessary burden on interstate commerce. Since 1936, the Act has directed the Commission to

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

establish such limits on trading as it finds " -- are necessary to diminish, eliminate or prevent such burden." Also since 1936, the Commodity Exchange Act has exempted bona fide hedging transactions from position limits. Initially the Act defined the term bona fide hedging as transactions that were offsetting price risks in the cash market for the commodity. In 1974, Congress provided the Commission with discretion to define the term bona fide hedge transaction providing that the definition enables producers and users of a commodity to hedge their anticipated business needs.

The inclusion of position limits in the Commodity Exchange Act of 1936 was the culmination of a debate that had raged since the depression in farm prices set in after the end of the First World War. The initial legislation passed after the War to regulate grain futures did not contain any trading limits. Throughout the 1920s and 1930s the argument and the debate continued as to whether regulation could better be accomplished by

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

the exchanges rather than by a federal agency, whether speculators were to blame for depressed farm prices and whether limits on speculation would impair hedging in the grain business. By the mid 1930s during the Great Depression the tide of opinion had turned and Congress passed legislation to regulate the securities markets and strengthen the regulation of the commodity markets to prevent excessive speculation.

In Section 4(a) of the Commodity Exchange Act, the Commission found that excessive speculation in futures contracts constituted an unnecessary burden on interstate commerce. It directed the Commission to establish such limits on trading as it found necessary to diminish, eliminate or prevent such burdens. After the passage of the 1936 Act, the Commission held hearings and set position limits for single months and all months combined and daily trading limits of 2 million bushels for wheat and other grains. Later the Commission established position limits for cotton and several other agricultural

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

commodities. Because prior to 1974 the Commission did not have legal authority over all of the futures contracts that were being traded on the exchanges, for a number of commodities such as the livestock commodities, the exchanges set position limits themselves. These exchange set limits set the precedent for the Commission to rely on the exchanges to set limits after the CFTC's jurisdiction was expanded in 1974 to cover all futures contract in all commodities. After the passage of the 1974 Act, the Commission studied both whether and how it should establish position limits for these additional commodities that were just brought into its jurisdiction. In 1981, in the aftermath of the manipulation of the silver market by the Hunt Brothers, the CFTC found and determined that large positions in fact had the potential to distort prices. It adopted Rule 1.61, now Rule 150.5, requiring exchanges to impose position limit for all commodities that did not have Commission set limits.

In January 1992, the CFTC approved the

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

Chicago Mercantile Exchange's request for an exemption from the position limit requirement and permitted the CME to establish position accountability for certain financial contracts traded on the CME. Position accountability levels were not fixed limits but, rather, position sizes that would trigger review by the exchange of traders' positions. Initially the CFTC stated that position accountability could apply to financial instruments that had a high degree of liquidity. Six months later, in June 1992, the Commission determined it also would allow position accountability to be used for highly liquid contracts in the energy markets. In 1999, the Commission issued a rule that formally recognized the practice of position accountability so that it would no longer have to issue exemptions from its regulations to allow the exchanges to implement it. The rule provided however that the exchanges were still required to set spot month position limits at a level no greater than one quarter of the estimated spot month deliverable supply.

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

In the Commodity Futures Modernization Act of 2000, the Congress statutorily authorized the use of position accountability by the exchanges. Designated Core Principle 5 states, "To reduce the potential threat of market manipulation or congestion especially during trading in the delivery month, the Board of Trade shall adopt position limitations or position accountability for speculators where necessary and appropriate." The CFMA did not alter however the Commission's mandate in Section 4(a) to establish position limits as it finds are necessary as to prevent undue burdens on interstate commerce that may arise from excessive speculation.

Since 1936 again the Congress has stated that position limits should not apply to the users of the futures markets by commodity producers or users to discover prices and manage their price risks. Section 4(a) originally defined a bona fide hedge transaction to mean sales or purchases of futures contracts that were offset by purchases or sales of the same cash commodity. By the mid

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

1950s, concern had arisen that the statutory hedge exchange criteria was too restrictive in light of the commercial practices of the time. In 1956, Congress responded by permitting anticipatory hedging. In 1974, when Congress expanded the jurisdiction of the CFTC to include financial futures contracts, the Congress repealed the statutory definition of a bona fide hedge transaction and gave the CFTC discretion to define what constituted bona hedging provided that its definition permits commercial producers, purchasers or users of the commodity " -- to hedge their legitimate anticipated business needs." In 1977, the Commission defined what constituted a bona fide hedging transaction in Rule 1.3(z). This definition remains in place today.

In 1987, the Commission clarified its interpretation of its bona fide hedging rule. The CFTC stated there was concern that the link to transactions in the physical commodity markets required under Rule 1.3(z) precluded numbers hedging strategies that reduced risks. The CFTC

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

clarified that the bona fide hedge exemption should not be construed to apply only to firms using futures contracts to reduce their exposure to risks in the cash market. The CFTC concluded that to qualify as a bona fide hedge, the transaction in the futures market could also include various trading strategies that are risk reducing and otherwise consistent with this interpretation.

The CFTC subsequently granted a number of hedge exemptions to swap dealers using the futures markets to offset price risks arising in the over-the-counter market. Since 1991, the Commission has granted a number of hedge exemptions to swap dealers hedging their financial exposures from swaps tied to the value of a commodity index, so-called commodity index traders. In September 2008, the CFTC's report on commodity swap dealers and index traders recommended that the CFTC staff develop an advanced notice of proposed rule making for whether to eliminate the bona fide hedge exemption

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

for swap dealers and replace it with a limited risk management exemption. In March 2009, the Commission published a concept release on whether to eliminate the bona fide hedge exemption for certain swap dealers and create a new limited risk management exemption from speculative position limits. The longer legislative history is submitted for the record and I'd like to acknowledge everyone in my office who worked on that and the other divisions who contributed to that review over the past 70 years and more.

CHAIRMAN GENSLER: General Counsel Berkovitz, I thank you for particularly putting that together in the midst of all that we're doing in working with friends and colleagues in the administration also on over-the-counter derivatives legislation, so that I know a lot is going on.

I feel every time I'm with you it's like I'm with an historian, so if I can ask a couple history questions and then legal questions and then turn it over to my fellow Commissioners. On

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

the history, the various exemptions, I understand that what we now call an inventory exemption that's automatic, that came up first in 1936.

MR. BERKOVITZ: That's correct.

CHAIRMAN GENSLER: Secondly, what we call a commercial exemption for anticipatory needs, that first came up in 1956?

MR. BERKOVITZ: That's correct.

CHAIRMAN GENSLER: But the risk management exemption I'm a little confused. This is for the swap dealers. Did you say that in 1977 we adopted a rule, I think you called it 1.3(z), but it was not until many years later that we actually had the risk management exemption?

MR. BERKOVITZ: It was in 1987 that the Commission that the issue arose whether indeed 1.3(z) was limited to instances where there was a transaction in the cash market for the commodity. This issue had been debated in the Congress and the Congress directed the CFTC to study the issue. It didn't make a change in the statute. It just said please study the issue, and the Commission

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

issued a clarification. It did not change the actual wording of the regulation but it clarified that we believe that the purpose of the regulation is to enable users of the futures markets to reduce risks and therefore that it would be consistent with the purpose of the regulation to permit these risk management techniques even without use of a cash market.

CHAIRMAN GENSLER: So one last history question and then I have a couple legal questions because you are a lawyer. So it was in 1991 that the first exemption for risk management was granted by the Commission, so to speak, a swap exemption was granted?

MR. BERKOVITZ: Correct.

CHAIRMAN GENSLER: So the 10 to 14 that are in the agricultural products that have been granted by this Commission were granted starting in that period of time and then following along the years?

MR. BERKOVITZ: That's correct.

CHAIRMAN GENSLER: And then the

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

exchanges separately granted exemptions, total exemptions, about half of that, so maybe it's call it 20, but roughly the earlier slide showed 35 to 40 total exemptions and about half of those are risk management exemptions were granted by the exemptions starting in 1991 or did they start granting exemptions later?

MR. BERKOVITZ: I would have to check on the data when the exchanges first granted those.

CHAIRMAN GENSLER: Maybe if we have people from the exchange they could answer. Let me ask some questions about the law and then I'll turn to Commissioner Dunn. Do I take it from your testimony that the Commission has the authority to set position limits for all commodity futures contracts?

MR. BERKOVITZ: Yes, that's correct.

CHAIRMAN GENSLER: Does the Commission have the authority to set position limits even if an exchange has already established a limit?

MR. BERKOVITZ: Yes.

CHAIRMAN GENSLER: Does the Commission

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

have to make an affirmative finding that there has actually been excessive speculation?

MR. BERKOVITZ: No. The Commission has been able to set position limits without such a finding.

CHAIRMAN GENSLER: So if the Commission doesn't have to make that finding, do we have to make an affirmative finding that there has been undue burden on interstate commerce that has resulted from excessive speculation?

MR. BERKOVITZ: No, the Commission has interpreted the statute and position limits have been applied in a manner, and the direct wording of the statute is to prevent such undue burden, so as the Commission has described it's a prophylactic measure. So you don't have to wait for some damage to the market or some undue burden on commerce where the Commission is directed to actually prevent it.

CHAIRMAN GENSLER: So I take it that historically at least in the agricultural products that the Commission found that the concentration

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

of individual traders, meaning the large size of those traders in itself should be limited and was necessary to eliminate, diminish or prevent the burdens that may come to interstate commerce from excessive speculation.

MR. BERKOVITZ: That's correct.

CHAIRMAN GENSLER: Thank you. For energy products, energy contracts right now, do the exchanges have a statutory responsibility to set position limits and accountability levels to prevent excessive speculation as contrasted with manipulation and congestion?

MR. BERKOVITZ: Core Principle 5 does not refer to excessive speculation as one of the purposes of position limits or accountability.

CHAIRMAN GENSLER: I just want to understand this a little bit better. Core Principle 5, what is that? That's the principle that the exchanges have to follow?

MR. BERKOVITZ: Correct.

CHAIRMAN GENSLER: In Core Principle 5 what is it that they're setting position limits to

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

address?

MR. BERKOVITZ: I'll quote Core Principle 5, "To reduce the potential threat of market manipulation or congestion especially during trading in the delivery month, the Board of Trade shall adopt position limitations or position accountability for speculators where necessary and appropriate."

CHAIRMAN GENSLER: I gather that the statute as amended in 2000 and as stands today, there is not a statutory responsibility of the exchanges to set position limits to address excessive speculation.

MR. BERKOVITZ: That's correct.

CHAIRMAN GENSLER: Is there a statutory responsibility for this Commission to set position limits to address the burdens that may come from excessive speculation?

MR. BERKOVITZ: That is the language of Section 4(a) of the statute of the direction to the Commission.

CHAIRMAN GENSLER: What does the word

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

"shall" mean in 4(a)? There's a word that the Commission shall set.

MR. BERKOVITZ: 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.

CHAIRMAN GENSLER: Thank you, General Counsel Berkovitz. Commissioner Dunn?

COMMISSIONER DUNN: Thank you, Mister Chairman. This morning -- I usually get up around 3:30 and the first thing I do is go to the computer and see what's on the blobs, and lo and behold I got a message from our Chief Counsel at 3:35, and if you were just getting to bed when I was just getting up, I give you a great amount of support for being here this morning. You may not be able to answer some of the questions I have, but if other staff are in the room, we might call on them to get some of these answers. What I want to take to take a look at is how does the Commission come up on federal spec limits. What

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

criteria do they use in establishing those?

MR. BERKOVITZ: The Commission uses I believe, and I would also welcome Division of Market Oversight to assist, but the criteria are set forth in the Commission's regulations in 150.2 as to what the specific criteria are.

CHAIRMAN GENSLER: I'm inviting up as Chair, I think I have the prerogative to invite up our head of Division and Market Oversight Rick Shilts who can assist where appropriate.

MR. SHILTS: The formula or the procedures that the Commission has adopted in its policies for setting limits in the agricultural commodities federal limits, for the spot month it's geared to deliverable supplies and it's generally about one-fourth of the estimated deliverable supplies for the commodity, and then for individual months outside of the spot month and in all months combined it's generally geared toward open interest for the previous year. The limits aren't adjusted on an annual basis, but when they are it goes back looking at average open

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

interest for the prior year looking at 10 percent up to the first 25,000 and then a marginal rate of 2-1/2 percent after that. So it's to address concentration in the particular contracts, but it's deliverable supplies for the spot month and open interest for the other months.

COMMISSIONER DUNN: We recently had where there has been a drought on the agricultural of course because that's the ones we set, and there is less deliverable supply available, do we ever step in and change those mid- contract or midyear?

MR. SHILTS: No. Federal limits are established via rule making and generally not to apply to existing positions. I think that's a provision in the law that we can't modify limits and effect position positions, but it's all done through an open process through a proposed rule making and then an adoption of final rules.

COMMISSIONER DUNN: When someone exceeds a position limit or even an accountability limit, could you describe what the action is between the

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

CFTC and the exchange that is responsible for that contract?

MR. SHILTS: Yes. Our surveillance staff is in regular contact with the surveillance staff of all the exchanges and they have large trader to do oversight of positions as do we. So if a trader is over a position, we will know that there is a potential violation as well as the exchange. There will an immediate dialogue with the exchange to make sure that the facts are correct. Then if it's a federal limit, then obviously we will immediately take action to get the trader down, what caused the violation, and if it's egregious then we can refer that to Enforcement because any violation of either the federal limits or exchange set limits is something that our Division of Enforcement take action on which happens.

COMMISSIONER DUNN: Is the same true for accountability levels?

MR. SHILTS: No. Accountability levels are not limits. They are alert levels where the

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

exchange can take additional action, additional oversight and get more information from the exchanges or they can take action to tell a trader to either not increase their position or reduce the position. But exceeding an accountability level in and of itself is not a violation.

COMMISSIONER DUNN: Is there a requirement for an exchange to notify the CFTC when someone has exceeded the accountability level or to tell us what actions they intend to take?

MR. SHILTS: No, there is no specific rule or requirement for that, but as part of our ongoing surveillance we get reports of traders from the exchanges that are over the levels and there's a continuing dialogue, but there is not a formal requirement for that.

COMMISSIONER DUNN: To follow up on Core Principal Number 5, when you're looking at an exchange, how do you determine whether or not whether they're in compliance with that core principle?

MR. SHILTS: For looking at the spot

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

month limits which is what's essentially required, again it's an evaluation of the estimated deliverable supplies for that particular commodity. When we look at a rule enforcement review we'll be looking at the exchange's procedures for monitoring the positions, ensuring that traders are taking action if they do exceed the limits, as well as their oversight in implementing their accountability provisions. But again, exceeding the level is not a violation.

COMMISSIONER DUNN: On the rule enforcement review, these are normally scheduled. How long is the period between those reviews?

MR. SHILTS: Generally we have striven to have the reviews done every 2 years, but because of staffing issues, it's been extended generally about 3 years on average, and they are all posted on our website too.

COMMISSIONER DUNN: Thank you, Mr. Shilts. I appreciate your coming up ad hoc here. I've got another question for Mr. Berkovitz.

CHAIRMAN GENSLER: Rick, don't go too

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

far.

COMMISSIONER DUNN: Thought he'd get away easy. Senator Sanders brought up the fact that Goldman Sachs predicted that crude would hit $200 per barrel and that is also in the testimony that Mr. Cota has submitted to us. How do we delineate between someone who is an active trader and someone who is giving investment advice when we look at those particular entities?

MR. BERKOVITZ: We don't have any what would be consider insider trading requirement or prohibitions like they would have in the securities context.

COMMISSIONER DUNN: We don't have a prohibition from the trading desk getting information?

MR. BERKOVITZ: No.

COMMISSIONER DUNN: Thank you.

CHAIRMAN GENSLER: Commissioner Sommers? Again, if we need another round we'll go another round.

COMMISSIONER SOMMERS: Thank you, Mister

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

Chairman. I think that probably my questions will be directed more at Rick as well.

CHAIRMAN GENSLER: Glad you didn't go far.

COMMISSIONER SOMMERS: You mentioned that when we look at the formula for position limits that we do not adjust those limits annually. When is the last time we adjusted the limits for the federally set?

MR. SHILTS: I believe the last time was in 2005. It generally has been at the request of the exchanges. The last time we adjusted the limits the Commission had said we would try to do this on a more regular basis. There was a proposal in 2007 but there was various concern in the industry and that was withdrawn.

COMMISSIONER SOMMERS: If we consider these changes to position limits right now, would it be more appropriate to consider and put in a rule that we would have annual adjustments relating to the formula?

MR. SHILTS: Yes, I think that probably

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

would make sense.

COMMISSIONER SOMMERS: Also with regard to the formula, is the formula across the board appropriate for every commodity or are there differences in commodities that would make it difficult to apply the same formula across the board for all the commodities?

MR. SHILTS: I think that's a good question and something we'd have to evaluate, if the Commission decides to go forward what would be the appropriate formula to use for different types of commodities.

COMMISSIONER SOMMERS: But it's possible that each commodity might be different?

MR. SHILTS: Yes.

COMMISSIONER SOMMERS: I'm not sure which of you this question is more appropriately directed at, but when we were talking about the legislative history, has there ever been a discussion or a recognition in the long history of the debates about excessive speculation and position limits as to the difference between cash

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

settled contracts and physically settled contracts? Has that ever been a factor in the debate?

MR. SHILTS: In terms of the spot month limits it has been a consideration because, to use the shorthand I said for the spot month limit we look at the estimate of deliverable supplies. For a cash settled contract there is no delivery so there aren't deliverable supplies. But there the spot month limit has been geared toward the size of the underlying market from which the cash settlement price is determined. So of you're looking at a feed or cattle contract we'd be looking at the volume of sales and all that to into determination of the cash settlement price if it's something like on euro dollars where you're looking at a LIBOR rate or something then there may not be a need for a limit or whatever because of the issues about how it's calculated. So, yes, there are different considerations.

COMMISSIONER SOMMERS: Would we consider that it would be appropriate to have different

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

levels for cash settled versus physically settled? That's not how we do it now is it?

MR. SHILTS: For the ag commodities essentially they're all physically delivered, so this would be something that we'd have to consider.

COMMISSIONER SOMMERS: For energy.

MR. SHILTS: Yes.

MR. BERKOVITZ: One of the distinctions that is found throughout the legislative history in more recent years since the financial futures began to be traded in the 1970s and the 1980s and there was a lot of discussion back then and it continues now is the discussion focuses a lot on the inexhaustible supply issue, that in the financial commodities you're not dealing with something in a finite supply and so then the question becomes what do you do with a commodity that might have a larger type of supply. The energy commodities, should they be like a financial commodity where there's nearly an inexhaustible supply and apply the same concepts

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

to the commodities of finite supply that are very large as you do to financials or to the agriculture commodities where you do have that finite supply and those concepts I think came together in the position accountability rule where you have a spot month limit for an energy commodity for example or a metal but you don't have your other month limits.

COMMISSIONER SOMMERS: Thank you. I don't have any other questions.

CHAIRMAN GENSLER: Thank you, Commissioner Sommers. Commissioner Chilton?

COMMISSIONER CHILTON: Mr. Berkovitz, you talked about how we could deal with position limits on exchange, but people talk about loopholes. Senator Sanders talked about loopholes, people talk about the swaps loopholes and about the London loophole. Can you address our ability to address either of those different areas of trading, both OTC trading and then look-alike contracts?

MR. BERKOVITZ: Legally the Commission's

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

authority to establish position limits only goes to designated contracts, designated derivative transactions, execution facilities or where there is a finding that there's a significant price discovery contract on an exempt commercial market. So we do not have statutory authority to impose position limits in the over-the-counter market or other markets.

COMMISSIONER CHILTON: Hence, you'd probably need some legislative authority to deal in particular with the OTC market, but we'd need something from Congress to change that. Then there are other things though with regard to look alive contracts that we could do regulatorily even though we may not have a clear statutory responsibility? Is that correct?

MR. BERKOVITZ: If a look alike contract is traded on an exempt commercial market for example, to use the example of the Intercontinental Exchange and the Henry Hub natural gas contract which was traded on the Intercontinental Exchange which is either Friday

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

or yesterday the Commission actually found was a significant price discovery contract, so with that determination under the provisions that were enacted into law in the Farm Bill last year, the Commission upon the finding that it's a significant price discovery contract, the exchange now has an obligation to follow the core principle with that and the Commission has statutory authority under Section 4(a) to actually establish its own position limit should it make the finding and determine to do so.

COMMISSIONER CHILTON: For Mr. Shilts, what about look alike contracts like the WTI in London? What sort of regulatory oversight do we do? ICE has been cooperating in giving us data and we've been working with FSA, but what sort of legal constructs are there that we are using to ensure that we're monitoring the markets to the extent that we can?

MR. SHILTS: I'll let Dan talk about some of the legal issues, but we do get data from ICE Futures Europe.

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

COMMISSIONER CHILTON: On a daily basis?
MR. SHILTS: On a daily basis.
COMMISSIONER CHILTON: We get it directly from ICE?
MR. SHILTS: We get it through the FSA.
COMMISSIONER CHILTON: Do we sort of C.C. it? It goes to FSA and we're C.C.'d, so we're getting it in real time unfiltered from ICE in London?
MR. SHILTS: Right. The same timeframe we would get large trader data.
COMMISSIONER CHILTON: And the same type of information that we would get from NYMEX?
MR. SHILTS: Correct.
COMMISSIONER CHILTON: And it's in the same form and we can understand it?
MR. SHILTS: Yes.
COMMISSIONER CHILTON: So this is easy for us to digest as part of your general surveillance mechanics that you do every single day?
MR. SHILTS: Yes. So we get that data

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

and we can integrate it into the data we get from NYMEX to do oversight of the NYMEX market. But as to whether our authority to, I think the other part of your question, oversee the foreign boards of trade market, I'll let Dan respond to that because I don't believe we do have that authority.

MR. BERKOVITZ: I think it's problematic from several points legal as well as policy to directly regulate the foreign board of trade. The path that's been chosen by the Commission has not confronted that issue directly, but instead the Commission has chosen to put conditions on the process by which ICE Futures Europe or any other foreign exchange is permitted to install its terminals in the United States. It's called the no action process where we have said we will not bring an action for a violation of any of our regulations if you install terminals subject to the following conditions. Last year the Commission added several conditions to that and worked with ICE and the FSAs and one of those conditions was that you have comparable position

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

limits. So while we don't have the direct authority to establish on a foreign board of trade or may not, these position limits we can condition their access into our markets by the imposition of these, and that's the way we've chosen to do it.

COMMISSIONER CHILTON: So we do have some regulatory hook there to ensure that that ICE Europe is abiding by positions, not that they haven't suggested that they would do so anyway voluntarily both through accountability levels or position limits which I commend them for, but there is some sort of legal hook that we have to ensure that would be the case should they decide they didn't want to.

MR. BERKOVITZ: That's correct. We have tools at our disposal in that event.

COMMISSIONER CHILTON: Thank you.

CHAIRMAN GENSLER: I just have two quick follow- ups. One is, General Counsel Berkovitz, I take it that from what you said earlier that somewhere along the line that the Commission decided that financial futures as you used the

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

term had sort of an inexhaustible supply and thus position limits would not apply to them and accountability levels would be appropriate, is that right, somewhere in the 1991 or 1992 period?

MR. BERKOVITZ: Yes, that's correct.

CHAIRMAN GENSLER: In a close reading of your long but well-written testimony, I take it that some number of months later but in a separate action the Commission said that the exchanges could set accountability levels as well on energy and I believe metals at the time, but at least energy.

MR. BERKOVITZ: At least energy. That's correct.

CHAIRMAN GENSLER: So you said that at the center of that discussion then back in 1991 was whether the energy futures was more akin to financials which had an inexhaustible supply or was more akin to agricultural products which of course have a finite supply.

MR. BERKOVITZ: The Commission's determination at that point to apply to energy

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

said that like financials, they have a nearly inexhaustible supply. That was the rationale that the Commission used to extend it to the energy market.

CHAIRMAN GENSLER: But if this Commission now, given 18 years of history and development of markets came to a judgment that I have but I can't speak on behalf of the Commission that energy products are a product of finite supply and that though they are larger than agricultural products and they may be larger by multiples but they still have more similarities to products in agricultural supply, could this Commission now take action to set position limits based on our current judgment on this?

MR. BERKOVITZ: Certainly, if the Commission were to make that finding. Certainly, the initial finding in 1991 was a statement and a decision to allow an exemption. It was not adopted through a formal rule making.

CHAIRMAN GENSLER: So it was just through an exemption. It wasn't even a rule

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

making.

MR. BERKOVITZ: Correct.

CHAIRMAN GENSLER: That's very helpful. So you believe the statute is clear and even the history our rule making is clear if this Commission came to the view that energy products are a finite supply and have more similarity to the agricultural products where we do set federal position limits, that we have clear authority to do that if that's our determination?

MR. BERKOVITZ: Yes.

CHAIRMAN GENSLER: Thank you. Following-up on Commissioner Chilton's I thought very helpful questions about both the significant price discovery determination on ICE exempt commercial market or the natural gas contract and on ICE Futures U.K., I took it that you felt while it was a little indirect but it's clear we have currently the tools to set position limits and make sure that those position limits are complied with on both the natural gas contract and on the linked contacts on ICE Futures U.K.

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

MR. BERKOVITZ: We clearly have the tools to apply position limits to the linked contract in the United States. We also have tools to clearly condition the access of the foreign terminals to put those in the United States on compliance with conditions.

CHAIRMAN GENSLER: I hear that we have a very clear tool on one exchange, the natural gas contract, and through ICE -- I apologize, is it ICE U.K. or ICE Europe? ICE Europe. You believe that we do, but it's through this conditional way and through the no action process?

MR. BERKOVITZ: That's correct.

CHAIRMAN GENSLER: But we will have a member of the senior management of ICE on the next panel, so we can ask directly where I'm headed because if we were to set as the Commission position limits I want to make sure that we would have clear authority that these would apply on both of these ICE linked contracts. I don't have any further questions.

COMMISSIONER DUNN: Thank you, Mister

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

Chairman. Rick, since we've got you on the hot seat, a couple others. We talked a little bit about the rule enforcement reviews that you do, and for ICE Futures U.S. you have authorities to do those reviews?

MR. SHILTS: Definitely for ICE Futures U.S.

COMMISSIONER DUNN: ICE Futures Europe?

MR. SHILTS: No.

COMMISSIONER DUNN: ICE Futures Canada?

MR. SHILTS: No.

COMMISSIONER DUNN: ICE over the counter?

MR. SHILTS: For contracts just declared to be a significant price discovery contract, yes, we will.

COMMISSIONER DUNN: For the new SPDC?

MR. SHILTS: Yes.

COMMISSIONER DUNN: I had sent some questions to the ICE and CME asking what they do and how they do things. I was told by ICE that on setting their accountability limits for both ICE

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

Futures Europe and ICE over the counter under the new SPDC they are going to utilize those that are in NYMEX. Mr. Shilts, does that give them or give somebody who wants to have a lot of speculation position two bites at the apple? Are they allowed to then since they're not aggregated to be able to have similar positions in both exchanges?

MR. SHILTS: Yes. The way the limits are set up, again these exchange limits, so each exchange would set their own limit. So presumably one could have limit sized positions at both exchanges because they're not aggregated.

COMMISSIONER DUNN: Is there a size issue here? If NYMEX says we have say 25 contracts on 100 outstanding contracts, that's the limit that we have on there, and then another exchange comes on and says we'll se the same 25 contracts but they only have 50 outstanding, does that skew the situation in that other exchange?

MR. SHILTS: Presumably not because as I said, since the limits are set separately for each exchange, then there is parity there in that

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

sense. I think the issue is if the overall limit should be really set at that level then potentially you could have a position by a trader that exceeds that level by doing it on multiple exchanges which would suggest an aggregation provision.

COMMISSIONER DUNN: When you have observed folks who have positions exceeding those and have asked them to reduce those positions or the exchanges have asked them to reduce those, have you observed them migrating to other exchanges and over-the-counter and other OPEC swap deals that we do not have oversight over?

MR. SHILTS: For the federal limits that really aren't alternative markets so we haven't observed that. As far as migration from other markets, maybe that might be a good question for the NYMEX people who would be watching that when they take provisions under their accountability procedures to tell traders to reduce.

COMMISSIONER DUNN: Would they know if that customer of theirs went to another exchange?

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

MR. SHILTS: Presumably I think they would.

COMMISSIONER DUNN: Does this argue for us to look at the aggregate of positions that an investor might have?

MR. SHILTS: Just from my own personal opinion, I think if the Commission decides that a certain level is appropriate in terms of a speculative limit, then I think it makes sense that that be applied to all positions that are equivalent to that whether they be on multiple markets or not.

COMMISSIONER DUNN: Thank you.

CHAIRMAN GENSLER: Thank you, Commissioner Dunn. Commissioner Sommers I believe said she didn't have any more questions. Commissioner Chilton?

COMMISSIONER CHILTON: Just real quick. Senator Sanders raised and the Chairman referred to this issue of the trading arms at firms as opposed to their forecasting arms. I've talked about this before and I think it's an issue, but I

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

want to clarify legally. As the Commission we don't have the ability to distinguish and do anything about that if we thought it was a bad idea. Am I correct that that would take a statutory change to the Act?

MR. BERKOVITZ: I think our legal authority is somewhat tenuous in that area.

CHAIRMAN GENSLER: But I take it, Mr. Berkovitz, if we wanted to explore this, we could explore this more with you as to our ability through our regulation through futures commission merchants and the application of futures commission merchants to do things in this area.

MR. BERKOVITZ: Yes, certainly. There are segments of the market that we have clear authority over and I was referring to Commissioner Chilton as the whole market and the entire market in general.

CHAIRMAN GENSLER: I want to thank both Mr. Berkovitz and then at the last minute Mr. Shilts. I also want to thank the public because this is the way that this Commission can actually

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

meet as a Commission under the Sunshine Act and meet with staff, so there was a little back and forth that was very helpful, but the public gets to participate in that too. So if we excuse these witnesses, I thank our other experts for their patience, but I think I see some or maybe one of them actually left the room.

I want to express the Commission's deep appreciation for our next two witnesses. We have with us today the Chief Executive Officers each of the two major trading companies that trade energy futures not here in this country by globally who really make the significant share again both here in the U.S. and globally of the energy futures markets. I also wanted to express the Commission's appreciation that in the written testimony both Craig Donahue and Jeff Sprecher have indicated tangible, real steps toward trying to address the very real concerns that we here are grappling with with the possibility of setting position limits as I believe the CME has said in their written testimony though there still remain

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

many questions and many questions that we'll discuss and may have lively debate over, we appreciate the tangible indications in your testimony about the support for possibly setting position limits not only in the spot month but in single month and all months combined and the tangible steps that Mr. Sprecher has put in his testimony about if we were to do it, how to do that. I think this public dialogue is very beneficial to the process as we move forward. With that, I don't know if we flip a coin between the two of you or I'm supposed to go alphabetically, but Mr. Donahue? I promise if we have you back another time we'll go in the other order.

MR. DONAHUE: Thank you very much, Mister Chairman and Commissioners. We appreciate the opportunity to be here today and to provide our input to the Commission's review of the approach to speculative position limits in contract energy and hedge exemptions as well.

CHAIRMAN GENSLER: Your prepared remarks

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

will be entered into the record. I just wanted to make sure of that.

MR. DONAHUE: Thank you. I have prepared remarks, but I'd like to just maybe depart from that for a moment to clarify something that I think General Counsel Berkovitz might have neglected in his very good summary and I think mostly accurate review of the history of position limits. With respect to the question of the exchanges' obligations and roles, I wanted to point out Appendix B to Part 38 to Core Principle Number 5 which I will quote, "In order to diminish potential problems arising from excessively large speculative positions and to facilitate orderly liquidation of expiring futures contracts, markets may need to set limits on trader positions for certain commodities." I agree with many of the conclusions of Mr. Berkovitz, but I wanted to point out that I think that the Commission's own interpretation of acceptable practices clearly places that obligation on the exchanges.

I'd like to begin by saying that the

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

theory that speculators in futures markets cause unwarranted price volatility and excessively high and low prices is certainly not new. Congress has been repeating that notion since the late 1800s. Farmers and their legislative representatives have called for the elimination of speculators on futures exchanges and the Commodity Exchange Act, however, does not limit speculator but only excessive speculation. This is of course an implicit recognition that futures markets cannot operate without the participation of noncommercial participants. The so-called speculator such as index funds and swap dealers who are the focus of recent intense criticism are in fact not engaged in traditional speculative activity 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

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

fund aggregate the buying and selling decisions of many thousands of investors most of whom who are doing exactly what they've been taught for decades to do, diversity in their investment portfolios and hedging inflation risks in order to enhance their investment returns and to maximize their retirement savings and their individual wealth.

The debate regarding controlling excessive speculation in the energy markets by means of position limits or otherwise must be informed by two facts. First, it is rare for speculators, index traders and other swap dealers individually to have control of a large share of the open interest in any futures contract. And second, efforts to control price or volatility by position limits is generally a failed strategy. Position limits are not across this palliative to appease angry farmers or gasoline or heating oil buyers. Position limits when improperly calibrated and administered can easily distort markets, increase the cost to hedgers and effectively increase the cost to consumers.

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

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 a constituency desires, and the ability of position limits to deliver on that promise.

We have taken a very strong position in the past, and in the answers to your questions today respecting the value of additional hard position limits in energy markets. We employed position limits during the last 3 days of trading before the delivery period and position accountability levels at other times in order to avoid congestion and other market disrupting events that may flow from excessive concentrations of positions. Nothing we have heard or read discredits the principles upon which those policies were built. Although our administration

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

of accountability levels in the energy markets may not be broadly understood by the public, it is certainly understood by the Commission's own Division of Market Oversight, as it is routinely subject to rule enforcement review by DMO.

Notwithstanding the success of our accountability regime, we do recognize, Mister Chairman, that others have concerns respecting the role of index funds and swap dealers in the future market, and in particular the impact that their participation in the markets might have on energy prices. CME Group is prepared to respond to those concerns by adopting a hard limit regime for those products including single month and all months combined limits, in addition to the current limits that apply during the final 3 days of trading. This modified regime will include the administration of tailored hedge exemptions for swap dealers and index funds, and as a whole we believe should alleviate the external concerns that positions held by these investors and hedgers will increase price volatility or artificially

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

inflate or deflate prices.

CHAIRMAN GENSLER: I didn't know just how you were going to summarize, but everything will be in the written record.

MR. DONAHUE: Thank you.

CHAIRMAN GENSLER: I don't mean to cut you off. I didn't know how you were going to summarize. I'm watching the clock too.

MR. DONAHUE: It is important I think to include a brief word on the value of indexing. Index investing in commodity futures is an efficient means for thousands of small traders to gain the benefit of asset diversification or to hedge inflation risks. For example, contrary to the picture painted by a few witnesses at a recent congressional hearing, index funds are not monolithic entities where a single speculator controls a large block of capital. Also, a review of U.S. oil funds open positions shows that it was liquidating positions when oil prices were rising. Indeed, the net reduction of futures equivalent swap positions constituted an 11 percent decline

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

over the first 6 months of 2008. I heard the testimony of the two members of Congress this morning and I think it's important to note that there have been numerous studies, the CFTC's own study, other governmental studies and private economists who have studied these issues. None of them has established causation between the role of index funds, swap dealers and noncommercial participants in the futures markets and the price behavior that we saw last summer. In fact, in the year since those studies were largely completed, we have yet to see a single study based on empirical evidence and reliable economic analysis that concludes to the contrary. Thank you very much. I look forward to answering your questions.

CHAIRMAN GENSLER: Thank you very much.

MR. DONAHUE: I hope that was brief enough for you.

CHAIRMAN GENSLER: We'll do a couple of rounds of you both together. Mr. Sprecher?

MR. SPRECHER: Thank you, Chairman Gensler and Commissioners, and I very much

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

appreciate the opportunity to appear in front of you.

Before I start I'd also like to echo what Mr. Donahue said and just put a note of caution out there that we as well have not seen a quantitative study that's shown that speculation in the futures market was the cause of the increased energy commodity prices that we've seen over the last year. In fact, we see that markets where there are no active futures contracts traded have had similar price effect. So I'm sure you and the exchanges as well want to make sure that when we finish this process, American consumers will be left in a better position than they were when we started.

Against that backdrop, we've made five recommendations to you in our written testimony and I'd like to summarize them. First, we think that any aggregate system of position limits, accountability levels and hedge exemptions should be set and administered by you the CFTC and not by the exchanges. Second, we think that position

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

limits and accountability levels should be determined by you using a market neutral and transparent methodology in a manner that will preserve competition for trading venues. Third, we think that financially settled contracts and physically delivered contracts should be treated differently in a revised regime, somewhat going to the questioning of Commissioner Sommers. Fourth, we think that the CFTC should maintain the distinction between the expiring month position limits and future month accountability levels. Lastly, we think that there are changes that can be made to exchange traded commodity funds or ETFs that may be required to help administer any of these accountability levels, position limits and exemptions that we end up with.

I think rather than go through my testimony in any great detail I'd like to stop there and let you ask questions and I can elaborate on those. Thank you.

CHAIRMAN GENSLER: I thank our panelists. What I want to try to do is maintain a

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

5-minute clock even for us too and we'll go two panels and we'll decide whether we need a third, but maybe we can all get it done in two.

Mr. Donahue, your opening comment about Mr. Berkovitz's testimony, I appreciate that and I just want to draw your attention to though he was also trying to summarize in a short time, he's got a 27-page legislative history, but on pages 19 and 20 it goes through exactly what you're talking about and does specifically go through that the statutory regime in Core Principle 5 does not set in statute specific provisions or requirements for the exchanges to set position limits to prevent or diminish or eliminate excessive speculation. You're accurate that in part 38, and he refers to this in the document, is guidance by the Commission but not in statue say that you may. I don't think it says shall, but you may. The one distinction is that the statute says we shall. I'm glad you brought our attention to that because I think you're accurate that in the summary it didn't have a chance to -- so I guess my question

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

is, are we on the same wavelength with regard to that or maybe you want to follow-up later and have your folks read his fuller testimony to see if you concur with what he has there.

MR. DONAHUE: No, I think I've clarified that the Commission's own interpretation is that we have an obligation and presumably in reviewing our compliance with the core principles under the acceptable practices the CFTC would similarly conclude that we have an obligation to prevent excessive speculation -- wouldn't understand what the acceptable practices language meant.

CHAIRMAN GENSLER: We might need to bring Mr. Berkovitz back up, but what I'm trying to say is he did address it, and so if you'd take a look at the full testimony.

MR. DONAHUE: I only play a lawyer on TV.

CHAIRMAN GENSLER: What's that?

MR. DONAHUE: I said I only play a lawyer on TV these days so that's about as far as I can go.

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

CHAIRMAN GENSLER: I have a question for Mr. Sprecher and then maybe a couple back for Mr. Donahue. You had said that you thought that there is a need for competition in the marketplace and I understand that you thought to the extent position limits were set, these should be set by the Commission and not the exchanges. Could you elaborate on that a bit?

MR. SPRECHER: Sure. I think a couple of points actually flow from that. One is that we are asking for you to set aggregate position limits. I think what would be fair for users in the market is that if they were given a certain bucket of positions that they were allowed to hold that they should be able to shop for the exchange that will give them the best service. I think that keeps Mr. Donahue and my colleagues honest and drives innovation. Also a point that I don't think has really been made here and with great respect to the elected officials who were here, they were very focused on the U.S. markets, but today energy is really a global market and we

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

unfortunately in the United States import the bulk of our oil and so we are beholden to global competition. I think it's important that in setting this regime we respect the fact that these positions can move around and will move around, so it make sense that things be done in the aggregate.

We have worked very closely with CFTC staff and many of you now to try to bring both the over-the-counter markets into a more transparent and to put regulation over them as well as bring foreign markets into the United States and put regulation over them. In doing that what we've basically agreed to do is try to adopt as best we can and as best you can the regime that's in place right now for the incumbent exchange, the CME. In doing that, we've run into some problems as somebody willing and trying to become regulated. One is we have no transparency into how these position limits were established or how the exemptions are given. We have customers come to us all the time and say I have a hedge exemption

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

from your competitor. You should respect it. Should we respect it? We don't know what's behind it. So we're in a very, very difficult position. We also have had what we believe are some odd practices that in the guise of risk management I think are anticompetitive where our customers are being told that they can't carry a position on ICE if they want to get a hedge exemption somewhere else. That seems anticompetitive to me. I understand from a risk standpoint it would be better for the incumbent exchange to see the entire position, but I would like for you to help drive competition there.

Lastly, we've seen changes to limits that we can't explain and we've actually FOIA'd your staff to try to get documentation and understand how these things evolved and we find that there's very little documentation that you have in your files, so we don't understand it. All that suggests to me that it would be much better to have you as a neutral counterparty who has also an obligation under Congress to make sure

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

that there are orderly markets that are competitive administer that regime.

CHAIRMAN GENSLER: I thank you. To make sure that standards and limits are applied consistently across all Commissioners, I now turn to Commissioner Dunn.

COMMISSIONER DUNN: Thank you for that equality. Mr. Donahue, you said in your written piece to the extent that the Commission seems to impose position limits on over-the-counter markets, we do not believe that it currently has the authority to do so. I think we are finding that out. What happens when someone reaches that position limit on one of the exchanges?

MR. DONAHUE: Thank you for that question, Commissioner Dunn. We obviously recognize that the CFTC as you do lacks authority currently to regulate transactions in the over-the-counter derivatives markets and also that the CFTC has in fact limited authority in this regard with respect to exemption commercial markets and foreign boards of trade, and

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

potentially no authority whatsoever with respect to foreign exchanges that don't seek to provide direct access to customers through terminals in the United States. Despite Mr. Sprecher's complaints about the way in which the current market works, the sad reality is and we've seen numerous instances of this including Amaranth that when people run up against limits and levels in our regulated market NYMEX, they sometimes devolve to the less regulated markets or the markets where historically there have been neither position reporting nor position limits nor position accountability which apparently is very difficult to put in place for ICE, firstly. Secondly, we've also seen numerous instances including very recently where market participants have said in response to requests to reduce positions at NYMEX that they will instead gain the same exposure by going to the swap market and replicating the same exposures that they could otherwise achieve in the regulated market with reporting with limits and with accountability.

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

COMMISSIONER DUNN: In the supplemental questions that I had sent to you, I asked you what happens when position limits or accountabilities are exceeded and is the Commission notified, and you indicate that there is no formal requirement that that takes place. Is that true?

MR. DONAHUE: We continue to work with the DMO in giving them information with respect to participants in our markets. As I mentioned or might have mentioned and certainly is included in my written testimony, we do obviously provide that information. The CFTC conducts rule enforcement reviews. They look at position accountability level determination that we make and so they do have access to that information and there is an going dialogue between the Commission's staff and our market regulation staff.

COMMISSIONER DUNN: And those RERs that we do are on the exchanges that we have oversight?

MR. DONAHUE: That's correct, and they generally include a very detailed review of these very issues.

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

COMMISSIONER DUNN: I want to thank both of you for your staffs putting together supplemental questions that I asked and some of it that you supplied me is proprietary information so I won't release it.

CHAIRMAN GENSLER: Actually I'd like to ask because I read it just this morning to the extent that there is any proprietary information which I didn't see, but if there is if you could resubmit them so we could put them in the record. That would be helpful.

COMMISSIONER DUNN: Thank you, Mister Chairman. I would like to ask both of you to give us a brief overview of how your surveillance and compliance divisions operate.

MR. SPRECHER: As you probably are aware, we have three regulated futures exchanges, one in the United States, one in Canada, one in London all of which we acquired so they were preexisting exchanges. We have worked to try to harmonize the tools that they use really to try to get best of breed because one of the interesting

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

things we found in making these acquisitions is that both regulatory oversight and risk management differed from exchange to exchange so we've harmonized that. As General Counsel Berkovitz I think testified, as of Friday we now are putting oversight into the over-the-counter markets. We're drawing from that collective team as well as hiring a dedicated OTC staff. We allow those people to coordinate. We use similar tools. We use futures techniques now in the over-the-counter markets for surveillance. And all total that's a staff north of 50 people not including the oversight that we have for risk management and clearing.

CHAIRMAN GENSLER: Mr. Donahue? I know we're over.

MR. DONAHUE: Very briefly, we have 130 full-time professionals that work in our market regulation department, approximately 40 of those in market regulation. The annual cost of that is roughly $30- to $35 million a year and many of those market surveillance professionals are very

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

heavily engaged in not only reviewing position limit position accountability levels, market participants' behavior, but also reviewing exemption requests and granting exemptions where appropriate.

CHAIRMAN GENSLER: Commissioner Sommers?

COMMISSIONER SOMMERS: Thank you, Mister Chairman. I actually have the same question for both of you. You both in your testimony discussed the complexities involved in getting these position levels right and the unintended consequences of getting them wrong that it can damage or distort the markets. It's clear to me that the unintended consequences can be significant. Taking into consideration your answers to some of the previous questions about us not having authority over the OTC markets, how do we know not taking that sizable chunk of the markets into account when we're looking at what aggregate position limits should be, how do we know we're going to get it right? Or what do we need to look at to make sure we get it right?

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

MR. SPRECHER: Thank you for that question. We have in our written testimony and I strongly believe that we need to look at the entire market in setting the size of the limits. While the Commission may not have statutory authority to necessarily put position limits on the over- the-counter markets, I think we could all respect the fact that those markets exist and we should make the size limits in the futures market appropriate so that we don't inadvertently push people into the over-the-counter markets.

Just one aside. A lot of the index funds and institutional money that comes into ICE's markets are not actually traded on our markets. They're traded in the over-the-counter swaps market and then they're coming in to us solely for clearing. So limits that we would be putting on ICE would be really clearing limits, not trading limits, and what I think at least Secretary Geithner's proposal is which is resonating I believe in the Hill is to try to get much more of the over-the-counter market to come

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

into a clearinghouse so we don't want to inadvertently create clearing limits when we're really trying to talk about speculation limits and that means we have to look at the entire market in setting the exchange limits.

MR. DONAHUE: Commissioner Sommers, I would just add a couple of things. I think first of all this morning to Mr. Sprecher's point we heard the two members of Congress speak of swap dealers and Goldman Sachs and others as effectively just pure speculators in the market seeking to make profits on the price movements in the energy and commodity markets. I think in an area that we can clearly agree, obviously much of what's happening with swap dealers is they in fact are facilitating the hedging of more complex risks for commercial customers with underlying exposures in these markets and then hedging the net residual risks of their unmatched swap books in the futures markets. So I think first and foremost we together as a community of interested parties have to recognize that before we throw the baby out

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

with the bath water and limit or deny access to futures markets for legitimate and bona fide investment and hedging and risk transfer strategies.

Secondly, I think that this isn't an either/or equation and we certainly support the affirmative role of the CFTC in determining how to administer limits in these markets and particularly across different segments of the market and we have no argument with that, but we do strongly believe that we have our own responsibility and also do believe we have our own competency and infrastructure and capabilities to do that very effectively, and I think this industry will be best served if we work together to accomplish that. So one way in which you could get it wrong is if you were not to take advantage of the expertise and capabilities and infrastructure of at least the regulated exchanges in terms of how we do this. We interface very extensively with market participants on a real time basis and this isn't a science, it's a

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

science and an art and there are judgments that have to be made as we look at market conditions and trading strategies and market participants' behaviors, our knowledge of their related position as well as their financial condition.

Just thirdly I would say that I think that it's very important that we not act precipitously in a way that does just serve the antithetical purpose of driving more participants into unregulated or nontransparent markets. We talked about the fact that the CFTC does lack authority. We support the CFTC's greater authority to appropriately regulate where he can, although we recognize that there will be many instances where the CFTC cannot, but again we support that. But in the meantime and prior to the establishment of that authority, it would be indeed unfortunate if we saw more market participants gravitating away from regulated markets with reportability, with limits, with accountability levels into the ether where there is none of that. So I think the timing of how we

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

do this and how we get to where we want to be as an industry is very, very critical.

CHAIRMAN GENSLER: As we'll have another round, I turn to Commissioner Chilton.

COMMISSIONER CHILTON: Thanks, Mister Chairman. I wanted to make a little comment and then I'm interested in both your feedback. It seems to me sometimes that people talk past each other on a lot of these issues. They're complicated. You're trying to get sound bites at times. But for example, Mr. Donahue was saying there lacks this conclusive study that shows speculators having an impact. There are studies that say they're having an impact. There are studies that say they're not having an impact. I think you have to listen carefully to how people talk about this and to some extent I'm guilty of it too, that for example, last year we said that speculators weren't driving the price, driving. I think a lot of people would agree they're not driving the price, that it's based on fundamentals, but were they having an impact? And

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

is that impact potentially, and it's our job to think about potentially, having some uneconomic influence on prices, prices that are devoid from supply and demand which is why you've seen these crazy supply-and-demand charts and prices. So sometimes I think we have to listen to the exact words that people use and it's not just speculators are evil and they're causing these big problems, I don't believe that, but I do think that they some impact either up or down and that's why it's important that we get this right. So I'm interested if you think I'm on the mark or what your thoughts are on that. In particular, Mr. Donahue talked about if we didn't calibrate this right, and this goes a little bit to what Commissioner Sommers said. By the same token, speculative activity unchecked at least theoretically from your perspective, could it have the same dangerous consequences? Both of you, Mr. Donahue first.

MR. DONAHUE: I'll just begin by saying that I think that most of the economic analysis

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

that I've reviewed indicates that speculators generally are responding to price activity in the market versus driving in your terms price activity in the market, and I think that's fairly uncontrovertible and there are many studies that have been done over the decades that have come to that conclusion having nothing to do with the more recent price movement activity in energy and commodity markets over the course of the last year and a half. Secondly, and I guess the point that I would make is that to a certain extent, many of the people who are in favor of imposing hard limits or denying access to the market for swap dealers or index funds many of whom once again are engaged in legitimate hedging risk transfer and investing in inflation hedging activities, but we heard the members of Congress this morning expressing concern which I think we all share about price increases in gas markets and oil markets and food markets as well. But to make the point, as of July 7 in the energy markets, swap dealers are actually more net short than they are

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

net long and so you can make the value judgment that you think they're speculators and you should deny them access to the market, but you're denying access to sellers, and at least the last time I studied economics that's likely to have a depressing price on the market and not an inflationary price on the market. So these are the kinds of issues that I think need to be very carefully discussed before we just jump to the conclusion that we should either limit exemptions, prevent exemptions altogether, and claim to understand what people are doing in the market.

MR. SPRECHER: Let me make a similar point, and I think it goes to some of your public comments, which is I don't want to be left with anybody thinking that ICE is saying that we don't believe they have any impact because they do have impact, and the person that we've seen that's done the most research on this has been Professor Verleger who I believe may testify later. We believe strongly that they are not the cause of $147 oil, but they do have an impact and their

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

movements tend to dampen actually price swings and that's a double-edged sword. It may mean that prices don't go as low as they could go without them, but it also means that they may not go as high as they will go without them. So right now we're in an historically low period for natural gas prices and people may argue that they could go lower, but you would hope that the index funds would actually prevent the price from going higher. So that's the research of Dr. Verleger and it's the best that I've seen and so I would really point you to that.

CHAIRMAN GENSLER: Thank you, Commissioner Chilton. I think we're going to probably with the patience of the witnesses need a few more rounds. I'll try to do it quicker if I can get at least three questions in. Mr. Donahue, I take it from your prepared testimony and from your oral testimony that the Chicago Mercantile Exchange through NYMEX is prepared to adopt a hard limit regime for those products, the energy products, including single month and all

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

months combined limits in addition to those that are currently in place for the spot month. Is that correct?

MR. DONAHUE: Yes, sir.

CHAIRMAN GENSLER: Thank you. I thank you for that. Secondly, I wanted to ask on the data I know that there were some charts, but is that data roughly consistent? I know the numbers we might have to get into, but they're roughly consistent about accountability levels and so forth that I've presented earlier?

MR. DONAHUE: Are you referring to the number of exemptions that have been granted or the number of times in which people --

CHAIRMAN GENSLER: That's right, approximately nearly 70 parties in these four energy contracts have been over the accountability levels in the last 12 months, the rough presentation or the thrust of that presentation.

MR. DONAHUE: Right. Our data shows from June 2008 through July 7, roughly 46 instances I believe in energy and metals markets

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

where that has occurred, and although your data didn't show it, I believe in those cases the position limits were typically exceeded by somewhere between two contracts and 569 contracts or an average of roughly 122 contracts which of course would be incredibly small in relationship to average daily volume and open interest --

CHAIRMAN GENSLER: Mr. Donahue, I did read that in your testimony. I think that we might be speaking --

MR. DONAHUE: I don't think that was in my testimony.

CHAIRMAN GENSLER: Or in a document that you prepared for Mr. Dunn, confusing, because you were very kind and I would like to make sure if you both would commit to look at that data that you provided Commissioner Dunn and see if we could submit it for the record. I think I was asking about accountability levels and we might have been speaking past each other. You might have been referring to the position limits. But on the accountability levels, if you don't know now, if

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

you could get back for the record to see. I'm not terribly interested whether we're at 69 and it's really 66, but just whether the main thrust of what we presented in the numbers on accountability levels that would be helpful.

Lastly, one other question I saw and this was in what you provided to Commissioner Dunn. He was good. He has good questions. He asked a question, How often are position limits and accountability levels exceeded? Then went on in your answer you said that the exchange employs certain tolerance levels for market participants who breach accountability levels. These levels are generally at 20 to 25 percent of market concentration in the front month, 30 percent in months two to six, and approximately 40 percent in back months. So these are as it was written market concentrations that you employ as tolerance levels. Do I take that to mean that if a trader is below those tolerance levels, they're above the accountability levels but below what you wrote to Commissioner Dunn, below those tolerance levels,

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

then it's just a notice, but when they hit those tolerance levels is when you start to talk to them and take actions?

MR. DONAHUE: No. Actually, the accountability level itself is intended to act as an early warning system within our large trader reporting system. That would generally trigger an immediate review of the positions.

CHAIRMAN GENSLER: A review as you said in your testimony, I think this was in the testimony, 22 times that you took some action, but if we're correct, at least 70 unique traders were over and sometimes they were over multiple times in a year. So a majority of cases you did not talk a position down? Our understanding is probably at least three-quarters of the time it was just a notice. So it wasn't a stop sign or a yield sign, it was sort of honk if you go past this sign?

MR. DONAHUE: Correct, and that's as it is intended and designed to be. If it were otherwise it would function like a hard limit and

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

it's not intended to.

CHAIRMAN GENSLER: Thank you. Mr. Sprecher, if I could ask you a question, the last question in this round. You said that you thought there should be a difference between cash settled. In fairness, I'm going to hand it to Commissioner Sommers because it's probably going to be a long answer, or I'm sorry, Commissioner Dunn.

COMMISSIONER DUNN: Thank you, and thank you so I don't have to talk about the tolerability levels which was a new term that I had heard in this paper. Senator Sanders talked very eloquently about the men and women who are his constituents who are genuinely suffering because of high prices. But I'd like to know who are these folks who are speculators. Are there differences between ETF and who might they be, managed monies and hedge funds. Could you both respond to that?

MR. SPRECHER: The interesting thing about energy is when people think of energy they think of crude oil, and if you think about who

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

buys crude oil it is refiners, and anyone who is not a refiner is using it as some correlated asset. So the airlines that have been quite vocal on this actually don't buy crude oil, they buy jet fuel, and obviously crude oil can be converted into jet fuel. But we also have people come on who are portfolio managers who say they have exposure to energy prices in their portfolio either via inflation or dollar escalation or the unique nature of their portfolio. So there's this area of all grays that we're grappling with and I think as part of this hearing process of what is proper hedging and speculation and what is improper and that is a very difficult question to answer because we really don't know the root cause of an investor's needs.

MR. DONAHUE: I'll just add that with respect to the index funds and the ETF managers, the ETF manager is not some monolith who's making these speculative decisions. They're issuing literally as I think various of you are aware billions of shares of ETF units that themselves

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

reflect the buying and selling interests of the individual investors who are seeking exposure to these markets or perhaps they're sophisticated enough to be hedging inflation risks or doing what most of us were taught in terms of portfolio management to diversify their returns in a noncorrelated way to the equity market. So literally they're making investment decisions in the aggregate that reflect the underlying investment decisions of many, many thousands of investors. Swap dealers as you know from your own data gathering and report last September 2008 tend to be an amalgamation of activity representing not only commercial participants who are going to swap dealers to hedge more customized and tailored risks, but also noncommercial participants as well. But I believe the data that you produced at least at that time indicated that the vast majority of activity underlying those swap agreements was commercial hedging activity of more particularized risks.

COMMISSIONER DUNN: Mr. Sprecher, you

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

had a very good appendix and I notice some of the charts you used were very similar to the ones that Senator Sanders had used. I guess it gets back to that quantitative analysis or anecdotal analysis of how you look at these particular charts, and I appreciate you putting them in there. But you also mentioned that when you took over ICE Europe that it rapidly became all electronic as have almost all of the exchanges today, and a tip of my hat to those bloggers who usually my wife puts me onto early in the morning looking at, there is a great deal of chatter with the econo- bloggers about high frequency trading or flash trading as it's been called. It occurs to me as I've gone through the exchanges and I see people paying very high rent to have their computers right next door, is that a concern for us and a concern for us for the possibility of front running? I have asked our staff to begin looking at that, but I'd like to get your opinion. I know it's off the subject, but it is something that is relevant today.

MR. DONAHUE: With respect to the

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

so-called practice of flashing, we do not engage in that practice, so that is not permitted on the GLOBEX platform. I think the other part of your question relates to collocation services which is a common convention used in almost all segments of the market, the equity markets and options markets, certainly the exchange traded derivative markets, and would generally fall into I think a no harm category and represents just the nature of competition and innovation in the market where we used to have people who would wear platform so they could see a little bit higher in the pit and get more trades than the guy next to him, so that people do those things all the time. But I don't believe there's anything harmful about collocation services. Flashing practices we would never allow.

MR. SPRECHER: Similarly we don't have any so- called dark pools or anything that shows orders to any unique participant ahead of any other participant. But the collocation actually started when we found that there were traders who

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

had determined where our servers were located and had themselves gone and tried to put their computers next to ours. In fact, the anecdotes are when EUREX first came over and listed electronic bonds in Germany, many Chicago traders actually flew over and put computers in Germany. So we actually as exchanges have tried to organize up what is already going on and that is to create a level playing field for people who want to be close to be there on the same terms and we felt that was the fairest thing to do.

COMMISSIONER DUNN: For both of you, those who aren't there who have a 3 millisecond delay, that does put them at a disadvantage.

MR. DONAHUE: I'll just say on that that we provide a totally level playing field, open access and nondiscriminatory practices with respect to eligibility for collocation services and all of our customers are eligible to do that. I think to Mr. Sprecher's point, it helps level the playing field because people are smart and they figure out where your data centers are and

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

they start to locate around that and this affords everybody essentially a more equal opportunity to obtain the same speed advantages. Unfortunately it's a law of physics in an electronic world where the closer you are to where the match is made the faster you're likely to be. It's just the speed of light phenomena unfortunately.

COMMISSIONER DUNN: I would remind you there are other laws in the area of regulation as well.

CHAIRMAN GENSLER: Just to have the opportunity as Chair to associate myself with the comments of Commissioner Dunn, I think that there are other laws and that as this becomes aware to the public and to this Commission, I think that we're going to take a look with our staff and hopefully with each of the exchanges about practices in collocation so that we could actually achieve what each of the chief executive officers say here is a level playing field even in the collocation practices because many people in the room and maybe the press aren't aware, but the

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

closer you put a computer to the servers of the CME or ICE or EUREX or the New York Stock Exchange, the trade can happen even if it's a few milliseconds faster. So I certainly want to associate myself with the Commissioner to say that we're going to ask staff to work with you all to really understand the practices and see whether there's any rules that are appropriate in this area to better protect the public and make a level playing field. With that, Commissioner Sommers?

COMMISSIONER SOMMERS: Thank you, Mister Chairman. I have a question for Mr. Sprecher regarding ICE U.K. or ICE Europe. I just want to make sure that I understand with regard to the way the industry has evolved and the way that people now have access to U.S. customers with the no action letters. Terminals are no longer actually involved in this process. Is that right?

MR. SPRECHER: That's correct. It sort of lends itself to the last conversation.

COMMISSIONER SOMMERS: I want to clarify. If we were to contemplate revoking a no

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

action letter, ICE Europe has a successful WTI contract that I assume would not stop trading.

MR. SPRECHER: That's our assumption, yes.

COMMISSIONER SOMMERS: A couple of different numbers have been thrown around with regard to the percentage of volume that comes from the U.S. Do you have an idea of what that might be?

MR. SPRECHER: I do, and the number that sticks in my head is maybe 60 percent, and I can correct that for the record, but I think the important thing that we see is the people that are the large traders are actually the global companies who also find us out of other offices around the world and have the ability under law to act as brokers for foreign exchanges and move business overseas. I think that number would change overnight if for some reason we pulled out of the United States.

COMMISSIONER SOMMERS: I've just briefly glanced at your membership list and I think the

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

numbers of members of ICE Europe that are located in the U.S. is maybe a third of your membership.

MR. SPRECHER: That sounds about right, but I would point out that the largest traders of oil which is what that contract really is tend to be located in London. I think our top five customers are London based and that's simply because it's time zone oriented, they can get to the United States and they can get to Asia. So over time we've seen them really put their domicile in London.

COMMISSIONER SOMMERS: Thank you very much.

CHAIRMAN GENSLER: Commissioner Chilton?

COMMISSIONER CHILTON: I just want to follow-up. I talked about this earlier and it's in your testimony, but just for the record people here hear you say it, Mr. Sprecher, if we implemented aggregate position limits on WTI for example, you'd be willing to comply with those even though there's only this tangential legal certitude that we have that Mr. Berkovitz talked

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

about?

MR. SPRECHER: Absolutely, and we continue to work with staff here to try to see if there are any other things we can add particularly go give you enforcement capabilities if somebody were to go over those limits.

COMMISSIONER CHILTON: Thank you. If you can give me a quick one on this both of you, I think I know the answer but again for the record I wanted to get it. I talked at the beginning about whatever we do here whether or not you agree conceptually with it or not, there's another part to this that if we don't get it right, and I think we're going to get it right and that's why you're here, but there is a danger of some of this moving to OTC. Do both of you support giving us the generic ability, and I'm not asking for a specific legislative bill if you'll support that, providing the Commission with additional oversight and regulatory authority over the OTC market?

MR. DONAHUE: We definitely support the CFTC's overall interest in having a higher degree

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

of regulation over the over-the-counter derivatives markets if done intelligently. In this particular area we certainly do support your ability to understand OTC swap market activity and swap dealer activity for purposes of having an intelligent regime for position limits and position accountability and ensuring what we all have an interest in which is avoid disruption in the market.

MR. SPRECHER: I would echo Mr. Donahue's statement on that.

COMMISSIONER CHILTON: One of the things that goes back to my comments earlier about talking past each other, a lot of this data doesn't exist and we'll hear a little bit of testimony later, but we can only see the regulated market and vicariously through our 1805 authority, our special call, we can ask the swap dealers what they're doing OTC. But it hasn't to date, and I've talked about this in the media today, been I think something you want to hang your hat on. It's been good, it's been helpful, it's been a

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

good benchmark for us to go forward, but we're getting better at that in the future and I commend the Chairman for pushing in that regard. Should there be some sort of distinction between position limits should we decide to put mandatory position limits in the back months between commercials and noncommercials in both your opinions?

MR. DONAHUE: Are you speaking specifically of back months?

COMMISSIONER CHILTON: Yes.

MR. DONAHUE: I think my view would be that I think that's unnecessary. Obviously the entire marketplace benefits in commercial hedgers with longer term exposures benefiting from having liquidity farther out. As you know, our contracts go out approximately 9 years in the energy arena and I think to circumscribe more deferred contract month liquidity in that way would be counterproductive and ultimately would raise costs for users, decrease liquidity and make it more difficult to hedge longer term exposures.

COMMISSIONER CHILTON: Thanks.

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

MR. SPRECHER: I agree exactly with those points.

COMMISSIONER CHILTON: Thank you both. Last time before I get the alarm, Mr. Donahue you talked about what you were going to do with position limits, et cetera, in energy. Is there some reason why metals shouldn't be treated the same? We've talked about contracts of finite supply. Is there some reason why we should be more careful about including metals in anything that we do or the metals complex in general?

MR. DONAHUE: I think that again we're happy to look at ourselves and to work with the Commission in addressing those kinds of issues. We have to look at each of these markets very, very differently. As you know, the energy market for example is 25 times larger than most of the agricultural commodity markets and so one of the concerns in going back to Commissioner Sommers's question about how do we get this right and how do we avoid getting it wrong is we need to be very careful about understanding these major

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

differences between these different markets and that has implications for not only the regime that's adopted but the percentages and levels and the way in which we would go about putting in place an effective regime, and we can talk about that.

COMMISSIONER CHILTON: But I mean the same sort of fundamental principles would apply to the metals market. If somebody were concerned about a trader or a group of traders holding a large percentage that could potentially, I'm not saying intentionally, but could potentially manipulate the market, those same types of generic concerns, there is no difference between energy and metals is there? If you had those concerns, I'm not suggesting you do, but if one had those concerns, wouldn't you say they'd be the same across both complexes?

MR. DONAHUE: If you believe that accountability levels are just not effective in preventing excessive speculation or undue burdens on commerce, then you probably wouldn't draw much

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

of a distinction, but you might set the regime and the levels differently depending on the dynamics of the metals market from the energy market and the energy market from the commodities market.

COMMISSIONER CHILTON: Thank you.

CHAIRMAN GENSLER: I checked with the other Commissioners and I don't think we're going to need a full round, but I did have one follow-up question for Mr. Sprecher that came from our dialogue earlier with General Counsel Berkovitz. If I could separate the two questions about ICE, as it relates to the Henry Hub natural gas contract that was just cleared, a significant price discovery contract, do you believe that you now have all the authority to ask any individual participant in that market or trader in that market to comply with the position limit or to get their positions down if they're over some level even if it's set by somebody else?

MR. SPRECHER: Yes. In fact, I think it's identical to futures regulation with the one difference in that we don't have any brokers in

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

that market. By rule it's a principals only market so there are some rules about how you interface with brokers and we don't have those simply because we don't have brokers. But otherwise it's identical to what's in the futures --

CHAIRMAN GENSLER: And as I understand it, you gained in essence additional authority as of Monday or Friday when we signed that.

MR. SPRECHER: Correct.

MR. DONAHUE: If I might, because that comment has come up twice now with respect to his limits being set somebody else, presumably us, but I'm not aware of anything that would limit ICE from voluntarily adopting their own limits regardless of what our limits are, whether they were the same, higher or lower.

MR. SPRECHER: The issue is not so much the limit as it is how do you give an exemption and if you're not giving an exemption and I am or if you are and I'm not, we haven't really solved the problem which is what is the actual limit.

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

MR. DONAHUE: We won't make it a debate, but you can make your own exemptions too obviously using your own criteria, but to say that you're dependent on our limits is ridiculous. Adopt your own limits. You've chosen not to which is why you default to ours, but adopt your own limits. I don't think anybody is going to stop up there.

CHAIRMAN GENSLER: To my core question, you feel that the significant price discovery contract and the Henry Hub natural contract gives you full authority to work within your current regime to get people down.

MR. SPRECHER: Absolutely.

CHAIRMAN GENSLER: The second one is just on the ICE linked contracts or ICE Europe. I thought I heard you say and I greatly appreciate it that it's something tangible, your willingness to work to see whether there are additional provisions that we would add and additional conditions to that regulatory regime of the CFTC's oversight of ICE and obviously ICE's oversight of its markets. Is that correct?

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

MR. SPRECHER: Yes, absolutely.

CHAIRMAN GENSLER: I thank you. I don't know if there were any further questions.

COMMISSIONER CHILTON: I thought we were going to do one more round. If I could just be real quick. I'm out of turn. I don't know if my colleagues have any.

CHAIRMAN GENSLER: Commissioner Dunn is none. Commissioner Chilton?

COMMISSIONER CHILTON: Just very quickly. I think your last little exchange about the exemption is a good reason for us to consider doing it. You guys are some of the best businessmen in the world and that's your primary motive. You want transparent markets, you want to ensure that they're operating efficiently and effectively and everything, but that's not our job. Our job is to protect consumers, and as long as we don't mess up what you're doing as long as we're ensuring that these are markets that are operating efficiently and effectively, they're avoiding fraud, abuse and manipulation, it seems

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

to me that we should figure out a way on the exemptions, we should be the independent arbiter or at least have a greater role and understand them. So the little discussion made me think, yes, obviously it should be us at least looking at these to a greater degree.

The second thing, and I just want to make sure this wasn't lost, because the Chairman was I think very good in explaining on his PowerPoints earlier these accountability levels, that they're important and Mr. Donahue says sort of an early warning system, but they're abrogated all the time. Maybe abrogated is too strong a word because they're not mandatory. But the Chairman talked about how many times they go over and he talked about the average, about how they go over by an order of magnitude in the average, but that's the average. There are some that are very high. And I'm not saying that they have manipulated the market, but they at least hold the theoretical possibility and I think the exchanges have done a good job at being cognizant of those.

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

But like what I said on the exemptions, it seems to me that's our job to look at this stuff and if we can find the right level whether or not it's a percentage of open interest or hard number contract limits or maybe a combination of them both, it seems to me that's where our focus should be. So anyway, thank you very much.

CHAIRMAN GENSLER: I thank each of our witnesses today. I don't know if you had anything else you wanted to share with us before we let you go and take a 10-minute break, and I mean just 10 minutes because we'll be back because we have another panel. But I thank both of the chief executive officers of the major energy exchanges not only for their testimony today but for their real tangible evidence of willingness to support setting position limits.

(Recess)

CHAIRMAN GENSLER: I thank you. I think I'm officially reconvening the Commission and I want to thank our next panel. I had an opportunity to read all of your testimony and I

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

hope my fellow Commissioners have as well and each of the full testimony will be entered into the record. Apologies in advance if you're able to summarize your testimony, we'll try not to beep you too much with that little light and then we'll see to the extent the Commissioners want multiple rounds, we'll go through that. But it's a pleasure you have Todd Petzel, Ben Hirst, Laura Campbell and Sean Cota. Some of you I've met before and know and I look forward even beyond today to getting to know all of you and having an open dialogue with this Commission. With that, as my grandmother always taught me, if I can, Ms. Campbell first, and then after that we'll go left to right.

MS. CAMPBELL: Thank you, Chairman Gensler and Commissioners. I appreciate this opportunity to testify before you today. My name is Laura Campbell and I'm the Assistant Manager of Energy Resources for Memphis Light, Gas & Water. MLGW is the nation's largest three service municipal utility. I testify today on behalf of

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

the American Public Gas Association. APGA is the national association for publicly owned natural gas distribution systems. There are approximately one thousand public systems in 36 states, and over 740 of these systems are APGA members. Publicly owned gas systems are not for profit retail distribution entities owned by and accountable to the citizens they serve. APGA's members are active participants in the various segments of the market for natural gas including the forward markets, regulated futures markets and over-the-counter OTC markets. Together these markets play a critical role in the utilities securing natural gas supplies at stable prices for their communities.

The topic of today's hearing, whether the Commission should apply position limits consistently across all markets and participants is perhaps the single most important issue for the energy markets. The various market segments for energy contracts are economically linked and actions in one market segment can affect prices in

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

the other segments. Accordingly, APGA believes that a unified position limit administered by the Commission across all markets in addition to the limits adopted and administered by each separate market would provide the only effective limitation on the total size of positions that a speculator could amass and offer meaningful means of preventing evasion of the limits by traders moving positions from one market to another.

In this regard, APGA strongly supports the use of spot month speculative position limits as a proven and effective tool for addressing markets with constrained deliverable supplies which is typical for the market of natural gas. The Commission recently promulgated rules implementing the provisions of the CFTC Reauthorization Act relating to its new oversight authority with respect to significant price discovery contracts. APGA believes that the final rules are a very good foundation for addressing the issue but recommends that the Commission consider additional steps. In that regard, APGA

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

notes that the Commission deferred action to make spot month speculative position limits or back month position accountability rules apply to noncleared transactions on an exempt commercial market on which SPDCs are traded despite recognition of the important role that the noncleared transactions may play in price formation. This weakens the preventative protection that speculative position limits are intended to provide. Accordingly, APGA suggests that the Commission take this opportunity to include linked noncleared SPDCs within the current position requirements. As noted above, APGA also recommends that the Commission consider adopting its own unified speculative position limits for economically linked contracts in order to prevent speculators from amassing very large positions by spreading their positions among multiple markets. In this regard, APGA considers that it is vitally important that bilateral noncleared OTC contracts also be included within such unified market Commission set speculative position limits.

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

Bilateral noncleared OTC contracts that are economically linked to contracts traded on regulated exchanges or exemption commercial markets may have an important influence on pricing and on the performance of other market segments. Speculative position limits can only fulfill their regulatory purpose if they apply to all economically linked or fungible contracts. Otherwise they will only push trading into a less regulated market segment.

Moreover, a dual system of Commission and market speculative position limits would be a far more effective regulatory tool than reliance upon only separate market imposed speculative position limits. A dual system of position limits is not new. It's existed as part of the regulatory landscape since the enactment of the Commodity Exchange Act in 1936 with respect to domestic agricultural commodities. APGA has for many years supported greater transparency and oversight with respect to market segments for the markets of natural gas including financially

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

settled OTC derivatives. However, APGA's members also believe that the continued availability of bilateral noncleared OTC derivative transactions is vital to their being able to provide natural gas to their customers at stable prices and at the lowest possible cost.

We believe that more transparency is not inconsistent with continued availability of noncleared bilateral transactions. Although APGA has been a strong supporter of increased transparency and market oversight, proposals that would require public systems to clear their OTC derivative transactions would have a significant impact on the financial operations of these systems, ultimately increasing costs to consumers. Proposals within the administration and Congress that would mandate clearing of all OTC transactions would require public gas systems to post initial margin and meet potential margin calls whenever required on little notice.

APGA commends the Commission on holding these hearings and we look forward to working with

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

the Commission and I look forward to your questions.

CHAIRMAN GENSLER: Thank you, Ms. Campbell. Mr. Cota?

MR. COTA: Thank you, Honorable Chairman Gensler and distinguished members of the Commission. Thank you for the invitation to testify before you today. I appreciate the opportunity to address the application of position limits and exemptions from position limits in energy markets. I'm here today on behalf of the Petroleum Marketers Association of America, the New England Fuel Institute, and as President of Cota & Cota of Bellows Falls, Vermont, a home heating fuel provider where I actually see the end consumer.

Mister Chairman, this summer's run-up in oil prices occurred despite a sluggish world economy, increasing high unemployment, dismal consumer confidence, demand for oil at a 10-year low and U.S. inventories at a quarter century high and the dollar value essentially flat over the

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

past 3 months. Prices did not and do not reflect supply and demand.

With regard to the Commission's question on application of position limits and exemptions from position limits in energy markets, I would take this opportunity to present PMA and NEFI's recommendations. Question on, on apply position limits across markets and participants, yes. Failure to include index fund, swaps and other financial energy products has helped ruin these commercial markets. It is vital to bring integrity to energy futures markets and to help purely financial traders from overwhelming these finite energy commodity markets.

On your question two, position limit effects on market function, integrity and efficiency, we propose that the Commission facilitate the risk management of clearinghouses by requiring all OTC derivatives to at least clear through regulated exchanges in order to effectively enforce aggregate position limits. This will expose the person or entities attempting

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

to corner the market and would help to mitigate oil price volatility. Therefore risk management is enhanced because participants will see what's happening in all aspects of the trade.

As to question three, CFTC's additional authority, PMA and NEFI and their allies in the commodity market oversight coalition continue to urge Congress to amend the Commodities Exchange Act by reversing exemptions provided in the Commodities Futures Modernization Act of 2000 for over-the-counter derivatives products and swap traders. NEFI and PMA specifically also recommends that derivative trading be exchange traded or at a minimum exchange cleared in order to mitigate energy price volatility and to better manage risk. Clearinghouses are only useful to the extent that they have the same guarantees are regulated exchanges. If Congress requires the clearing of OTC derivatives, the CFTC should successfully implement aggregative speculative position limits at the control level entity without new legislation even Congress fails to do

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

so. Still we believe that Congress specifically direct the CFTC to impose these limits and we'll support that.

Exemptions from position limits for anyone other than a bona fide hedger for the conduct and management of commercial enterprises should not be allowed. Bona fide exemptions need direct proportionality to the physical product handled. In other words, speculative amounts in excess of direct proportionality for swap dealers should not a bona fide and therefore would require position limits, disclosure and reporting requirements.

As to question four, methodology of position limit levels. Passive investors like index funds need to have much smaller limits to prohibit them from banding together and driving up prices. Secondly, PMA and NEFI recommend the establishment of an advisory panel of physical hedgers to advise the Commission as to how to set appropriate aggregate position limits across all exchanges for energy. As to the quantitative

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

measures for setting these limits, the Commission might consider setting limits by percentage of allowed contracts for these finite markets. We've had a lot of discussion which I wish I'd heard before my testimony on that subject. Should limits apply to all months? Our view is, yes, the limits should apply to the delivery month, single months and all months combined similar to agricultural commodities. In 2008, speculators controlled over 70 percent of the open interest on NYMEX oil futures. PMA and NEFI urge the Commission to take necessary steps to limit the speculation in these markets. Thus, noncommercials should never make up more than 30 to 40 percent of the total open interest. This will allow sufficient liquidity in the marketplace without overwhelming physical hedgers, and Amaranth did a lot of trading in the outer months, so if you're going to capture that, that's part of that.

Should trade spreads be incorporated in this calculation? Spread trades should have their

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

own separate limits, but limits should apply across all months and all terminals. Should the Commission limit aggregate position limits held by one person across different markets? Yes. Also every individual noncommercial trader needs to be distinguished within each hedge fund. For example, if a sovereign wealth fund utilizes 30 different hedge funds for all its similar positions in crude oil, the Commission must require the hedge fund to identify the sovereign wealth fund or the other large -- and its subsidiaries to identify this aggregate limit. This is a national security issue from our perspective. PMA, NEFI and our customers need public officials to stand against the abuse of trading practices that artificially inflate prices and severely damage our economy particularly at this weak point. We strongly support free exchanges of commodity futures including speculators on an open, well regulated transparent exchanges that are subject to the rule of law, oversight and accountability. Again thank you for

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

this opportunity.

CHAIRMAN GENSLER: Thank you, Mr. Cota. Mr. Hirst?

MR. HIRST: Thank you, Mister Chairman. I appear today on behalf of the Air Transport Association which represents the major passenger and cargo airlines in the United States, an industry that has been devastated in the past 2 years by the high price of fuel oil and volatility in oil markets. We appreciate your determination to address the causes of these conditions which have destroyed some airlines and deeply damaged the rest. We strongly support strengthened regulation of the oil futures market.

U.S. airlines are suffering through a very difficult economic climate and have been forced to cut employees and air service. Unfortunately, the impact of the recession on the airline has been exacerbated by the recent volatility in the fuel markets. In 2008 alone, U.S. Airlines spent $16 billion more on fuel than they did before despite the fact that we decreased

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

our fuel consumption by more than 5 percent. Because fuel is our largest single expense, around 40 percent of our revenues, we are particularly susceptible to the recent wild swings in fuel prices. At Delta Airlines we consumer approximately 4 billion gallons of jet fuel annually which makes us the second large consumer of jet fuel in the world after the U.S. government. A one dollar increase in the price of oil annualized increases our fuel costs by $100 million. The speculative oil price bubble that began in mid 2007 cost Delta $8.4 billion in fuel and hedge losses compared to what we would have spent if the price of oil had remained at $60 a barrel. In addition, it forced us to reduce capacity by 10 percent and eliminate 10,000 jobs.

In the last 3 years we have seen a significant increase in the volatility of oil prices. This increased volatility has been associated with a massive increase in speculative investment in the oil futures market. The total value of investment in commodity indices which are

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

heavily weighted to oil has increased from an estimated $15 billion in 2003 to around $200 billion, and I've even see higher estimates, in mid 2008. Over the same period while volatility has increased, global demand for physical barrels of oil has remained virtually unchanged.

For airlines, a volatile oil market driven by excessive speculation creates three serious problems. First, it increases the costs and risks of hedging. As a result of last year's oil bubble for example, Delta incurred about $1.7 billion in hedge losses. Second, speculative activity last year pushed fuel prices so high that capital within the industry has been depleted. Finally, with each spike in oil prices, airlines ground aircraft, reduce air service, eliminate jobs and defer capital expenditures.

It is worth remembering that the ultimate purpose of commodities markets is to provide hedging opportunities for producers and end users of commodities. Speculators play a valuable role in providing the liquidity needed

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

for hedging to occur. However, to the extent that there is excess speculation above this level, it destabilizes commodity markets. The Commission should use its authority in our view to ensure that there is enough speculation in the market to provide liquidity but no more.

We strongly recommend that the Commission impose position limits on individual oil traders as it has in other markets. In setting these limits, the Commission should ensure that in the aggregate they represent a percentage of the market that provides adequate liquidity without causing excessive volatility or market behavior divorced from fundamentals. Historically the Commission can look to the period before the explosion of index fund investment as a guide to appropriate speculative levels in relation to acceptable levels of volatility.

The Commission has adequate existing authority to impose federal position limits on designated contract markets, exempt commercial markets and foreign boards of trade that trade

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

energy futures, options or swaps in the United States. In addition, we think the Commission should seek to impose position limits in the OTC market, and to the extent it needs additional authority to do so, it should ask Congress for this authority.

As a general rule, exemptions from speculative position limits should only be available in our view to persons who produce, process, manufacture or consume a commodity. The management of financial risk alone should not qualify traders for hedge exemptions. The commodity markets were never intended to serve as investment vehicles for enormous capital flows from hedge funds and institutional investors as they do today.

Mister Chairman, we recognize the challenges the Commission faces in crafting policy that will adequately limit excessive speculation. However, the current state of the oil futures market is totally unacceptable to the airline and to our employees. Recent developments in the

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

commodities markets have undermined their fundamental purposes and strong action from the Commission is needed to restore the proper balance between commercial hedging and speculation. I look forward to answering any questions you may have of us.

CHAIRMAN GENSLER: Thank you, Mr. Hirst. Mr. Petzel?

MR. PETZEL: Thank you, Mister Chairman and Commissioners. My name is Todd Petzel, and I'm the Chief Investment Officer of Offit Capital Advisers, a New York based registered investment adviser.

I have long been a student of and a practitioner in the futures markets. My academic research dates back over 30 years. From 1982 to 1995, I was First Chief Economist of the Coffee, Sugar and Cocoa Exchange where my duties included market surveillance, and then the Chicago Mercantile Exchange. During that time I worked very closely with the CFTC and its staff on market surveillance and position limit issues. In 1996 I

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

became a money manager. Also since 1996 I have been elected as a public director to both the National Futures Association and the Futures Industry Association. I want to emphasize that my testimony here today represents my own views and not that of either organization or their members.

The three broad topics I addressed in my written commentary concern market information, position limits and the impact of traditional investors not active in commodity futures markets. Information is clearly the lifeblood of both well functioning markets and effective market regulation. I support the Commission's recent efforts to collect background detail on positions and provide regular summaries of that data to the public. Most commercial participants already have a very good understanding of current market dynamics, but the boarder public should benefit from a clearer understanding of who is participating in the markets and why.

We've had federal mandated position limits for select agricultural commodities since

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

1936, and for just as long there have been exchanges allowed to those limits for hedging purposes. Over time, exchanges were charged with establishing position limits for other futures. The goal was simple. Avoid outsized positions that can disrupt prices in general or the convergence of spot and futures prices at expiration. The exchanges have a very strong reason to get this right. Commercial participants act voluntarily. As I used to say, manipulation was not only a federal crime under law, it was also very bad for business. If a market is perceived to be either inaccurate or easy to disrupt, those commercial participants simply will not trade. But a balance has to be maintained. Limits that are too large may allow for market disruptions, but if the limits are too small there will not be enough capital in the market to provide regular liquidity or adequately transfer risk.

The growth of these markets over decades suggest that the exchanges have generally gotten

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

this balance correct. In the early part of the 1990s the traditional concept of hedge exemptions evolved to include risk management exemptions covering unleveraged synthetic financial positions. We also came to embrace hedge exchanges for dealers who were creating off-exchange financial and commodity index products for their clients and who then needed to manage the risks of those products created. It is sometimes suggested that such off-exchange activity can be used to circumvent existing position limits. The expanded position information mentioned above will shed light on this conjecture. I simply don't know that we have enough information today to answer that question. If a problem exists, there are suggestions in my testimony how this might be addressed.

While the proper size and effectiveness of position limits can be debated at great length, what cannot be disputed is the necessity of dealer hedge exemptions associated with any activity that is consistent with and allowed by the established

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

position limits. The negative impact of disallowing such exemptions on the effectiveness of our futures markets cannot be overstated.

Turning to traditional investors who are now participating in futures markets, over the past two decades institutional and individual investors alike have increasingly embraced the use of unleveraged commodity futures contracts as part of their long term asset allocation. In my written testimony I go into some detail concerning how these investments work and their impact on the markets. In these remarks I will simply say that I believe the investors in aggregate have had a material impact on price levels, price spreads and the level of inventories currently being held. That does not mean however that these investors are manipulators or that they should be banned from the markets. There is much concern today in the investor community about federal deficits, the size of the Fed's balance sheet and the prospect of wealth destruction through inflation. These investors are looking to real assets including

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

commodities as their own hedge. If they are precluded from using unleveraged futures positions they will not go away. Instead, they will shift their focus to foreign and physical markets where it may prove less efficient for them and it will definitely be less transparent to both regulators and other market participants.

In summary, the importance of well functioning futures markets is beyond dispute. The exchanges have strong incentives to provide reliable, open and nonmanipulated markets to all users. Recent improvements in transparency should be maintained and applauded. If changes are made to position limits in any market, great care should be exercised to not set them too low, discouraging a wide range of participants who bring valid market information and liquidity to all market users. It would be a major step and in my opinion a most unfortunate one for a free society to move from a stated policy of preventing market manipulation to using laws and regulation in an attempt to change temporarily unpopular

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

market outcomes. Thank you.

CHAIRMAN GENSLER: Mr. Petzel, thank you. All of our witnesses, thank you. If I could ask a few questions and then to my fellow Commissioners.

Mr. Petzel, I take it from your oral, and I was able to read your full written late last night, that you do believe that financial investors, these index investors and other financial investors, have had as you say a material effect on markets. Is that correct?

MR. PETZEL: That is correct.

CHAIRMAN GENSLER: While it's a rather narrow piece, but it does relate to the topic that we were looking at as well, in the wheat markets as well if I could just ask, I noticed in your testimony that you said also that you thought that investors and index investors particularly in how they enter the market can lead to having the deferred contracts trading more at a premium and the near contracts more limited and thus have more positive carry. Is that correct as well?

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

MR. PETZEL: I think the effect is a cumulative one over time because as these holders of index positions roll their positions to deferred contracts, they're selling the near by and they're buying the distant one which naturally widens the spread.

CHAIRMAN GENSLER: One of the things that I said at least in testimony and believe that in the wheat markets some of the problems in wheat convergence relate to when the markets are in full carry that the design of the contract is less appropriate and it doesn't work as well in full carry, and what I think I'm hearing is that full carry may be a cumulative effect of those index investors.

MR. PETZEL: It also has an impact on the people who are holding inventory which is reflective of the full carry markets and that often times is a sign of dislocations of large pools of the inventory.

CHAIRMAN GENSLER: I see. Let me ask the other witnesses a question. Mr. Hirst, I take

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

it from your testimony that you believe that it is necessary for the Commission to set or the exchanges, but it's necessary to help eliminate, diminish or prevent the burdens of excessive speculation that position limits be set.

MR. HIRST: We've come to that conclusion, Mister Chairman, that's correct.

CHAIRMAN GENSLER: Ms. Campbell, I take it from your testimony that you believe it's necessary for position limits to be set.

MS. CAMPBELL: We do.

CHAIRMAN GENSLER: Mr. Cota?

MR. COTA: We do, and you need to identify what they are first. There are still huge chunks of the market that are not seen, particularly the over the counter and a lot of the hedge fund activity which I know you've been inquiring into recently.

CHAIRMAN GENSLER: Could you help the Commission out? I'll start with Mr. Hirst first from Air Transport and Delta. I don't mean to leave you off. You can add in too. How does

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

Delta specifically now or if you want to speak more generically use the markets to hedge your fuel risks? Do you use the futures market primarily, the over- the-counter market? Give us a sense of how you address your risks.

MR. HIRST: I'd be happy to, Mister Chairman. We use primarily the over-the-counter market. The instruments that we use are largely customized to our purposes. The over-the-counter market has that advantage as well as the fact that it's unnecessary for us to post an initial margin and so the costs of hedging are more manageable in that market. Obviously it's very important to us though that volatility within the market be managed. Our ultimate concern is the effect of the futures market on spot prices, and to the extent that the futures market is a volatile market and volatility increases beyond historical norms, it makes it very difficult for us to do the kinds of planning we need to do and to do the kinds of risk management that we need to do as well.

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

CHAIRMAN GENSLER: And though you use the over- the-counter markets and therefore your counterparties are largely swap dealers, I hear you're saying to this Commission that those swap dealers should be subject to appropriately set position limits within this marketplace.

MR. HIRST: Yes, for the same reason that we believe the exchanges or exchange participants should as well, and that is to limit the volatility in the market as a whole and avoid the kinds of extreme impacts that have occurred in the spot market.

CHAIRMAN GENSLER: Ms. Campbell, could you give us a sense of whether it's Memphis Light & Gas or the APGA whether it's in the futures markets or over the counter and how that influences your thought?

MS. CAMPBELL: Most of the APGA members use the OTC market to hedge their risk. They have also customized products where they're able to make sure that the income coming in from the customers matches the out-go for their swaps

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

contracts, so they're limiting that risk. For Memphis Light, Gas & Water we typically are accessing the NYMEX to hedge our risks. However, we go to the OTC to manage our basis risk, so we use a combination of both.

CHAIRMAN GENSLER: Given that you're still recommending that the swaps dealers themselves would be subject to these position limits that you think are necessary.

MS. CAMPBELL: I think with the swaps dealers, perhaps there's a refinement there and looking and who their counterparty is should there be some consideration as to who their counterparty is in determining whether an exemption is granted. Perhaps the exemption is not granted to the dealer, but perhaps the exemption is granted to the transaction.

CHAIRMAN GENSLER: Mr. Cota, I have to cut myself off, but when we come back to my next round, if you can help me out on that. Commissioner Dunn?

COMMISSIONER DUNN: Thank you very much.

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

Dr. Petzel, reading your background here I've been looking or persons who have been so involved that we could blame them, and this is a very impressive background and long history of interactions with both the Commission and the marketplace. Could you tell me have speculators in the energy markets made money or lost money?

MR. PETZEL: I can't comment in general. I would say on average a lot of studies over time have shown that speculators tend to do worse than the commercial participants in the marketplace.

COMMISSIONER DUNN: What's gained by being a passive long?

MR. PETZEL: The passive long like an index investor?

COMMISSIONER DUNN: Yes.

MR. PETZEL: You have a broad hedge against general price movements or against the depreciation of the U.S. dollar where a lot of these commodities are traded internationally in dollar terms, so as the dollar goes down, the value of those portfolio go up. And most of the

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

people I know or the institutions I know that are trading in this way see this way see this as a core part of their hedge inflation strategy versus their equities versus their regular government bonds which tend to do very, very poorly in an inflationary environment.

COMMISSIONER DUNN: Some of the other charts that we've seen, the one that ICE had, the cost of fuel versus the strength of the dollar and it looked like a mirror image of each other. Do you think that as there became more volatility then in the securities and the capital markets, people were looking for a safe place to park their funds, and is that a reason why we saw a buildup of speculators in commodities?

MR. PETZEL: With all due respect, Commissioner, I tend not to use the word speculator for these types of investors any more than I would call their activity in their stock portfolios speculative. So what I would argue is that over the last 10 years in particular there has been an increasing awareness of the role that

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

these kinds of commodity investments can play in a portfolio. These are not active traders. These are not people who are trying to manipulate the market. Quite the contrary. They are simplify sitting there passively trying to gain exposure to any motion that would move in that direction. The theory here is that this will be a benefit in very tough times.

COMMISSIONER DUNN: This ultimately is a hedge against inflation is what you're saying.

MR. PETZEL: That's the primary reason. Yes, sir.

COMMISSIONER DUNN: Mr. Cota, you're getting to be an old hand here in this room. You recommend the establishment of an energy market advisory board made up of physical traders and stakeholders to advise the Commission on setting appropriate aggregate position limits across the exchanges. You are a member of our Energy Advisory Board aren't you?

MR. COTA: Yes, I am.

COMMISSIONER DUNN: You don't feel that

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

that's going to be able to perform that function?

MR. COTA: I think it does need to relate to the finite. I think it could. After listening to the discussion earlier today, I do feel that with a lot of the position limits that we were talking about that it's appropriate that the CFTC particularly when it looks at things in an aggregate position really is the best entity to do that so you don't have one exchange working against another exchange working against over-the-counter types of transactions. So I think that having physical players in the market where you do take an analysis to what's actually deliverable is something you need to do. Amaranth when it decided to try to corner the natural gas market whether it did willfully or through just inertia of money, they had 70 to 80 percent of the February natural gas contract for the entire United States. Obviously that's a limit that's too high. And you can only make sense of it when you do it in an aggregate manner, so that's the general thrust.

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

With regard to index funds, because I'd like to comment on that briefly, the index funds are the new chumps in the market from my perspective. They're invesculators. They're not really speculators, they're just putting huge amounts of money which has money momentum in it. If you take a look at a lot of the index funds and you chart it against the underlying commodities, it doesn't match up and it doesn't match up from my perspective because the contango in the market is being charged to the index funds so people may be profiting separately on spreads that are outside of the index funds but the contango in the storage fees like the very large crude carriers that are now for the first time ever storing refined product offshore, those fees are being charged to the index funds and that's something new. So it's a bad investment for whoever it is, whether it be Harvard University or whoever it is. They think that they're diversifying their portfolio. In my opinion they're being taken advantage of and they're driving up contango in

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

the markets which all consumers are paying for.

CHAIRMAN GENSLER: Commissioner Sommers?

COMMISSIONER SOMMERS: Thank you, Mister Chairman. I actually want to go down a little bit of the same line of questioning as the Chairman did in this first round with regard to the specific ways that you each use the markets in talking about the fact that you each have customized needs and use the OTC markets and how we look to set appropriate position limits when we're not seeing those transactions right now and whether or not you think we need to have the authority before we can assess what appropriate levels would be, if you each could answer that.

MR. HIRST: Commissioner Sommers if I may, we believe that there needs to be more transparency in these markets broadly speaking and in particular in the over-the- counter market. And to the extent that the Commission needs additional information to understand those markets and understand the effects of any regulations that it might adopt, it needs to obtain that

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

information. So that's clearly a first priority in our judgment. Having said that, to the extent that the Commission needs additional regulatory authority to deal with the over-the-counter market, we very strongly support that.

MS. CAMPBELL: I'll agree with Mr. Hirst. We have long thought that the Commission needed greater transparency within the natural gas markets in particular and so we welcome that, and if it does require further authority from Congress, we would be supportive of that.

MR. COTA: I think there is somewhat of a timing issue. When NYMEX was the only game in town it was easier for them to have both position limits and margin requirements that in a volatile market would fluctuate pretty dramatically from what you see today, but now everyone is worried about competition. We really have no idea, at least we as the retail gasoline and heating industry, about what the total over-the-counter derivative part of that market is. Part of my trading is in the market, but in order to really

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

aggregate what that is you need to see what the total is, but in the list of priorities, Rome is burning. So if in the markets that you can see what's going on and in those markets you can apply things like the traditional agriculture methodology for aggregate limits in that aspect, that might be the best first step while you fix the legislation. I do think you need to deal with the legislation in capturing as much of the other markets as you possibly can, but meanwhile we're in a very weak economy and we need to do something right now.

MR. HIRST: Mister Chairman and Commissioner Sommers, if I could add, I echo on behalf of the airline industry Mr. Cota's comment that Rome is burning. We encourage you to take action, and while we believe that you will get it right or generally right, if you don't, you are a Commission, you are not Congress, you have the ability to make midcourse corrections and adjustments, and so we encourage you to act before we see a repeat of last year's oil bubble.

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

Because if that happens, at least as to our industry, it will change into something that hasn't been seen before. There will be fewer airlines, more consolidated airlines, and serious impacts on the nation's air transportation system and on the economy.

CHAIRMAN GENSLER: Commissioner Chilton?

COMMISSIONER CHILTON: Todd, I'm curious. You talked about speculators not doing all that well last year. Is that correct?

MR. PETZEL: I know there have been academic studies that have tried to figure out whether speculators on average make money or not, and on average the commercial participants have more information, they probably have better skills and on average they take money away from speculators.

COMMISSIONER CHILTON: You're not suggesting that passive long speculators who were in for example the WTI contract last year when it got up to $147.27 didn't make a boatload of money?

MR. PETZEL: I'm suggesting that those

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

people who either went into that contract or the index in the second quarter of 2008 lost a ton of money as the prices went down.

COMMISSIONER CHILTON: How about at the end of the second quarter?

MR. PETZEL: At the end of the second quarter, if you went into the market in the second quarter of 2008, you were buying at the highs.

COMMISSIONER CHILTON: Mr. Cota, what do you think the actual impact has been? You talk with people all the time every day. You monitor these markets from your perspective. What do you think the impact of not having these position limits has been?

MR. COTA: The trend is always your friend, so if you've got large money come in, the market has no choice but to react to that. Certain commercial players, yes, could if they plan things and they pay attention to it they can plan around that, but that's all at much higher costs. Volatility is measured generally in option costs pricing dynamics which the consumer pays for

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

and those numbers have just kept increasing and as a percentage of the total it's a just higher all of the time. So I think that because of the large inertia and the direction that some of these trades can really drive up pretty dramatically, there is no knowledge to when that trend is going to end and because these things are expensive on a hedge perspective or you don't hedge in the spot market perspective because the futures market determines the spot price directly, the consumer ends up paying a much higher price than they would otherwise and that's what I'm seeing. Demand is down. Fifteen percent of my business is gone and will not come back and that's because of conservation and we're seeing that trend across all markets. So price does relate to demand, but there is no reason why it's going up now.

COMMISSIONER CHILTON: Ms. Campbell, this might be helpful for my colleagues. You guys are in this market all the time, you specifically in Memphis, but some of your colleagues, members of your association, really don't get into the

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

market even though they may have a desire to. Is part of that because of their concern about the markets, about the concern of the excessive volatility in energy markets?

MS. CAMPBELL: So much of what happens to municipals is what happens on the front page and when we see a catastrophic failure like with Amaranth these things resonate with a mayor and a city council and it makes everyone concerned about whether they should be in those markets or not. So I think most gas managers would say that we need to be in that market to protect customers, but no doubt we have members who do not participate in these markets because there is so much uncertainty and fear that there may be some type of manipulation that affects consumers.

COMMISSIONER CHILTON: I don't want to make a direct correlation and I'm not, but some say that if you put position limits on you're going to lose liquidity and some traders would exit the market. By the same token, aren't there some potential new traders who might get into

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

these markets if they had more confidence that there wasn't the volatility that has existed for the last several years?

MS. CAMPBELL: I think traders are drawn to volatility, but then hopefully to dampen that out. What I think is if there is greater confidence in the markets and certainly that they are free from manipulation, then certainly I do think that there would be new entrants. Also to Mr. Petzel's point that so many people are getting into this marketplace as a hedge against inflation, then perhaps it's not that it would be very large entities that are out there, but again the demand for that contract is still there and there will be other entities who come about to fill that space.

COMMISSIONER CHILTON: Thank you. Thank you, Commissioner Chilton. If I could return myself to Mr. Cota on the question of how the industry you represent or even you individually use the markets to hedge risks whether it's in the futures, over the counter, how you do that and

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

then how that influences your thinking on position limits.

MR. COTA: It's evolved dramatically. We've been hedging since probably 1988. The industry particularly in Northern New England where I'm located we've seen the percentage of consumers who want to buy a hedged program go as high as 75 percent of your total market. Heating oil is a seasonal demand.

CHAIRMAN GENSLER: This is the homeowner?

MR. COTA: Homeowner, right. So what we try to do is match up with the homeowner on individual contracts and aggregate those together in order to buy hedged positions. Traditionally we did it with just futures contracts, NYMEX based futures contract with our wholesalers with a fixed differential for different months depending upon what the contango in the market was and our minimum number on that was generally about 10 to 12 contracts, so about a half million gallons at a time where the average consumer uses 800. Over

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

time what we've seen is that as things became slightly more volatile, people wanted to buy options for capping these programs. So at that point about 7 years ago we could buy a put and call into an oil contract for about 6 cents a gallon and that's both directions together. Last summer that number was over a dollar and now it's somewhere around probably about 60 to 70 cents. So as time has evolved depending on where the market is, sometimes we'll do a put derivative offset by a futures contracts, again a NYMEX futures contract for physical delivery with my wholesaler where I pay a small margin for that portion because we're part of the physical trade and the derivative is done separately. Currently we're doing over-the-counter derivatives and we make our consumers buy that. So whatever that cost is, we pass that on.

CHAIRMAN GENSLER: I'm at the risk of running out of my own time. Just as a yes or no, being aware of all that though you still think it's necessary to set position limits and those

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

position limits should apply as well to the swap dealer community?

MR. COTA: Absolutely, and after Lehman went bankrupt I went into a panic mode and said you're exchange clearing these. Right? And I should have asked that question --

CHAIRMAN GENSLER: Let me just see if I can slip this in before the buzzer. Mr. Hirst, I take it from your testimony specifically, I may have misread this, but that you also think that we should have a position limit on the aggregate amount a speculator, so it's not just on individual speculators, but also the aggregate of the class itself or did I misread that?

MR. HIRST: Mister Chairman, what we were getting at is that it seems to us that there needs to be a proper balance between physical hedging and speculation which provides the liquidity to allow that to occur. So the question really is how do you get to that balance. We're certainly not experts in regulating these markets and we're confident you'll find the right way to

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

do it. It appears to use that one conceptual way to think about this is to ask what was the level of speculative interest in the market say 10 years ago when volatility was operating within a reasonable range and then use that as an overall objective to build your limits toward. So you could say individual speculators can only have so much individually, but then you sort of set that number with an eye to creating an overall limit, and it can't it seems to us be precise, but it can be sort of directionally --

CHAIRMAN GENSLER: What you're suggesting is that the aggregate pool of speculators somehow helps us in our analysis as to setting individual trader --

MR. HIRST: Exactly.

CHAIRMAN GENSLER: Then there's a question I think it was in Mr. Cota's testimony which was I thought you had a phase in there of a bona fide speculator. Of course as the public knows and the witnesses know, we have a roll around bona fide hedging, but you had a concept of

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

bona fide speculator. Did you want to just tell us a little bit more about that?

MR. COTA: It's not a fully formed idea.

CHAIRMAN GENSLER: But it is in your public testimony.

MR. COTA: It is. We debated it last night as to whether we should put it in there. In general terms, a speculator will take a long position or a short position over a time of time and the index funds and a lot of these large invesculator groups only go long and they'll short the near month and go to the long month and they'll do that forever. A speculator actually will help to take out those tops and bottoms. So if I had a real speculator in there, the guys who used to be in the pits at the NYMEX, maybe they're okay compared to a lot of big dumb money. That was the idea behind that.

CHAIRMAN GENSLER: Commissioner Dunn?

COMMISSIONER DUNN: I think I saw the term in somebody's testimony of speculavestos as well, so we're learning all kinds of new things

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

here. First I'd like to commend the Chairman for trying to put additional transparency in our commitment of trader's report in establishing new categories, and I'd like to ask all four of you to reflect on that and tell us how this is helping or hurting, hopefully not hurting, but how it's going. Ms. Campbell, I'll start with you and then Mr. Hirst and then go around.

MS. CAMPBELL: Thank you. And thank you, Chairman. We have been very pleased and we'd like to continue to see more information provided in the commitment of trader's report because it is very helpful for us to understand who the players are in the marketplace as we look forward in what we're going to do in our hedging strategy. I would also say that to the extent that we can have more information as I alluded to earlier into the OTC markets provided to the Commission, we would certainly like to see that as well in the commitment of trader's report and further refinements in there can only help in understanding what's going on in the marketplaces.

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

MR. HIRST: It clearly makes good sense to find ways through the existing reports to bring some greater precision to understanding who is a physical hedger and who is a financial player in the market and disaggregating those categories. But beyond that, it seems clear to us that these markets generally have suffered from a lack of transparency and we applaud the efforts that you're initiating to bring more transparency to all aspects of it. I think it's critical that you do that.

MR. PETZEL: I think I touched on this in my testimony that I was very supportive of the efforts. The one thing I would say which probably isn't going to win me many friends at the exchange or maybe even at the Commission is that periodically you want to drop the reporting limits to a very, very low level to take a little survey of those who currently fall under the active reporting levels to see if they're reflective of what you're capturing currently or whether they're actually behaving in a different way, and I think

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

that would probably reinforce the whole reporting program and add to the transparency.

MR. COTA: Commissioner, I agree with Mr. Petzel as well. I look at the trader reports. I get a newsletter from Cameron Hannover every day and I take a look at what the positions are long and short of the different segments, and even I know that on a fundamental basis what I'm seeing is completely nuts, if I see that the prevailing volume of the market is going in the other direction, I just got to go with the market regardless of what's right or wrong. So those are critical for me in seeing the volume of money and the direction of the money as critical for my consumers to do an appropriate hedge.

COMMISSIONER DUNN: Ms. Campbell, on page 8 of your testimony, and you touched on it a little bit with the Chairman, that first full paragraph with regard to classification of traders as hedgers are speculators and believe that the ultimate characterization of the position should reflect the nature of the counterparty, i.e.,

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

commercial market end users, hedgers and speculative end users and speculators, could you drill down and amplify a little bit on that?

MS. CAMPBELL: Again it goes to what we were just talking about, a better refinement in understanding who the participants are and the nature of their activity. If we're looking at a swaps dealer who is on the other side of a transaction where a utility is on the other side, clearly that transaction is one that is in the benefit of the hedging community to help them provide liquidity. But I think there becomes a gray area as was alluded to earlier and so better understanding who all those counterparties are I think is critical to us getting our arms around the market and understanding not only, one, what's going on in the market, but, two, as we look to setting position limits and potentially even position limits in the OTC markets, having an understanding of who those market players are is critical.

CHAIRMAN GENSLER: Chairman Sommers?

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

Commissioner. I keep doing that.

COMMISSIONER SOMMERS: That's kind of weird.

CHAIRMAN GENSLER: It's a long day.

COMMISSIONER SOMMERS: Thank you, Mister Chairman. Actually I'm going to get off the topic of this hearing for a minute and on to something that a couple of you addressed in your written statements, and that is something that we are also dealing with now, the concept of mandatory clearing for your customized contracts. I just wanted to know if you'd be willing to talk a bit about the unintended consequences for you if mandatory clearing were imposed.

MS. CAMPBELL: I'll start with there are a couple of issues really at stake here. One is the customized as I alluded to earlier how some of the OTC contracts are customized to match the cash flow of some of our members. But then also if you think about if we went to mandatory clearing, and really as I see it when I first heard about this, it seemed to be to address systemic risk. It was

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

addressing credit quality in the marketplace. So as you look at a distributor such as us, then most of our cash flow comes during the winter, yet most of the positions we have are in the later summer in anticipation of the winter. So if we were put in the position where we were required to do that margining then there could be some short term loans that we would have to take out during the summer to get us to hold those positions into the winter and therefore increase costs to our customers. So that's really the two issues, the customizable effect of using the OTC derivatives, but then also if any margining were required there would be additional costs for our consumers.

MR. HIRST: Commissioner Sommers, we're of two minds in the airline industry about mandatory cleaning because on one hand mandatory clearing would give you more tools to control the impacts of the market that we're concerned about, volatility and other effects, it would give you greater information to do that with. On the other hand, today as I mentioned earlier, we use the

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

over-the- counter market almost exclusively for hedging, A, because of customization and, B, because of cost. Between the two just speaking for Delta, if mandatory clearing led to a restoration of volatility to historical levels, we would be fine with that because hedging would be much less important to us at that point. Between the two, we would prefer to see normalization in the market in terms of price and volatility.

MR. COTA: Commissioner Sommers, the credit risk for me is real from a delivery perspective. My commodity cost fluctuates by many multiples of my margin, so if the end over-the-counter player isn't able to perform for whatever reason, I'm out of business. So if there's an additional cost to that, I'm happy to pay that cost. The consumer ends up paying for that in the long run. And currently a lot of these over-the-counter derivative things in my opinion are already pricing in a lot of that credit cost into it. They may be doing it with credit default swaps which I think is another

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

problematic issue with the over-the-counter products that do this, but I think an unexpected benefit as opposed to an unexpected consequence may be that a lot of these over-the-counter products will evolve into separate credit types of packaging deals which will do credit packaging in a different sort of way than they've currently doing it with credit default swaps. Will that cost more money? Perhaps. Maybe it's at a less leveraged level which I would encourage. Leverage is a great tool if you play it well, but it can wipe you out very rapidly and I need to be in business for my consumers because if my counterparty goes bad, I go bad and thousands of customers go bad and I got to head for the hills because they're going to hunt me down.

MR. PETZEL: I do have a philosophical point here. Just to remind everybody that the clearing members who are backing the clearinghouses are all volunteers. There is no government guarantee for the clearinghouse. When I hear the phrase mandatory clearing, I get

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

concerned about things that get pushed onto a clearinghouse in a margining system that may not really be well placed there, that may pose more risks to these clearing members than they are willing to assume. At that point, they withdraw capital from the clearinghouse, the whole system becomes less strong and I don't think we're really reached our objective. I think this is a very big subject that needs a lot of intensive scrutiny, but it's not an easy problem.

CHAIRMAN GENSLER: Commissioner Chilton?

COMMISSIONER CHILTON: I just had a final comment and not even a question. One, you were talking about transparency a little bit ago and I just wanted to thank the Chairman for that effort both in the commitment of trader's report but also in our swaps report. We're doing another swaps report coming up here fairly soon and I think we're going to have a lot more confidence in that and that is important.

But it highlights the problem that we've had in that that's going to the swaps dealers and

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

asking information about what's going on in over-the-counter markets, so it would be natural that the confidence that you might initially have in these sorts of reports wouldn't be very high. But we're getting better at it and I commend the Chairman for his emphasis which we see every day in that regard.

The final thing I wanted to mention is members of this panel or members of our Energy and Environmental Markets Advisory Committee that Commissioner Dunn talked about a little bit earlier, Mr. Sprecher and Mr. Donahue are members also, and who knows what we're going to do on timing with regard to this if anything. But on September 16 we're going to have an EMAC meeting and if there is some proposal out there then we have to worry about the appropriate comments, et cetera. We may not be able to comment, but that doesn't mean that we couldn't listen to what members of the EMAC have to say about a proposal if the Commission determined that it was going to put one out. I'm not prejudging that we will or

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

won't. So anyway, I want to thank the Chairman. This was very helpful to me. And like you said earlier, I learned a lot and I think it will be good as we go forward.

CHAIRMAN GENSLER: Thank you. I think the reason I kept calling my fellow Commissioners Chairman is because there are four Commissioners and we work well together and I think we're all trying to grapple with this very important topic here today.

I just wanted to comment on something that Commissioner Chilton just raised and I know that some of the panelists were just asked about by my fellow Commissioners about some of the transparency initiatives that we're moving forward with. I think on July 7 we announced that we're going to bring greater transparency to the commitment of trader's report, breaking that out into four categories instead of the two that we've done traditionally. In addition, that in furtherance of what was put out last September in the swaps report, we're going to be going forward

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

and putting out on a quarterly basis and hopefully at some point on a monthly basis an index investor report and that data we're trying to make a bit more thorough. We're also going to be looking at putting both gross longs and gross shorts as contrasted to just the net positions that were once put out. I think that it would be inappropriate to speculate on the data that's going to be in reports that we've yet to put out, and frankly none of the four Commissioners have even seen. So reports that the CFTC will release a study reversing the positions that were taken about energy speculation last year are premature and inaccurate.

Just turning back to these hearings, I think these hearings have been of tremendous benefit, this hearing and these panels today I can't thank the four of you enough. We're going to have I think seven witnesses tomorrow and we also have a full day next week, and we look forward to keeping the record open for the public. Thank you.

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

(Whereupon, at 1:22 p.m. the PROCEEDINGS were adjourned.)

* * * * *

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190

CERTIFICATE OF NOTARY PUBLIC

I, Carleton J. Anderson, III do hereby certify that the forgoing electronic file when originally transmitted was reduced to text at my direction; that said transcript is a true record of the proceedings therein referenced; that I am neither counsel for, related to, nor employed by any of the parties to the action in which these proceedings were taken; and, furthermore, that I am neither a relative or employee of any attorney or counsel employed by the parties hereto, nor financially or otherwise interested in the outcome of this action.

/s/Carleton J. Anderson, III

Notary Public in and for the
Commonwealth of Virginia
Commission No. 351998
Expires: November 30, 2012

Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190