CFTC Hearings to Discuss
Position Limits, Hedge Exemptions and Transparency for Energy Markets

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Introduction

Chairman Gensler and fellow Commissioners, my name is Don Casturo and I am a Managing Director of Goldman, Sachs & Co. I would like to thank you for this opportunity to share our views regarding position limits, swap dealer hedge exemptions and greater transparency in the energy markets. I would also like to commend the Commission for its leadership in ensuring the integrity and efficiency of the commodity markets.

During my 14 year career in the commodities markets I have served in two distinct capacities at my firm. These positions have provided me with insight into the role of certain key market participants and the evolution of the markets. First, I was responsible for trading and managing all of the risk of the global crude oil derivatives business at Goldman Sachs. In this capacity, I was responsible for facilitating the hedging of commercial participants, such as oil producers, airlines, and refiners. Currently, I am responsible for the trading and managing of all the risk associated with the commodity index business at Goldman Sachs. In this capacity, I facilitate asset allocation into commodities markets by financial participants, such as the pension funds and endowments.

Increases in volatility and the outright prices of energy commodities have caused concerns to be raised at the CFTC and among policymakers about changes in the marketplace and regulatory practices. Some have questioned the role played in the marketplace by index investors, other financial participants and intermediaries such as my firm that are commonly referred to as “swap dealers”. These questions have prompted the CFTC to hold these hearings to obtain input on three particularly important areas of regulation: namely, position limits, swap dealer hedge exemptions and transparency.

We welcome the opportunity to share our views on these important topics. In particular, we believe that the role that is played by non-traditional participants such as index investors and other financial participants often has been mischaracterized. While we understand concerns that have been raised with respect to non-traditional participants, we believe that any steps to address these concerns should be taken in an effective and non-disruptive manner. Further, we believe that some of the courses of action that have been proposed not only will fail to address the perceived harms but also will have unintended consequences that may be disruptive to liquidity and the markets generally.

Financial Participation In Commodities Markets, Swap Dealers and the “Hedge Exemption”

I have observed and participated in an evolution in the commodities markets during my career. Two trends have been particularly noteworthy.

First, increased participation by financial investors, both in commodity indexes and in single-commodity products, has brought new capital to the markets that has facilitated the ability of commercial market participants to hedge their price exposures.

Second, swap dealers have largely replaced the floor traders as the predominant source of liquidity to buyers and sellers in the commodities markets and in so doing have provided more customized forms of risk management products to end-users.

We believe that both of these trends have been positive for the marketplace.

Financial Participation

The first trend that I would address is the advent of greater financial participation in the commodities markets through the creation and growth of commodity indexes and through the participation of collective investment vehicles that provide speculative capital.

One of the exceptional achievements of the commodity futures markets is the separation of the ownership of commodity price risk from the ownership of the physical commodity. That is, commodity futures markets allow participants to buy and sell the commodity price risk without requiring the exchange of the physical commodity. This separation creates real economic benefits. The producer—who by nature must hold the physical commodity—is no longer required to bear all of the risk of price fluctuations, against which it would need to hold expensive equity capital. Instead, the producer can hedge this risk, freeing up expensive equity capital and allowing the producer to focus on its core competency of operating its business, rather than the management of commodity price risk.

Index investors are remarkably well-suited to bear the commodity price risk as they are generally long-term investors for whom commodity price risk is a source of portfolio diversification. Because of this, the transfer of price risk from producers to index investors actually lowers the cost of managing commodity price risk.

Consequently, in my experience the growth of commodity index investments has reduced a market distortion, rather than created one. In fact, the development of the commodity indices was driven by the need to supply capital to meet the hedging demands of commodity producers, which are typically far larger than the hedging demands of commodity consumers, creating a market imbalance.

I have also observed greater participation in the commodities markets by collective investment vehicles that provide speculative capital. While index investors supply passive capital that helps to offset the inherent imbalance in hedging demands in the commodity markets, speculators actively position themselves to profit from anticipating price fluctuations. That is, they buy commodity futures when they believe the market has underpriced the commodity relative to its fundamentals and they sell when they believe the market has overpriced the commodity relative to its fundamentals.

Importantly, speculators attempt not only to assess the price relative to its current fundamentals but assess the commodity price relative to its forward supply and demand fundamentals as well. For example, a speculator in the natural gas market could examine the supply of natural gas, the amount of natural gas in storage, and the likelihood of experiencing a very cold winter and conclude that there will likely be a shortage of gas in the coming winter. The speculator would buy natural gas for delivery in winter. This will result in prices being bid up for the winter futures contracts, resulting in contango which would incentivize storage operators to put more natural gas into storage for winter. As more gas is put into storage less is available to meet current demand, spot prices will increase thereby curtailing current demand which in turn would increase current supply thereby bringing the spot market back into balance. If the speculator was right, it would profit by selling the winter contracts at a higher price when the market mispricing met the fundamentals of a cold winter. More importantly, the market as a whole would benefit as higher inventories – induced by the speculative buying – would mean more natural gas available for heating homes and at a lower price, than in the absence of speculation.

There has been much debate recently over whether this financial participation has distorted prices away from the fair “fundamental” price. In order to address this concern it is important to note that this participation occurs in the futures markets and not the physical markets, making it necessary to understand futures market dynamics. Futures, as the name implies, are contracts whose values express the equilibrium price for commodities at distinct points in the future. The assessment of fair value for these points is far more complicated than spot fundamentals which are derived from more observable data. Too often recently, however, many market commentators have tried to explain futures prices by only applying spot fundamentals. It is only at expiration, through a reliable deliverability mechanism or cash market settlement, that a futures contract reflects the spot market value. This condition, known as convergence is absolutely vital to well-functioning future markets, and enforces that fundamentals dictate the ultimate settlement of a futures contract. The expression of views about forward fundamentals is what gives shape to futures curve. We believe that it is important to bear these considerations in mind when setting policies that will apply either to the futures markets or to derivatives markets whose transactions are determined with reference to futures contract prices.

For example, it has been argued that the presence of long-only index investors has distorted prices away from their fair "fundamental" price by increasing demand for futures contracts. However, the potential supply of futures contracts is not finite, like the supply of the physical commodity, but effectively infinite, as price sensitive speculators will initiate new short positions if they think the futures price has moved away from fundamentals. The convergence of futures prices to physical prices at contract expiry provides the speculator with a powerful incentive to find distortions in futures prices and to take positions in the futures market that help to restore the futures market balance.

Swap Dealers

The second trend I would note is the increasingly central role of the swap dealer in the commodities futures markets. As markets have grown, the swap dealer has increasingly been at the center of price discovery and liquidity. We believe that this has been a positive development for traditional commodity producers and consumers seeking to hedge their exposure to price risks. Swap dealers have successfully developed risk management products that are tailored to absorb specific risks with a level of precision beyond what is practical in the futures markets. Swap dealers have also developed a more sophisticated approach to establishing credit lines with end-users that recognizes the relationship between credit exposures and the ability of an end-user to meet obligations under hedging arrangements.

Consequently, the swap dealer has emerged as an important financial intermediary, using the liquidity and price discovery of the exchanges to make OTC markets tailored to the risk management needs of its customers. Where it might appear that a swap dealer has taken a large position in the futures market, looking at the positions of the swap dealer—as is done in the CFTC’s special call—reveals that the swap dealer is using the exchange to manage the risk created by its role as an OTC market maker.

It is important to note that making markets for producer and consumer hedgers is at the heart of the swap dealer business. This is often misunderstood, based on a common misperception that the positions of swap dealers exclusively represent either proprietary speculative trading positions or transactions with index investments. However, looking through the swap dealer's futures positions to see the financial intermediation it is conducting reveals a far different story. Swap dealers manage risks inherent in their transactions with long and short clients on an aggregated net basis, across derivatives, futures and physical transactions. Maintaining relationships with producers, consumers and financial participants enables the swap dealer to provide more competitive pricing and tailored products to each. In addition, access to futures markets has facilitated the ability of swap dealers to provide tailored risk management products with efficient credit terms.

For example, a swap dealer may enter into an energy index derivative with a financial investor (swap dealer is short) and hedge its risk by purchasing futures contracts on an exchange (swap dealer is long). The existence of the energy index derivative position may facilitate the swap dealer's ability to enter into a hedge transaction with a utility that sells power linked to an average of floating energy prices by constituting an offset for the utility's hedge that allows the swap dealer to exit the futures position it had maintained as a temporary hedge. The utility obtains a hedge that is tailored to match its average price exposure and more competitive pricing by virtue of the offset that exists in the swap dealer's book in reliance on a hedge exemption.

Hedge Exemptions

Hedge exemptions have facilitated the ability of swap dealers to rely in this manner on the futures markets. In order to obtain a hedge exemption, the swap dealer must certify to the Commission or exchange, as the case may be, that it has commitments under derivative transactions for which the futures will serve as a hedge. The hedge exemption recognizes the economic reality of the financial intermediation being conducted by the swap dealer. Removing it in the example above would likely result in the utility in the example above either paying a higher price for the customized hedge with the swap dealer or bearing the basis risk between the exposures inherent in its business and hedges available to it on futures exchanges.

A swap dealer that executes futures trades in reliance on a hedge exemption by definition cannot be engaged in excessive speculation (or any speculation) because it has a matched position. To the extent that the swap dealer enters into futures transactions for reasons other than hedging its risks, it is subject to the same position limits that apply to all market participants. Notwithstanding the risk neutral position of a swap dealer that relies on a hedge exemption, some have argued that swap dealer hedge exemptions enable counterparties of the swap dealer to engage in excessive speculation or otherwise avoid position limits. Based on our data and what we have seen in the markets, we believe that there actually have been few instances where an entity held derivatives in a size that would have exceeded futures position limits had they been applicable to derivatives. Nevertheless, we understand the concerns that have been raised with respect to this so-called "swap loophole". At the same time, we do not believe that eliminating hedge exemptions or limiting them to situations where the dealer is transacting with a commercial hedger will address the concerns and we do believe that such an approach will have unintended and undesirable consequences.

From our point of view the concerns relating to the swap loophole would be best addressed by having the Commission continue to recognize the underlying economic reality associated with the financial intermediation and related services provided by swap dealers. This may be accomplished by looking to swap dealers for information regarding counterparty positions as the Commission has done since establishing the special call procedures last summer and then looking through the swap dealers to apply limits to end-users across derivatives and futures. Importantly, we believe that this may be accomplished within the scope of the CFTC's existing authority. The size of the limits that we believe would be appropriate is addressed below.

<u>Position Limits In Energy Markets</u>

While the CFTC has traditionally evaluated its obligation to use position limits as a means of eliminating manipulation and market imbalances, we understand that the Commission is evaluating the prevention and elimination of excessive speculation as an independent requirement under the Commodity Exchange Act. Taking this approach, the question then becomes at what size should the limits be set to prevent excessive speculation. In other words, at what level are the position limits low enough to prevent excessive speculation while still being high enough so as not to restrict the level of speculation that is necessary to ensure a balance between commercial and speculative interests or what we refer to as "necessary speculation". That is, because speculative positions move to push the market back into balance with current and forward fundamentals, position limits on the individual need to be set high enough to allow aggregate speculative flows to offset the full range of market imbalances between the hedging of producers and consumers. Such an approach would need to take into consideration the inherent capital imbalances between producer and consumer hedging in each market as well as the capacity of financial participants to supply the capital required to balance the market against the potential range of imbalances that may be experienced as fundamentals change. This would require that such an approach would consider producer and consumer hedge ratios, the size of the physical commodity market and the size of the futures market.

Transparency

The Commission has indicated that it is interested in promoting greater transparency in the energy markets by expanding the categories that are used in the weekly Commitment of Traders reports to include separate information for swap dealers, index investors, etc. Our position on transparency is simple. We support providing the CFTC on a confidential basis detailed information regarding our activities in the commodities markets, both in the OTC and futures markets. We have done this each month since the establishment of the special call and have found the exercise to have been very useful in terms of how we view the data that we supply the Commission. Further, we support providing aggregated data to the market in a manner that does not compromise legitimate proprietary interests.

Recommendations

We believe that swap dealers play an important role in providing liquidity, price discovery and customized risk management products to end-users on favorable credit terms. We believe that eliminating or limiting swap dealer hedge exemptions not only will not address the "swap loophole" but actually will have several negative consequences. First, such an action will encourage more transactions to be executed off futures exchanges in derivative markets where positions may be offset. Second, the market would splinter, as end-users would allocate exposures among a greater number of swaps dealers and other financial intermediaries that would enter the markets—not on the basis of knowledge or experience in managing commodity price risk—but simply on the basis of having room under the regulatory position limit. The commodity markets have a history of entities seeking to establish a position only to retreat quickly upon realizing that they have under-estimated the complexities of the business, potentially creating risks to the markets upon their exit. Finally, the large number of index and other investors that are based outside of the U.S. will likely allocate capital to non-U.S. commodity futures exchanges.

In order to address the underlying concerns without causing these consequences, we recommend:

- Institutionalizing the special call in order to look to swaps dealers to report on OTC positions of the swap dealers' counterparties as the CFTC currently looks to FCMs to provide information on large traders of futures positions.

- Using the data provided by swap dealers and FCMs, look through the swap dealers to apply aggregate net position limits across derivatives at the end-user/counterparty level.

- We believe that it is possible to structure this within the scope of current CFTC authority but would be supportive of legislation that would provide the CFTC with authority to set limits on derivative positions that reference the prices of futures contracts that are subject to position limits in order to implement this approach.

In sum, we appreciate the focus that the Commission is bringing to important issues in the energy markets. We believe that it is possible to address the underlying concerns with respect to the involvement of speculators in these markets without disrupting liquidity or risk management practices. Simply eliminating or limiting swap dealer hedge exemptions will impair liquidity, have other unintended consequences and would very likely not achieve the stated objective. We appreciate the opportunity to share our perspective and views and we look forward to continuing to work with the Commission to improve the functioning of these markets.