Testimony of

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Before the

U.S. Commodity Futures Trading Commission

Regarding

Open Hearings to Discuss Energy Position Limits and Hedge Exemptions

Wednesday, July 29, 2009

Three Lafayette Center

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Washington, DC 20581

My name is John J. Lothian and I am here as a participant in, observer of and commentator about the global futures and derivatives markets. I want to thank the Commission for inviting me to testify on the important issues considered in today's hearings. I am a Commodity Trading Advisor registered with the National Futures Association, but am better known as the editor and publisher of the John Lothian Newsletter, what many call the most widely read newsletter in the global futures industry. I am also a futures broker and Internet entrepreneur, publishing three newsletters and founding and developing an online knowledge base about the global markets using the same software that powers Wikipedia.

My futures industry career has spanned over 30 years, since I started working for a Soybean trader and broker as a 17-year-old high school student. I began watching the markets when Treasury futures at the Chicago Board of Trade were just one year old, stock index futures were not yet introduced and the Chicago Board of Trade had over 50% of the volume of all yearly futures traded globally. I have been a news reporter for a wire service covering the wheat, corn and soybean markets, a discount commodity broker, a proprietary trader, and a full service futures broker.

I would like to outline some general observations about the markets, excessive speculation, finite commodities, index funds and investors and then specifically address the questions presented in the hearing invitation.

The purposes of the futures markets are two-fold; price discovery and risk transfer. The price discovery process is made up of people with an economic interest in the underlying commodities (bona fide hedgers) and those without (speculators). Traditionally, speculators have been defined as individuals or firms seeking to profit from anticipated increases or decreases in futures prices.[i]

Over the years, speculators have dynamically used futures to take micro views on price movement of an underlying commodity or financial contract, or take a macro view on an aspect of the national or global economy. High frequency electronic proprietary traders are examples of those taking a micro view on trying to profit from price movement. Index traders would be the most relevant and dominant contemporary example of those taking a macro view of prices and the global economy.

Futures markets price discovery and risk transfer functions allow for the supply and demand of a commodity or underlying instrument to be allocated or rationed over time. However, U.S. futures markets represent greater dynamics than just those of the specific contract specifications of the underlying commodity. Wheat producers around the world look to the benchmark prices and liquidity of the Chicago soft red winter wheat futures for hedging and risk management purposes. The same is true for the CME Group's West Texas Intermediate crude oil traded on the New York Mercantile Exchange for energy producers and consumers. These are global benchmarks of global commodities with interlocking pricing relationships and interchangeable uses.

The very concept of a finite supply of a commodity flies in the face of the market function of price and dynamic substitutability of the products. When the price of beef gets too high, people eat more chicken and fish and less beef. Consumers replace the high priced product with a lower priced substitute that accomplishes the same goal, thus reducing demand for the high price product. Producers of the high priced product, seeing the reduced demand, will seek to increase the supply to the market while prices are still high. This change in demand through substitution and increase in supply has the effect of bringing prices back into normal relationships with the competing substitutes. The best cure for high prices is high prices and the best cure for low prices is low prices.

Excessive speculation is another topic altogether. It is difficult to define and even more difficult to prevent. Traditionally there are position limits put on speculators to limit the number of contracts they may control, thus avoiding “excessive speculation.” However, these limits are mere speed bumps, not the true limits they are intended to be.

Another traditional limit that has been utilized in the markets to avoid excessive speculation is daily price limits. Many futures contract’s prices are capped, above and below the previous day’s settlement limit at some specified amount in the contract specifications. The intent is for the markets to take a time out while prices are limited and for volatility to cool off. However, these price limits are easily avoidable using futures spreads with contracts not in a limit position or spot contracts without limits. They are also avoidable using combinations of options on futures to create synthetic futures contracts. Additionally, they are also avoidable for some traders by using Over the Counter or OTC contracts. Also, there are related global markets that may be used to hedge existing positions or initiate new ones.

Speculators and hedgers have always found a way to manage their risk despite rules, laws and negative public opinion. During the 1979 Russian grain embargo when President Carter’s administration shut down trading for several days on the U.S. grain futures exchanges, traders substituted by trading contracts on the Winnipeg Commodity Exchange. Rather than waiting to offset their long positions at substantially lower prices when the U.S. exchanges reopened and began trading after a limit down move in prices, some traders shorted Winnipeg grain futures contracts to hedge their positions. In an example of the law of unintended consequences, price discovery moved from Chicago to Winnipeg for soybeans, corn and wheat through the surrogates of rape seed, feed wheat and other contracts.

During the Civil War in the United States when Abraham Lincoln and his Treasury Secretary Salmon Chase became incensed at the excessive speculation of gold, they pressed passage of the Gold Bill of 1864 outlawing delayed deliveries of gold. This law just had the effect of moving trading from the Gilpin’s News Room in New York to “traders’ offices and street corners.” The primitively organized gold futures market of the 1860s simply moved to an Over the Counter market.[ii] And in another example of the law of unintended consequences, this move probably substantially aided the development of bucket shops, which were a severe problem in the late 1800s.

Position limits for globally traded substitutable commodities are just speed bumps, which can slow down the speculative process and make it more expensive for speculators, but they are not true limits of speculation on commodities with a “finite” supply.

Last summer in response to soaring commodity prices and an outbreak of populist anti-speculator fervor I wrote an Open Letter to Congress[iii] offering my take on speculation. This is the beginning of what I wrote:

> When futures prices go up, they are advertising for selling. When prices go down, they are advertising for buying. With futures prices going up for crude oil and many other commodities, a truth has emerged in the cash markets that we have not grown our farming, drilling, mining or processing capacity to meet the increasing demand of a developing global economy. High commodity prices are sending an important message. We need to listen to that message and respond.
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> We need to respond to higher prices with more selling. We need to find a way to meet the growing global demand with real production of oil, metals, grains, fibers and many other commodities. We need the higher prices to spur the investment in that production. This is a demand-pull rally in prices, not a supply shock. We should not be shocked that millions of Chinese who work in factories in cities (rather than in agriculture in the country) need to buy food, transportation and clothing. This change in lifestyle has created a change in demand with higher wages and a rising of living standards. Look at the label on the goods you buy and the clothes you wear and you can find similar economic/human migration stories in other countries around the world.

> Laws artificially muting market prices will only make the problem worse. And messing around with a global problem in a narrow nationalistic way, especially in a way that exacerbates the problem, is the kind of thing that can lead to wars. People need to be fed, clothed and kept warm. They need transportation to get to work and move their goods and services around the world. History has shown free markets are the best mechanism by which this can be accomplished.

Several years ago, some savvy investors came to believe that we have underinvested in the production and processing of commodities and that the only thing that will spur the necessary infrastructure investment is higher commodity prices. In order to encourage higher prices, they put their capital on the line by investing in portfolios of commodities, using futures and OTC swaps as proxies to comprise the index. Different from traditional futures speculators who use large degrees of leverage, most of these index investors fully fund each and every contract the fund buys. Some in the futures industry have called these new investors, **financial hedgers** as opposed to commercial hedgers.[iv] As prices of commodities rose, aided by a declining U.S. dollar, more investors began to accept the concept of commodities as an asset class and an important way to diversify their portfolio, especially after the collapse in equity prices following the tech boom of the 1990s.

This growing interest in investing in commodities became the dominant speculative demand factor in the markets according to many market participants. I believe it also changed some of the behavioral aspects of individual markets as macro view investors' actions were inelastic to the price movements of components of the commodities indexes. Holders of open interest who were index investors did not respond to higher prices by selling their longs in specific contracts and taking profits. Rather, they took a macro view of the index, had a long term bullish outlook for prices, and continued to hold or add to their index investment. These investors believe we are in a 15 to 20 year cycle of higher commodities prices that began back in 1999.

I believe that position limits, while a necessary tool for moderating market volatility and speculative fervor, should be applied consistently to speculators. I believe financial hedgers, including index traders, ETFs and ETNs should be exempt from position limits. I believe they play a bona fide economic role, similar to that of commercial hedgers, and therefore should be exempt.

Applying position limits on financial hedgers will have the impact of fragmenting liquidity, negatively impacting the price discovery process and making the markets less fair and efficient. Investors will turn to OTC solutions that are far less transparent than regulated exchanges.

Position limits for funds representing groups of investors are easily overcome by establishing new entities, funds or individual managed accounts. Position limits are the Maginot Line of futures trading. Participants in the markets will follow the letter of the law, but not necessarily the intent.

Position limits for financial hedgers invites regulatory arbitrage by participants, resulting in decreased in market transparency and increased counterparty risk. It is in the interest of the U.S. and its citizens to have the transparent price discovery and risk transfer processes for these key commodities occur in U.S. regulated markets.

The CFTC should be granted additional authority over the OTC markets in commodity futures products that are substitutions for commercial hedgers, financial hedgers or speculators.

Position limits should be set dynamically by the Commission on a regular pre-defined interval. The Commission should take into consideration the size of the participation of commercial and financial hedgers and the volatility of the market. The Commission should have the ability to set divergent position limits for long and short speculators. When prices rise, the Commission should set the short speculative position limits at higher levels than long position limits. Position limits for speculators should for a fixed number of contracts for that particular interval. The limits should be applied to all months, with different levels set separately for delivery months. Spreads should be counted on a gross basis again the limit, meaning a long and a short is two contracts.

Position limits should be aggregated across markets for positions held by one controlling entity or person. The alternative invites regulatory arbitrage and the negative market dynamics outlined above. Both futures and OTC trades, whether cleared or bilateral contracts, should have segregated funds set aside for those positions.

As I indicated in my initial answer, I believe that financial hedgers as represented by investors in index funds, ETFs and ETN, have an economic interest in the particular commodity and therefore they should be exempt from position limits.

Lastly, as I wrote above, I don't recommend position limits on commercial or financial hedgers. I believe financial hedgers should be encouraged to participate in cash settled contracts for agricultural commodities to minimize the negative impact in those commodities on futures and cash market convergence. This may take some regulatory or tax incentives to help develop liquidity in new cash settle agricultural contracts. Encouraged migration to cash settle contracts for index traders would allow for greater development of complementary speculative short investor segment.

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[i] CFTC Annual Report, 1996

[ii] "Wheels of Fortune" by Charles Geisst.

[iii] http://www.marketswiki.com/mwiki/John_Lothian_July_2008_Open_Letter_to_Congress

[iv] Dan Brophy in Other Voices of John Lothian Newsletter, June 26, 2009