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United States Senate

COMMITTEE ON
HOMELAND SECURITY AND GOVERNMENTAL AFFAIRS
WASHINGTON, DC 20510-6250

March 28, 2011

VIA ONLINE SUBMISSION (http://comments.cftc.gov)

Mr. David A. Stawick
Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, D.C. 20581

RE: Proposed Rule on Position Limits for Derivatives (RIN: 3038-AD15 and AD16)

Dear Mr. Stawick:

The purpose of this letter is to express support for the proposed rule of the U.S. Commodity Futures Trading Commission (CFTC or Commission) to establish speculative position limits on commodities currently exempt from such trading limitations, and apply those limits to a variety of commodity-related instruments, including options, derivatives, and swaps, as required by Section 737 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act). This proposed rule is a critical step to stop excessive speculation and curtail price volatility in the commodity markets and promote fairer pricing and more efficient markets.

Roller Coaster Prices. The recent rapid rise in the prices of crude oil, food, and other commodities is placing another burden on middle class families and businesses already struggling to recover from the recent recession. Over the past several years, for example, energy prices have taken the American people on an expensive and damaging roller coaster ride. If that ride continues along with volatile prices for food and other commodities, the price disruptions threaten to undermine the economic recovery now underway.

In 2007, a barrel of crude oil cost \$50 and nearly doubled by the end of the year. In 2008, oil prices first soared to nearly \$150 per barrel and later crashed to \$35. In 2011, the price has climbed all year and is now nearing \$102 per barrel. In Michigan, the average gasoline price has also jumped and is now \$3.54 per gallon, up 25% from a year ago. This price volatility is taking place even though crude oil inventories have been above average. The Strategic Petroleum Reserve is filled to an all-time high, and domestic oil supplies appear more than adequate to meet current levels of demand. The resulting concern is that the recent crude oil and gasoline price spikes are due, not to forces of supply and demand alone, but in part to excessive speculation or manipulation of the markets.

To address the twin threats of excessive speculation and price manipulation, Congress has enacted new laws giving the CFTC broad new authority to set position limits on traders buying and selling U.S. commodities. The CFTC and regulated futures exchanges already limit the number of futures contracts that one trader can hold for commodities like wheat or natural gas to prevent excessive speculation and price manipulation. It is long past time to put the same type of position limits in place for related derivative markets and for energy-related commodities and derivatives that have a vital impact on the American economy, including commodities and derivatives related to crude oil and gasoline.

Subcommittee Investigations. Since 2002, the U.S. Senate Permanent Subcommittee on Investigations, which I chair, has conducted a series of investigations into how our commodity markets function, focusing in particular on the role of excessive speculation on commodity prices. Those investigations have shown how excessive speculation in futures and derivatives markets has distorted prices, overwhelmed normal supply and demand factors, and pushed up prices at the expense of consumers and American business. Those investigations have also shown that traders are actively trading commodities simultaneously in the cash, futures, and derivatives markets, affecting prices in all three and requiring their cross-market trades to be viewed, not in isolation, but in the aggregate.

In 2006, for example, the Subcommittee released a report which found that billions of dollars in commodity index trading on the crude oil market had helped to push up futures prices in 2006, caused a corresponding increase in cash prices, and was responsible for an estimated $20 out of the then $70 cost for a barrel of oil that year. Much of that increase was due to speculators who were buying and selling oil futures contracts in the hope of making a profit from the changing prices. In 2007, a report released by the Subcommittee showed how a single hedge fund named Amaranth made huge, speculative trades on the natural gas market using futures on a regulated futures exchange and swaps on an unregulated electronic energy exchange, pushed up futures prices, and increased natural gas prices for consumers and American business alike.

In 2009, the Subcommittee examined how the activities of many traders, in the aggregate, constituted excessive speculation in the wheat market. Specifically, the investigation found that commodity index traders, who were offsetting part of their exposure to commodity index instruments sold to third parties, were buying large numbers of long wheat futures, and as a result helped cause unwarranted increases in the price of wheat futures contracts relative to the price of wheat in the cash markets. The resulting price differential between markets impaired the ability of participants in the grain market, such as farmers, grain wholesalers, bakers, and others to hedge their price risks. The investigation also found that the index traders had an aggregate effect on futures prices, in part, because the CFTC had granted some of them waivers or exemptions from the position limits otherwise applicable to speculators, allowing them to accumulate wheat positions that were multiple times larger than other market participants.

These Subcommittee investigations have demonstrated that the failure to impose and enforce effective position limits have led to greater speculation and increased price volatility in commodity markets.

Proposed Position Limits. The proposed rule would help put an end to excessive speculation and market manipulation in U.S. commodity prices by creating the regulatory infrastructure needed to establish position limits across U.S. commodity trading venues, including futures and related derivatives markets, and across a variety of commodity related instruments. The proposed limits would apply, as intended by the law, to commodity-related trades in the agricultural, metals, and energy markets. Section 737 of the Dodd-Frank Act explicitly directed these new position limits to be developed to "diminish, eliminate, or prevent excessive speculation"; "deter and prevent market manipulation, squeezes, and corners," and ensure the market's price discovery function "is not disrupted."

While the proposed rule appropriately exempts true hedgers, such as farmers or manufacturers that use futures contracts and derivatives to hedge their exposure to changes in commodity prices (and transactions offsetting a bona fide counterparty's cash market risks), the proposed rule must make it clear that the new position limits will apply to derivative dealers and speculative traders that buy or sell commodity-related instruments, including index traders who trade commodity-related index swaps, and financial firms that sponsor commodity-related Exchange Traded Funds (ETFs) or Exchange Traded Notes (ETNs). These commodity-related financial instruments are designed to allow investors to profit from changes in commodity prices without having to purchase the actual commodities or manage a portfolio of commodity investments; they are inherently speculative and, in the aggregate, can have a significant effect on commodity prices.

That's because most derivative dealers and broker-dealers selling commodity-related instruments offset their financial risk by injecting substantial funds into the agricultural, metals, or energy markets to accumulate passive, long, speculative positions, affecting prices in the futures, swaps, and cash commodity markets. The result is that markets designed to respond to the supply and demand of market participants that use commodities in their businesses are being overwhelmed by the artificial supply and demand forces generated by financial speculators seeking to profit solely from changes in commodity prices. The proposed rule needs to design, establish, and enforce position limits that will ensure these speculative forces stop exacerbating the roller coaster prices that benefit their financial positions, while at the same time destroying the traditional relationship between commodity prices and true supply and demand.

The proposed rule would use a phased in process that would allow the Commission to develop position limits based upon actual market data. The CFTC has a long history of applying sensible position limits to trades involving commodities like wheat and natural gas, which have helped to ensure fair prices responsive to the forces of supply and demand. It is important not to delay extending those sensible limits to all other commodity-related instruments that impact commodity prices, including options, derivatives, and swaps. It is also important that the position limits are designed to apply to a variety of commodity-related instruments and trades in a variety of trading venues, and that they create an aggregate limit on the positions of a trader active in multiple markets using multiple types of instruments and trades related to the same type of commodity.

The proposed rule includes a revised exemption to position limits for "bona fide hedging transactions and positions" in line with Section 737 of the Dodd-Frank Act. The proposed rule would apply that exemption to swaps, as well as futures and options, to carry out the purposes of

the statute. The proposed rule properly refrains from providing a general exemption to financial firms seeking to hedge their financial risks from the sale of commodity-related instruments such as index swaps, ETFs, and ETNs. Those financial firms are not utilizing the commodities themselves, but seeking to hedge risks created by financial instruments designed to produce profits from commodity price changes. Those inherently speculative transactions should not be exempt from the law's position limit requirements whose very purpose is to curb excessive speculation and price manipulation. Instead, the new position limits should be designed to apply to financial firms dealing in commodity-related instruments like index swaps, ETFs, and ETNs without waivers or exemptions. Applying position limits in an even-handed manner to all market participants other than true hedgers is essential to curb harmful volatility and price swings in commodity prices caused by speculative demand.

The proposed rule also provides new reporting requirements and a new application for anticipatory hedge exemptions that will enable the Commission to identify traders who exceed individual or aggregate position limits without approved hedge exemptions and help clarify when firms are engaging in hedges versus other types of transactions. To carry out its statutory responsibilities, the Commission should ensure that the new reporting requirements direct traders to identify the specific risk being hedged against at the time a trade is initiated, enable traders and regulators to monitor the termination or unwinding of a hedge when the underlying risk has been sold or otherwise resolved, and create a practical audit trail for individual trades. The Commission should also design both the reporting requirements and the anticipatory hedge application to discourage traders from attempting to mask speculative trades under the guise of hedges. By mandating clear identification of hedging transactions at the time they are initiated, trade-specific information, and practical audit trails, the proposed reporting requirements and anticipatory hedge exemption application would offer powerful tools to enable the Commission to carry out its oversight and enforcement responsibilities under the law.

Until this proposed rule is adopted and effective position limits are put in place, the American economy will continue to be vulnerable to excessive speculation and the violent price swings it can cause, and American business and consumers will continue to be at risk. The Commission should to act with expedition to finalize the proposed rule and establish effective position limits to curb excessive speculation in the commodity markets and promote fairer and more efficient markets and commodity prices.

Thank you for this opportunity to comment on the proposed rule.

Sincerely,

Carl Levin
Chairman
Permanent Subcommittee on Investigations