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Testimony on "Harnessing American Resources to Create Jobs and Address Rising Gasoline Prices: Families and Cost-of-Life Impacts."
March 21, 2012

Good morning Mr. Chairman Hastings, Ranking Member Markey and members of the committee. Thank you for the invitation to Better Markets to testify today.

Better Markets is a nonprofit, nonpartisan organization that promotes the public interest in the domestic and global capital and commodity markets. I won't take the time or space here to list everything it does, but would refer you to our website at www.bettermarkets.com, which has more than 85 comment letters that Better Markets has filed, among many other things.

My name is Dennis Kelleher and I am the President and CEO of Better Markets. Prior to that, I was a senior staffer in the Senate. Prior to the Senate, I was a litigation partner at Skadden, Arps, Slate, Meagher & Flom, where I specialized in securities and financial markets in the U.S. and Europe. Prior to college and law school, I was a firefighter in the U.S. Air Force.

INTRODUCTION

Energy costs are skyrocketing, particularly oil and gas. Many are advocating drilling more, particularly in the U.S., in the hope that we can drill our way over the next decade or so to lower gas prices. But, that thinking ignores a key driver of higher gas prices: Wall Street speculation, which has poured hundreds of billions of dollars into the energy markets in the last eight years or so. It is no surprise that they are doing that for one reason: to make a profit and as big a profit as possible.

Unfortunately, those profits come from the pockets of America's families, farmers and communities. While the estimates vary on how much this speculation is costing, there's no denying that some of the pain at the pump, maybe as much as 25%, is from Wall Street and that can and should be addressed immediately, not many years down the road.

Commodity markets exist for commercial producers and purchases to hedge their risk. A certain level of non-commercial financial speculators is necessary for the commodity markets to serve their intended function. However, "excessive speculation" is prohibited because non-commercial financial speculators can overwhelm the commodity markets and drive up prices for no purpose other than to enrich the speculators. That's great for the speculators, but terrible for everyone else.

There is increasingly broad agreement that excess speculation is distorting many commodity markets, including in particular the oil markets. Thus, the real debate is no longer **if** speculation is having this effect, but **how great** an effect it is having. Research by Better Markets shows that the effect of excessive speculation is dramatic and is seriously damaging the commodity markets. It is needlessly driving up prices, damaging not just family and community budgets, but our entire economy as money is diverted from everything else just to pay an ever-increasing fuel bill.

Much of this is from financial speculation by Wall Street, as also demonstrated by Better Markets' research. That analysis shows that this excess speculation is coming from Wall Street's creation and marketing of what it calls "commodity index funds." While the label was no doubt designed to make people think that these funds are like passive, low-cost, low-risk **equity** index funds, so-called **commodity** index funds require very active trading, with hundreds of billions of dollars trading in and out of the commodity markets every month, month-after-month. This has caused the amount of non-commercial financial speculation to double or more and commercial hedging to be reduced to less than one-third of the market.

Not only has this needlessly run up prices for families, farmers, communities and even the Department of Defense, it has also increased the cost of hedging for the commercial producers and purchasers that these markets exist to serve. Indeed, some commercial market participants have been priced out of the market because the costs of hedging have become so high.

The primary proposal to stop the damage from excess speculation is by imposing position limits, which Better Markets agrees with. However, position limits as currently talked about are unlikely to get at the core reason speculation has become excessive. To do that and to restore the commodity markets to their intended purpose, **commodity index funds must be banned**. That will reduce much of the excess speculation quickly; start to heal the damage done to the commodity markets; and enable commercial producers and purchasers to hedge again at an undistorted market price.

SUMMARY

As detailed further below, our research shows that:

- Speculation in commodity markets has dramatically increased, has become excessive and far exceeds amounts necessary to facilitate legitimate commercial hedging;

- Excessive speculation has caused increased volatility and increased prices in the futures markets;

- Volatility and price increases in the futures markets directly increase hedging costs and, as a result, the cost of production, thereby increasing the prices of underlying commodities;

- Price increases in the futures markets are transmitted to and directly affect the prices in the physical markets via standard pricing methodologies of physical products;

- While increased volatility and prices have increased the need for hedging by physical producers and purchases, the increased costs to hedgers described above have caused many physical producers and purchasers to actually hedge less;

- Much of this has been caused by the creation and explosive growth of commodity index funds and their associated roll trading;

- Commodity index funds are liquidity takers and not liquidity providers, while also depriving legitimate commercial hedgers of sufficient market liquidity via competitive methods;

- Commodity index funds have disrupted the commodities futures and physical markets in ways that distort price discovery and increase commodities prices; and

- Producers and purchasers of commodities from the farms to the family table and gas pumps need protection from excessive speculation and that will require banning commodity index funds.

This testimony is based on extensive data and analysis by staff at Better Markets, much of which is set forth in the comment letter filed by Better Markets with the CFTC regarding its Proposed Rule on Position Limits (the "Better Markets Comment Letter"), which we incorporate by reference here. (The Letter is available at http://www.bettermarkets.com/assets/pdf/CL-CFTC-PL-Final.pdf). The data and analysis regarding the role of commodity index funds is set forth in a Report released by Better Markets on October 14, 2011 (the "Commodity Index Trading Report"), which is incorporated by reference here as well. (The Report is available at http://www.bettermarkets.com/reform-news/new-better-markets-research-report-shows-wall-street-driving-food-fuel-prices and on SSRN at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1945570).

DISCUSSION

In the last decade, we have witnessed a seismic shift in the worldwide mechanisms for pricing energy and agricultural commodities. This shift has coincided with the extensive deregulation of commodities markets and the proliferation of electronic systems by which buyers and sellers of derivatives are matched in the OTC markets, out of sight of exchanges, clearinghouses, and regulators.

These changes have profoundly affected the way that financial and fundamental forces interact to establish prices paid for gas, bread, cereal and other basic necessities across our country from Yakima, Washington to Waltham, Massachusetts. In fact, the advent of commodity index funds, and excessive speculation in general, has significantly distorted the price discovery and hedging function of commodity futures markets. This fact in turn has directly affected physical commodity prices, introducing an independent, persistent, and largely upward financial pressure on commodities prices.

Excessive speculation today is increasing costs for virtually every business and consumer throughout the United States. It will likely continue to do so unless an effective position limits regime is put into effect and/or commodity index funds are banned.

Speculation in commodity markets has dramatically increased and is excessive

The facts demonstrate that, today, financial speculators have overwhelmed the commodity markets and also driven out many legitimate commercial physical hedgers. Historically, when commodity markets have worked well (i.e., when there is sufficient liquidity and meaningful price discovery for all physical hedgers who want to hedge), physical hedgers have constituted at least 70% of the futures market and financial

speculators have been the remainder, at most 30% of the market. In fact, this ratio remained relatively constant for decades prior to the passage of deregulatory legislation in the commodities markets. Today, the ratio of participants has actually reversed in many commodities markets, with speculators now accounting for about 70% or more of the open interest in some markets while bona fide physical hedgers participation has fallen to only about 30% of open interest (and much lower in some markets).

The overwhelming importance of these facts can only be realized by understanding the legitimate purpose for commodity markets. As set out in the attached Exhibit 1, in sharp contrast to the much larger capital markets, commodity markets exist only for the purpose of providing a mechanism for producers and purchasers of physical commodities to hedge their risks. (All diagrams are included at the end of this testimony.) Financial speculators are only tolerated as commodity market participants solely to ensure that physical hedgers have sufficient liquidity for their hedging operations.

Recently however, speculation from financial participants has been allowed to far exceed the levels necessary to facilitate hedging, which has damaged and distorted the commodity markets, and further, increased absolute commodities prices for all commodities consumers.

This has been particularly pronounced in the oil markets. The diagrams in the attached Exhibit 2 illustrate how the Speculation/Hedging ratios have reversed using the example of WTI Crude Oil. In 2002, 89% of open interest was hedgers and 11% were speculators (in line with historic norms, as demonstrated by the data from 1996 as well, also in the Exhibit). By 2012, hedgers were down to only 37% of open interest and 63% were speculators.

This "ratio flip" is true for many commodities that were analyzed. For example, as shown in the attached Exhibit 3, the same is true for CBOT Wheat and Feeder Cattle. Note that in 1996, 12% of the CBOT Wheat open interest was comprised of speculators and 88% were hedgers. By 2010, those ratios had flipped: 40% were now hedgers and 60% were speculators. Similar results for Feeder Cattle.

Even more remarkable, almost all the increase in speculative participation has originated from commodity index funds. As shown in Exhibit 4, on a proportional basis commodity index funds have been the force behind most of the increased financial speculation here indicated using the example of CBOT Wheat. You'll note that in the 1996-2000 period, hedgers were most often between 60-70% of the open interest (the purple section of the Exhibit) and speculators were between 30-40% (the blue section of the Exhibit).

However, by the 2006-2011 period, hedgers were down to around 30% (purple) and speculators were up to around 70% (red plus blue). The data also shows that the traditional speculators didn't increase their participation in the market on a proportional basis (they are the purple portion of the Exhibit). In fact, the data shows that the speculation/hedging imbalance has been caused almost entirely by commodity index funds (the red section of the Exhibit).

While we have used wheat as an example here, this type of open interest change is common across many commodities as Better Markets illustrated in our comment letter and on our website.

Excessive speculation has caused increased volatility and often increased prices in the futures markets

The diagram in the attached Exhibit 5 illustrates that the volatility and price levels seen since the advent of the era of excessive speculation are unprecedented. That Exhibit uses the example of NYMEX WTI Crude Oil. Note the past effects of significant world events compared to the index fund era today.

Much of this damage to the markets have been caused by the creation and explosive growth of commodity index funds

Highly structured commodity index investment vehicles have become dominant forces in the commodities futures markets, with an associated dramatic impact in the physical markets. Commodity index investments were created to synthetically mimic ownership of market baskets of physical commodities valued according to indices derived from futures markets.

By far the largest amount of this type of investment is transacted in funds sponsored by some of the largest banks who act as commodities swap dealers in the derivatives market. In past years, these kinds of "investments" were marketed to large institutional investors as "a new asset class" for diversifying investment portfolios. (This hasn't actually turned out to be the case: *See, for example,* Javier Blas, "Commodity Indices: Rollover Practice Hits Investors," Financial Times, November 1, 2009, *available at* http://www.ft.com/intl/cms/s/0/453764e8-c586-11de-9b3b-00144feab49a.html#axzz1cMIFQSMR; *and* Tang, K. (Princeton University) and Xiong, W. (Renmin University) (2010): Index Investment and The Financialization of Commodities, and the related discussion in the Better Markets Position Limits Comment Letter.)

Remarkably, these investors have injected capital estimated to be between $200-400 billion into the commodities futures markets over the last several years, with commodities prices not surprisingly rising in tandem, as shown in the attached Exhibit 6.

Commodity index funds are liquidity takers and not liquidity providers, and are depriving bona fide hedgers of sufficient market liquidity…

A common myth concerning index funds is that they "provide liquidity" to the market, thereby fulfilling an important role in providing commercial hedgers with needed counterparties. **However, commodity index funds do not trade on the basis of supply and demand fundamentals or in response to liquidity demands**. Rather, they trade on the basis of investment inflows and the need to perpetually roll contracts forward as they regularly expire.

In some instances, this may accidentally provide hedging liquidity, but when it does so it is purely a coincidental phenomenon. It turns out that these commodities indexers actually have their own massive liquidity needs every month due to their need to constantly roll their positions forward in time. Therefore, most of the time, these giant funds actually compete with bona fide hedgers for market liquidity. They are, as a net result, liquidity takers and not liquidity providers. They are independently pursuing their

investment strategy regardless of price and supply and demand fundamentals, thereby simultaneously damaging the commodities markets.

Commodity index funds have disrupted the commodities futures and physical markets in ways that distort price discovery and often increase absolute commodities prices

Commodity index fund trading and other speculative activities have generated volatility in the commodity markets that is not associated with fundamental supply and demand forces. ("Fundamental forces" refer to the price effects of supply and demand in the context of production and transportation costs and elasticity of demand.) This additional volatility imposes direct costs on businesses legitimately using the markets to manage price risk. These costs then become a cost of production, directly increasing prices paid by consumers.

In addition, speculative distortions that contribute to artificially increasing prices of longer dated futures contracts are also directly linked to prices in the physical (or spot) markets.

For example, energy and agricultural commodities are generally priced via contracts or auctions in which the reference price is the next expiring futures contract price, as illustrated in the attached Exhibit 6. Another example, where the futures price is not directly used, "reported prices," such as those published by price reporting services like Platts, are used. These "reported prices" are also calculated via methods that place a great emphasis on nearby futures prices, as shown in Exhibit 7.

Therefore, nearby futures prices have an immediate and direct impact on physical commodities prices. Higher prices and volatility in futures markets, induced by excessive speculation, thus cause **physical** prices to be pushed higher than they would otherwise, while directly passing on the associated futures-led price volatility to physical (spot) commodity markets.

In fact, the claim that futures prices have no impact on physical prices – as is so often heard -- is simply wrong. Such arguments are only asserted by self-interested entities seeking to continue their speculative activities in these markets---regardless of how much harm they cause to the commodities markets.

Commodity Index Trading Distorts Futures Markets and Often Pushes Prices Up in Futures and Physical Markets

Index investors, many times large institutional investors managing giant funds and diverse portfolios, often turn the actual mechanics of commodity index investing over to swap dealer counterparty. Institutional investors generally enter into OTC derivatives with a bank (acting as a swap dealer) that agrees to pay them the return of a market basket of commodities. This is done via a swap that is designed to be a synthetic replica of a perpetual ownership of that market basket of commodities.

However, as a result of that swap, the bank acting as swap dealer that sold the swap now has to generate the future return over time of that specific market basket of commodities (which it is obligated to pay to the investor). And, of course, the bank acting as a swap dealer has to make a profit, and it has to protect itself so that its exposure in the commodities markets remains within its desired risk tolerances, which is often done by hedging their financial exposure.

Thus, the direct market issue of index funds concerns the swap dealer banks and their trading, rather than the swap purchased by the commodities index investors themselves. The bank swap dealers can hedge precisely by acquiring the futures contracts reflected in the index; or (as they often do) they can buy and hold physical quantities of the commodities, speculating on the difference between physical prices and futures prices or they can do a combination of the two. In fact, through this latter practice, commodities futures prices are arbitraged directly to spot market commodities prices. (It has been widely reported that swap dealers have accumulated large storage capacity for and holdings of physical commodities in recent years.)

The timing of this bank trading is dictated by the structure of the index and the futures market so that the bank matches its hedge with the notional amount invested under the swap. As a result, the banks' trading occurs at a few pre-set times every month. Moreover, **the banks are largely indifferent to price because futures prices are passed directly through to the investors** (as set forth in the original swap agreement with investors). That's why these investments are often referred to as "passive," but they are only passive to the original institutional investors who contracted with the bank (the swap dealer). In sharp contrast, the bank swap dealer that sells the swap is and has to be a very active trader in the futures and physical markets, both to provide the promised return to the investor and crucially for the bank, profit from the sale of its products.

That required trading by swap dealers is the key to understanding how commodity markets have been distorted and why commodity prices have been (and are) subject to significant volatility. The obligation owed by the bank swap dealers to the investor is perpetual (as long as the commodity index swap is held by the institutional investor).

The respective swap dealing banks have effectively guaranteed a return to the institutional investor as if the investor owned the commodities market basket until they ultimately sell it (although most institutional investors like pension funds and endowments have bought these commodities index products with the idea of buying and holding them for many years, if not perpetually).

However, futures, like all derivatives, are executory contracts that have fixed terminations. Thus, a bank acting as the swap dealer must offset its perpetual obligation with the futures contracts that regularly expire. As a result, the bank must repeatedly trade out of all expiring futures and replace them by buying other futures contracts having a later expiration. This is commonly referred to as the "Roll." Like the phoenix, the banks that sell index fund investments destroy the previously created index trades and recreate a new set of trades during each Roll period.

Predictable trading in large amounts always attracts other traders seeking to take advantage of and profit from that predictable trading. It is legal front-running made easy. It is almost the commodity market equivalent of shooting fish in a barrel. Thus, it should come as no surprise that the Roll is the highlight of the trading month for many other speculative traders since the potential for profit is large and relatively certain. (See Mou, Y., "Limits to Arbitrage and Commodity Index Investment: Frontrunning the Goldman Roll," Columbia University (2010) and the related discussion in the Better Markets' Position Limits Comment Letter.)

Predictable commodities index fund traders seem to be the perfect counterparties for others in the markets to exploit:

- The bank swap dealers engaged in index swaps are compelled by the structure of the index funds sponsored by index fund providers like S & P or Dow Jones to trade in the futures markets by selling the current, expiring contract, say October, and buying the next month contract, here November.
- Everyone knows this predictable pattern because the commodity index sponsor trading strategy and data are published publicly.
- The banks, for their part, care little about executed prices because they are just passed through to the institutional investor counterparty as per the original contract with the passive investor (a glaring example of agent vs. prinicipal conflict).
- The trading volumes generated during the roll period are enormous, since the entire invested amount has to be regularly and predictably traded during a short window of time specified by the index fund sponsor.

As would be expected, a trading "ecosystem" has emerged, in which volatility and spread traders feed off of the price dynamics generated by the bank swap dealer index traders (i.e., the "perfect counterparties" to exploit). All of this trading (by the swap dealer banks and the associated trading by those exploiting the banks' trading on behalf of institutional investors) is purely speculative and represents a significant amount of commodities market speculation. Importantly, this massive amount of trading done by the banks in roll trading amounts is estimated to equivocate to commodity index open interest amounts of between $200 and $400 billion. Moreover, an additional significant amount of speculative trading activity is done by other speculators feeding off this index fund roll activity.

Unsurprisingly, all of this speculative trading has changed the shape of the price curve for many commodities, which represent term prices for each commodity futures contract in each month into the future. Given that index traders are constantly and mechanically selling the expiring contract (i.e., October) and buying the next future month (i.e., November), month after month, whether the prices make sense relative to market fundamental forces such as supply and demand or not, longer dated contracts are repeatedly subjected to constant upward price pressure by index fund swap traders.

In fact, the forward commodities price curve is extraordinarily important. When it slopes upward – that is to say the price for the November futures contract is higher than the price for the October futures contract – the futures market is "signaling" to producers and consumers that prices are likely to rise. When it is flat or downward sloping, the corollary message is that prices will likely be stable or fall.

According to economic theories, when the price curve is set in the futures market, the market is perfectly basing its price "opinion" on equally shared and objectively sound information about supply, demand and production and transportation cost. This theoretical worldview is commonly known as the "efficient market hypothesis," which, though it has been repeatedly discredited, still lives on among academics, market fundamentalists and predatory traders. For example, bank swap dealers promote the claim that their massively profitable trading around the roll has no real impact on markets

because markets are always "efficient", with the actions of large market participants somehow meaningless to price formation.

But, if a price curve is sloping upward because of swap dealers trading the Roll, and thus the trading that happens around the Roll is done for reasons other than supply and demand (i.e., fundamental) information, then in this case the market is clearly sending misleading price signals to other market participants. In fact, it means that a price signal is being sent by the commodities market that prices are on the rise, when in actuality fundamental commodity supply and demand dynamics are not signaling this situation. Thus, in this case, supply and demand market price information becomes obscured and/or displaced by price formation arising from swap dealers trading on behalf of their institutional investors who are replicating a commodities index, rather than from bona fide hedgers trading based on their own views of supply and demand.

Remarkably, prior to 2004, when the commodities indexing trend really took off, the average commodities futures forward curve was actually most often flat or downward sloping, a type of curve called "backwardation". Since that time, however, many commodities futures forward price curves have been upwardly sloping far more often than not, a strong message during this period that "prices were on the rise" (this type of futures forward curve is called "contango"). Was this message being sent by the commodities markets due to supply and demand fundamentals, was it influenced by the swap dealers' trading around the Roll, or was it due to some combination of the two, or was it something else entirely?

To answer this important question, Better Markets undertook a study of historical futures price curve dynamics and the commodity index roll framework. To examine this closely, please see the Better Markets Commodity Index Trading Report, (*available at* http://www.bettermarkets.com/reform-news/new-better-markets-research-report-shows-wall-street-driving-food-fuel-prices). In this study, the predominant Roll period for each trading month over the last 27 years was isolated. Then any bias (delta) towards an upward sloping curve during each of these Roll periods was measured.

Our research found that before 2004, there was no bias related to what would later become the Roll period, i.e., the time of the month when the bank swap dealers would later roll large volumes of contracts from the expiring month to the future month. However, starting with 2004, this contango bias was much more pronounced. In fact, the upward price bias in the West Texas Intermediate crude oil futures market was correlated at a 99% level with the Roll.

Then the data was analyzed at every other 5 day period in every other month over the 27 years. Remarkably, there was no correlation between upward or downward prices for these other periods.

This analysis strongly demonstrates that the forces which signaled increasing prices were specific to the Roll period. In fact, there were no supply and demand events peculiar to that period. As a result, it is clear that Roll trading behavior by swap dealers was the direct cause of the change in the shape of the forward price curve.

Efficient markets ideologues could try to argue that other traders would have seen this phenomenon and squeezed this curve bias out immediately. However, the data shows that the bias caused by a given Roll persisted for days or weeks, depending on the market.

Why didn't arbitrageurs immediately squeeze out the bias? For one thing, the Roll is large and the trading risk to the arbitrageur is very high, due both to the amount of funds required to commit to such a strategy and also the risks that arise from high volatility during the trading period. In this case, it wasn't feasible for the Roll effect to be arbitraged out efficiently by arbitragers competing against the much larger swap dealers in the intermediate term and under the extant market conditions. Put another way, it appears that arbitrageurs could only take advantage of the Roll in amounts at acceptable risk levels, which are significantly lower (both for individual arbitrageurs and in sum) than would be necessary to arbitrage out the entire or predominate affect.

However, there is another clear and profound reason other traders didn't arbitrage away the entire curve bias here. Markets are actually driven by the perception of fundamental forces, not perfect reference to some definitive supply and demand chart. Market participants generally expect other traders to behave rationally, motivated by the desire to make money. In this case, there is no way for other market players to know whether those traders have better or different information. Moreover, the actual perception of supply and demand information can be altered toward the view that fundamental prices will be on the rise. Arbitrageurs still exist, but the available fundamental information and the quality of the information that drives them is often unclear and/or incomplete. Thus, when the arbitrageurs estimate the price to which the forward curve should be theoretically driven, the large and (apparently rational) trading activity associated with the Roll influences their perception of fundamental forces, causing their own price perceptions to change or, at a minimum, seem less certain.

Moreover, if a swap dealer is trading a commodity index position in which a profit and loss is passed through to the investor, it may also be trading the market purely for its own account. Such a dealer enjoys substantial advantages of asymmetrical information in that it will know the amount of index positions and the allocation of hedges between futures and physical positions. Such a dealer is best positioned to trade the Roll for its own account.

The message that prices are on the rise is transmitted to current real prices in many ways, some described above. One of the key reasons is that current prices must rise to induce suppliers to commit product to the market rather than holding back supply.

The market as a whole reacts to the message that prices will rise and a price bubble emerges.

Eventually, fundamental supply and demand forces overcome the trading-driven sentiment that prices will rise. When this finally occurs the speculative bubble bursts.

While Better Markets' staff have not yet undertaken to measure the cumulative effect of boom and bust cycles driven by Roll trading, it is obvious that the commodities futures market price discovery function, necessary for businesses to manage their commodities price risk, has been undermined. It is equally obvious that the persistent bias toward higher prices and the dislocations associated with the boom and bust cycle have together adversely affected consumers, who are paying both higher and more volatile prices for commodities as a result of this new speculative trading activity and its associated consequences for the commodities markets.

CONCLUSION

As described above, commodity index trading is damaging the commodity markets, interfering with price formation, and causing speculation to become excessive. Frankly, it is at the root of many commodity markets' problems.

After years of hearings, review and consideration, Congress mandated position limits as a prophylactic measure which did not require a finding by the CFTC that excessive speculation exists. However, the CFTC's Final Rule's focus on individual entity limits designed to prevent manipulation by a single trader, while necessary, is not enough. Excessive speculation, a different concept that is highlighted in the recent Dodd-Frank legislation, is not the focus of the Final Rule. This failure to better address excessive speculation was a missed opportunity.

While the limits imposed in the Final Rule could conceivably curb excessive speculation in the market as a whole, they are presently set at too high levels and are unlikely to have strong effects. Market-wide limits at appropriate levels are needed to eliminate speculative distortions in the market. Importantly, the Dodd-Frank Act also empowers the CFTC to take action with respect to a class of traders. Commodity index traders are and must be designated as such a class.

The CFTC's Final Rule fails to limit this class of trading as a percentage of the market. The CFTC must use the authority in the Dodd-Frank Act to limit trading which pursues a common expressed or implied plan or agreement. All positions tracking a single index act in concert and affect the market just as if transacted by a single giant market participant. As such, all positions under a common index should be aggregated for position limits purposes. Otherwise, excessive speculation created by commodities index trading will continue unabated, with all the accompanying volatility, price swings, and ultimately boom/bust cycles that are evidenced in the research.

Banning the misleadingly labeled commodity index funds will reduce excess speculation, facilitate price discovery and bring gas and other commodity prices more in line with supply and demand rather than being pumped up by Wall Street speculators profiting off the pain at the pump.

Thank you for your consideration of these very important matters.

EXHIBITS REFERENCED ABOVE ARE ATTACHED TO THIS TESTIMONY

Exhibit 1:

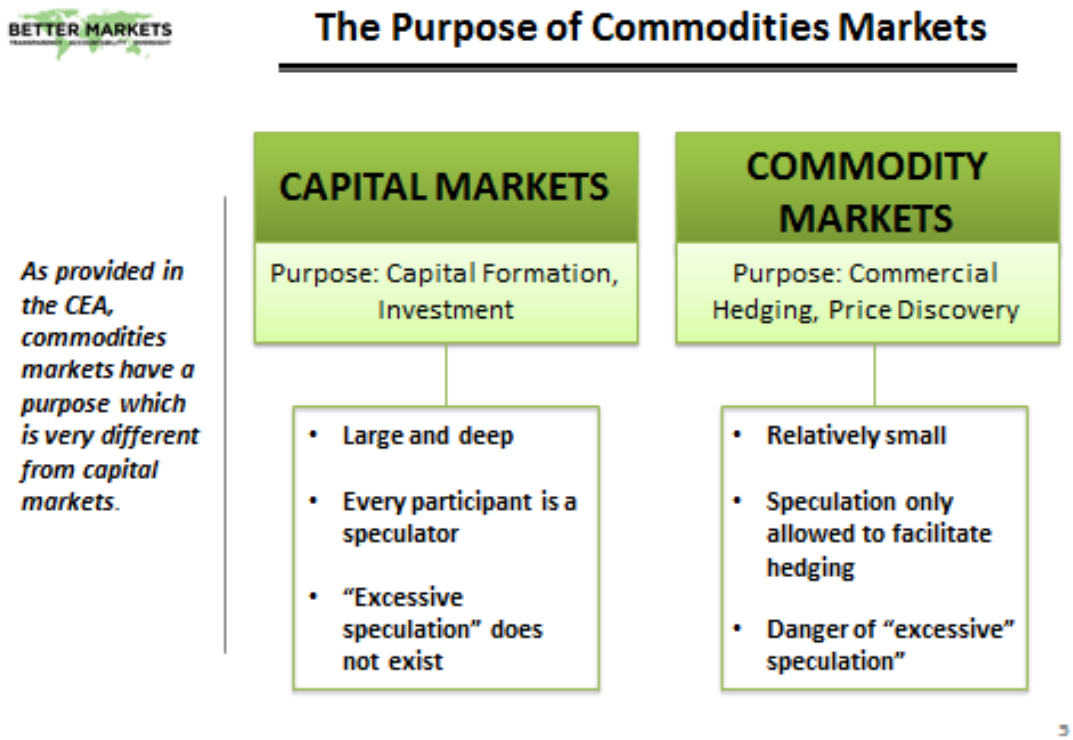

BETTER MARKETS
The Purpose of Commodities Markets
As provided in the CEA, commodities markets have a purpose which is very different from capital markets.
CAPITAL MARKETS
Purpose: Capital Formation, Investment
Large and deep
Every participant is a speculator
"Excessive speculation" does not exist
COMMODITY MARKETS
Purpose: Commercial Hedging, Price Discovery
Relatively small
Speculation only allowed to facilitate hedging
Danger of "excessive" speculation"

Exhibit 2:

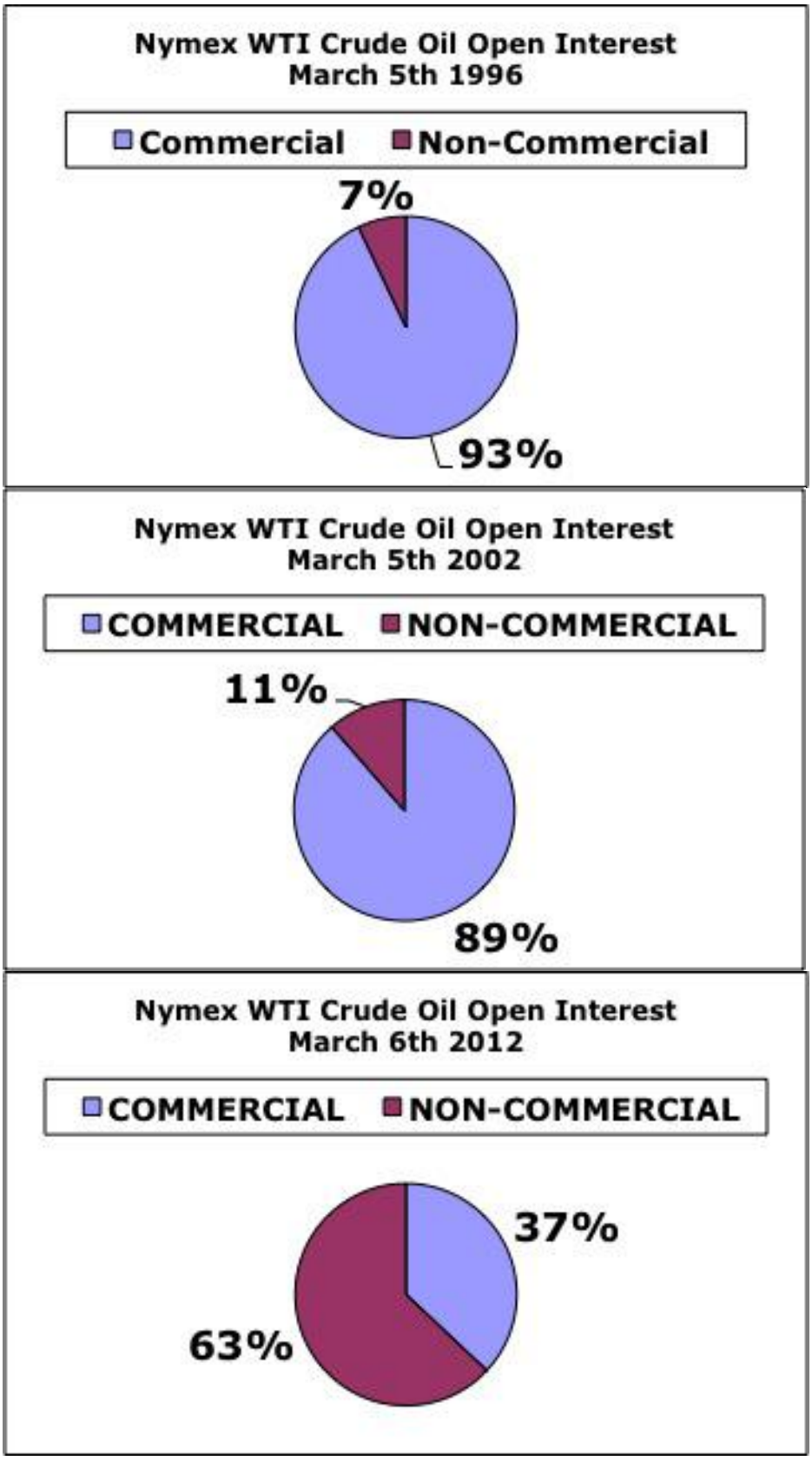
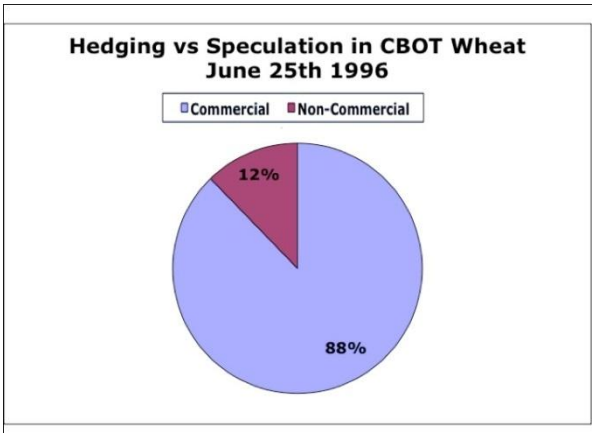
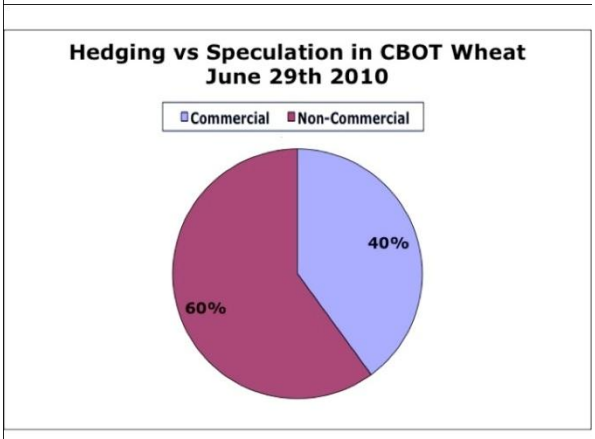
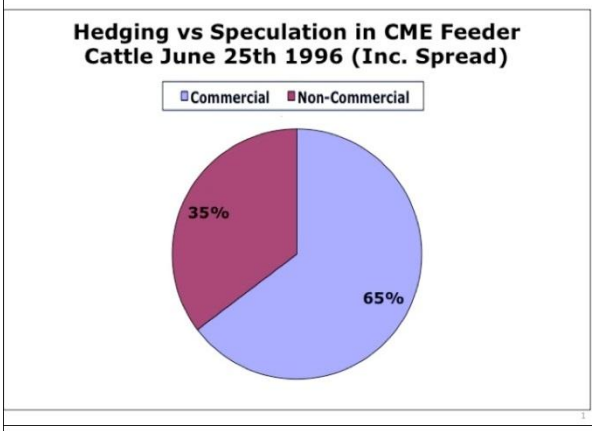

Nymex WTI Crude Oil Open Interest
March 5th 1996
Commercial
Non-Commercial
7%
93%
Nymex WTI Crude Oil Open Interest
March 5th 2002
COMMERCIAL
NON-COMMERCIAL
11%
89%
Nymex WTI Crude Oil Open Interest
March 6th 2012
COMMERCIAL
NON-COMMERCIAL
37%
63%

Exhibit 3:


Hedging vs Speculation in CBOT Wheat
June 25th 1996
Commercial
Non-Commercial
12%
88%


Hedging vs Speculation in CBOT Wheat
June 29th 2010
Commercial
Non-Commercial
40%
60%


Hedging vs Speculation in CME Feeder
Cattle June 25th 1996 (Inc. Spread)
Commercial
Non-Commercial
35%
65%

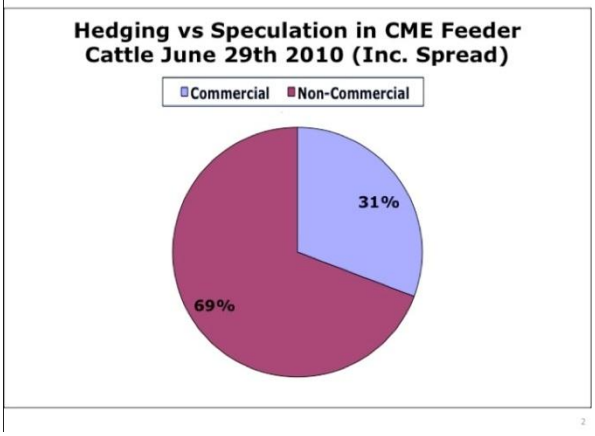

Hedging vs Speculation in CME Feeder
Cattle June 29th 2010 (Inc. Spread)
Commercial
Non-Commercial
31%
69%

Exhibit 4:

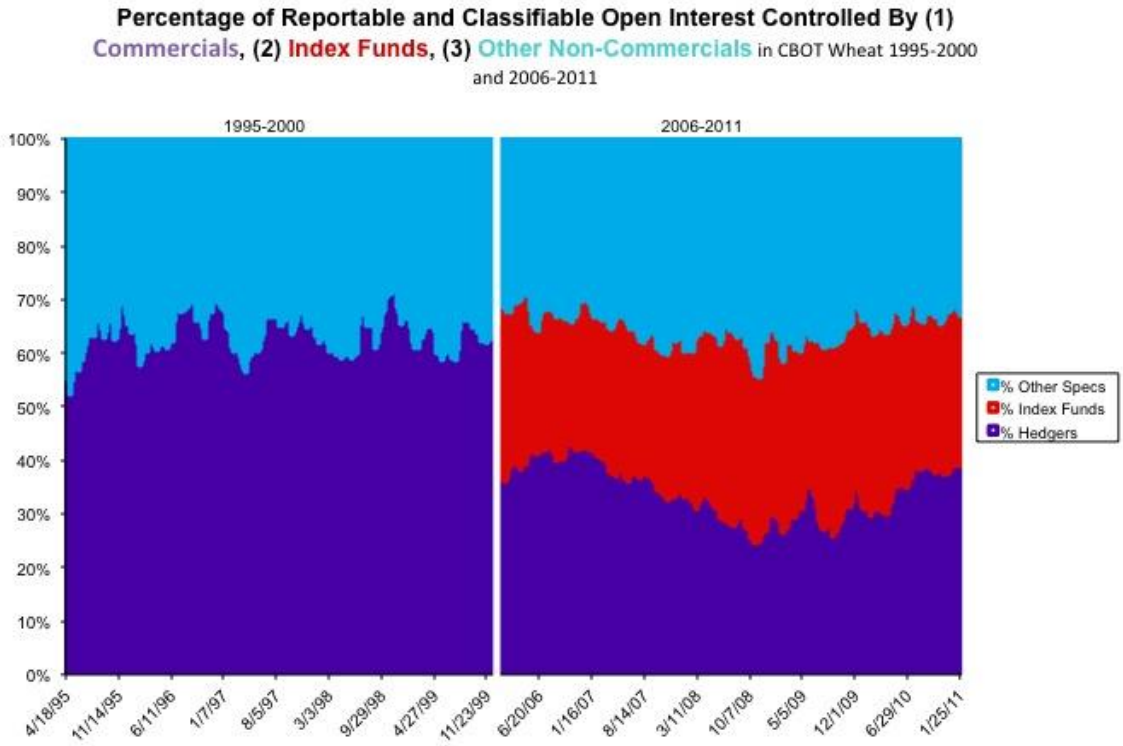

Percentage of Reportable and Classifiable Open Interest Controlled By (1) Commercials, (2) Index Funds, (3) Other Non-Commercials in CBOT Wheat 1995-2000 and 2006-2011
1995-2000
2006-2011
100%
90%
80%
70%
60%
50%
40%
30%
20%
10%
0%
4/18/95
11/14/95
6/11/96
1/7/97
8/5/97
3/3/98
9/29/98
4/27/99
11/23/99
6/20/06
1/16/07
8/14/07
3/11/08
10/7/08
5/5/09
12/1/09
6/29/10
1/25/11
% Other Specs
% Index Funds
% Hedgers

Exhibit 5:

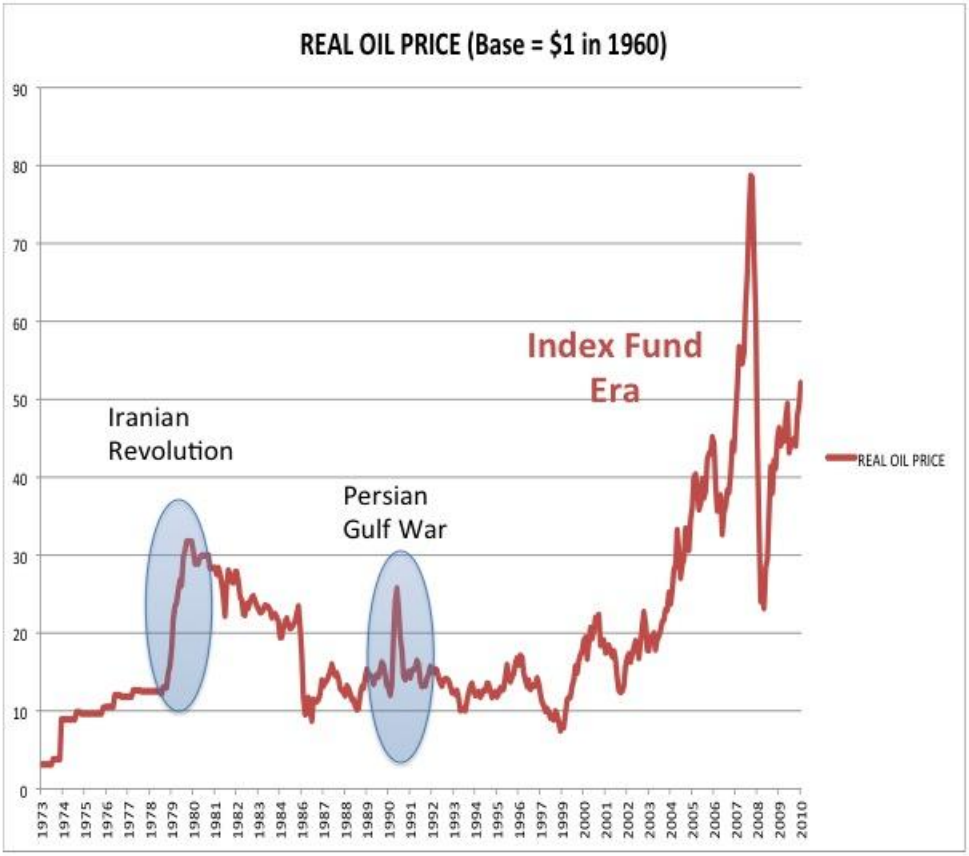

REAL OIL PRICE (Base = $1 in 1960)
Iranian Revolution
Persian Gulf War
Index Fund Era
REAL OIL PRICE
0
10
20
30
40
50
60
70
80
90
1973
1974
1975
1976
1977
1978
1979
1980
1981
1982
1983
1984
1986
1987
1988
1989
1990
1991
1992
1993
1994
1995
1996
1997
1999
2000
2001
2002
2003
2004
2005
2006
2007
2008
2009
2010

Exhibit 6:

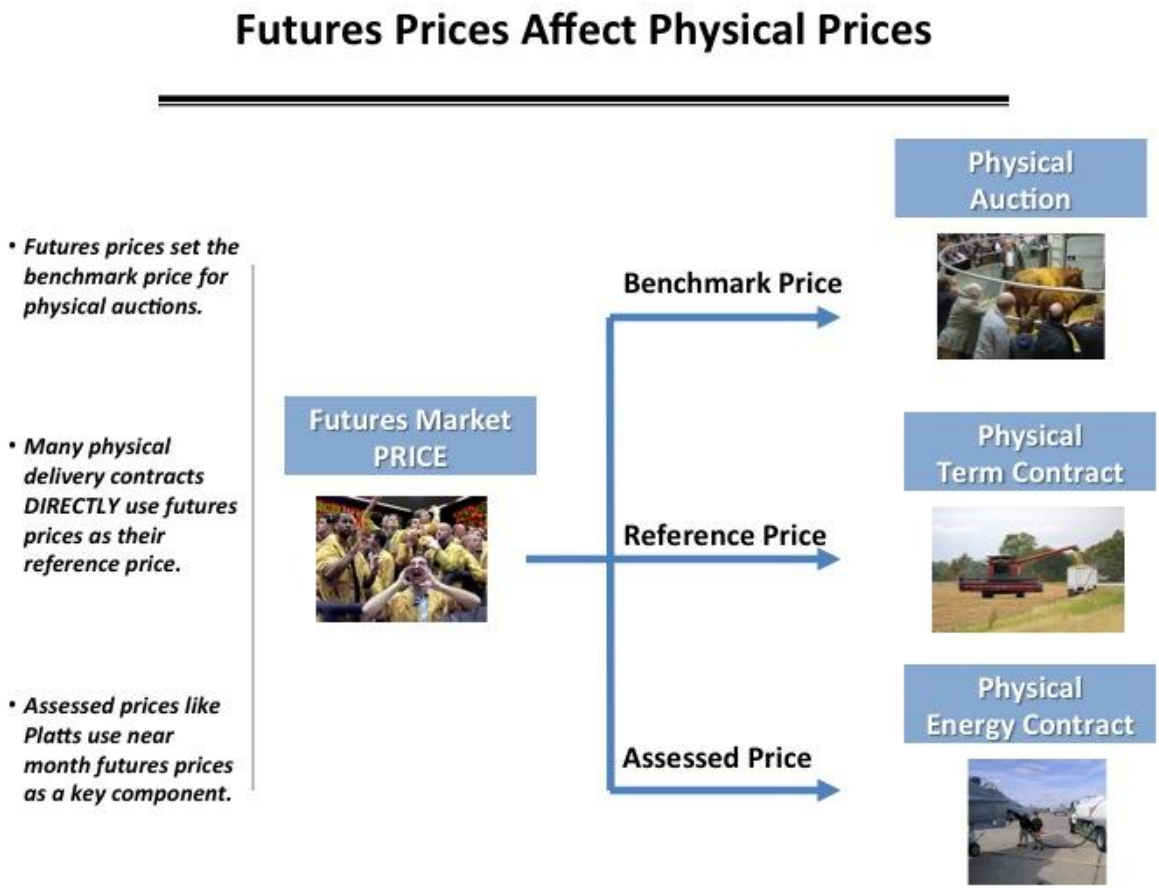

Futures Prices Affect Physical Prices
• Futures prices set the benchmark price for physical auctions.
• Many physical delivery contracts DIRECTLY use futures prices as their reference price.
• Assessed prices like Platts use near month futures prices as a key component.
Futures Market PRICE
Benchmark Price
Reference Price
Assessed Price
Physical Auction
Physical Term Contract
Physical Energy Contract

Exhibit 7:

Futures Prices Affect Physical Prices

[I]n those markets where commodities trade at differentials to futures, the prevailing futures' value as assessed by Platts at 3:15 pm ET will be used in the assessment process.

These physical markets typically may trade as differentials/exchange for physical (EFPs) to futures contracts and, therefore, both the futures value and the spot differentials are considered in the physical assessment process.

...

In the Americas, most physical refined products trade either publication-related or at a differential to an underlying oil futures contract: light sweet crude oil, New York Harbor RBOB gasoline barges, or New York Harbor heating oil barges. The primary exchange used to date is the New York Mercantile Exchange (NYMEX).

- Platts Methodology