UNITED STATES OF AMERICA

COMMODITY FUTURES TRADING COMMISSION

ENERGY POSITION LIMITS AND HEDGE EXEMPTIONS

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ANDERSON COURT REPORTING
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C O N T E N T S

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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. This is the second of three hearings of whether federal position limits should be set by the CFTC for commodities of finite supply.

I would like to start by thanking my fellow Commissioners, Commissioner Sommers, Commissioner Dunn, Commissioner Chilton, and our distinguished witnesses who will be here today. We're going to have two panels. And just to give a little heads up for our second panel, we're going to have -- we'll go through a couple rounds of questions using a five minute clock. Yesterday, it seemed that two rounds of questions were enough for the Commissioners, but if we go for three, I hope you oblige us, so it may be about an hour before we get to our second panel, judging from yesterday.

Yesterday, the CFTC held its first

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hearing on setting position limits to protect against the undue burdens that may result from excessive speculation in the energy markets. We had a very productive discussion on the legislative history of position limits, the current state of federal position limits and exchange-set accountability levels, and who would be best at setting position limits in the future. Our first panel included the Chief Executive Officers of the two biggest futures exchanges, Intercontinental Exchange and the Chicago Mercantile Exchange, or NYMEX, their subsidiary. Both exchanges made announcements that showed tangible progress towards regulation to protect the American public from the burdens that may come from excessive speculation.

The CME made a very significant announcement, that it supports adoption of a hard limit regime, including single month and all month's limits. This is a welcome change. No longer must we debate the issue of whether or not to set position limits. But there still remains

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three very important questions; who should set position limits, who should be exempted from positions limits, if anyone, and at what level should position limits be set and what formula might be used for them. I'm certainly going to be thinking about all three questions as I work with -- through my questions with each of the panelists.

As I stated at yesterday's hearing, I believe the CFTC does have a duty to protect the American public from fraud, manipulation, and the burdens that may come from excessive speculation. Thus, I believe it should be the CFTC that sets position limits on energy market participants. We have the statutory authority, we are the most able to strike a balance between competing interest and the public interest. I was interested to hear from a number of the panelists and their testimonies, from both today's hearing and in reading your testimonies, and also yesterday's hearing, that they believe the CFTC is also in the best position to set such aggregate positions.

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This is also every encouraging.

This brings us to the very important question of exemptions. Some panelists have suggested that a class of financial parties be exempted. Of course, the swap dealers testifying here today suggested that the swap dealers should be exempted from position limits. Index investors -- or an index fund testifying today suggested that index funds should be exempted. An exchange traded fund operator testifying today suggested that exchange traded funds might be exempted.

At the core of promoting market integrity is encouraging markets I believe not to become too concentrated or allowing concentrated economic power within a market. We do this in other laws at the core of the CFTC statute, this was set out in 1936 to set up position limits. I think this is even more relevant because of the developments that we've seen in financial markets since the first exemptions were issued in 1991. The financial markets are much more concentrated today than just 18 years ago.

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The financial crisis also highlighted the risk that can come to the markets and the American public brought about by large concentrated actors upon the financial stage. So I would like to hear from each of our panelists as to why, if we were to apply position limits, they think that they should not apply consistently to all non-commercial players.

While I believe that we should maintain exemptions for bona fide commercial hedgers, I'm just concerned about granting exemptions for financial risk management that in some way could defeat the effectiveness of position limits.

On the last question of what level position limits should be set at, I'm certainly interested to hear from our panelists ideas on this, and if we move forward in rule-writing, we look forward to see how to set formulas through a rule-writing process.

The CFTC's rules and decisions have meaningful implications on the day-to-day lives of the American public. It is essential that we

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utilize all of our existing authorities to ensure fair and orderly markets and protect the American public. To do this, I believe we must also work urgently with Congress to secure additional resources to effectively police our markets. And to the extent that we might be in the business of setting aggregate position limits, or as some, the panelists have suggested to look through swap dealers to the end users, we will need to work with Congress on additional resources.

I also believe that we need to work urgently with Congress to establish new authorities to police the over- the-counter markets, and particularly as it relates to the possibility of setting aggregate position limits.

I look forward to hearing from today's witnesses. On top of yesterday's very productive discussion, I believe today's hearings will add to the diversity of points of views on the very important subject. For the record, I also want to say that written comments on this topic, a record will be held open until August 12 for comments

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from the public or for additional follow-up with panelists. And with that, I'd like to turn to Commissioner Dunn for any opening remarks he might have.

COMMISSIONER DUNN: I have no opening remarks. I'm here to listen to the panel.

CHAIRMAN GENSLER: Commissioner Sommers.

COMMISSIONER SOMMERS: Thank you, Mr. Chairman. I just want to echo a couple of points that you made and to thank the panelists for being here. I think that these hearings are extremely important as we consider these issues.

This is a very challenging time, as I pointed out yesterday, and I think some of the questions that the Chairman pointed out in his opening remarks today still remain, but it's important for us to listen to the variety of market participants that we have testifying throughout the three days of these hearings, and to help us answer these challenging questions, because our mission here is to protect the U.S. futures markets, and we have an obligation to do

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that, it's in our mission, and we need to make sure that if we're moving down this path, that we carefully make these changes to make these markets useful for all of the participants, and I'm very glad to have you here today and participating in the dialogue, because it's important for us to consider. Thank you.

CHAIRMAN GENSLER: Commissioner Chilton.

COMMISSIONER CHILTON: Thanks, Mr. Chairman. The only thing I wanted to say is, I wanted to associate my remarks -- your remarks rather from yesterday on this press report about our swaps report. As I said, the last thing I said at the end of our hearing yesterday was that I commended the Chairman for the greater detail he is trying to put, the greater transparency both on our Commitment of Trader's Report and in our swaps report.

A lot of people know I disagreed with the data because I thought it wasn't good enough last year, and it wasn't good enough, in part, because we were asked to meet a timeline and

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didn't have the staff to do it, and I just thought it was faulty data, and I thought people, therefore, still made conclusions based upon that data.

I'm competent that this year, that we won't make conclusions based upon inaccurate data. And so I associate myself with your remarks, and don't want to pre-judge what the report is going to say until the report comes out, and it'll speak for itself, and I have a lot of confidence that it's going to be a much better report, our staff has done a great job, and I look forward to sharing it with you all at the appropriate time.

CHAIRMAN GENSLER: Thank you, Commissioners. Thank you, Bart, for those comments, too. And if we can turn to our panelists, I'm going to start with Ms. Masters, and we'll then go to Doctor Jarecki, and then around to Mr. Slocum, and Mr. -- is it Casturo?

MR. CASTURO: Casturo.

CHAIRMAN GENSLER: Thank you.

MS. MASTERS: Thank you, Mr. Chairman,

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Commissioners, the staff at the CFTC. My name is Blythe Masters, I am a Managing Director at J.P. Morgan, and I'm responsible for our global commodities business. I'm also the Chair of SIFMA. And I thank you for the opportunity to provide testimony today.

J.P. Morgan's commodity business provides thousands of customers with risk management and transactional services around the globe, in both physical and financial commodities. We wholeheartedly support your efforts to prevent excessive speculation, as well as to improve the overall framework for regulation of OTC or over-the-counter derivatives. We also believe that those efforts must be undertaken in the context of a broader understanding that speculation, per se, plays an essential role in all markets and commodity markets. If investors were discouraged or prevented from assuming price risks, hedges would have much more difficulty entering into transactions, markets would be more volatile, and the CFTC's mission of protecting

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risk management and price discovery would be compromised.

Thus, in discussing position limits and exemptions, it's critical to consider the role they play in facilitating risk management in the OTC derivatives market. The vast majority of American corporations enter into OTC derivative transactions to hedge risks that arise out of their core day-to-day activities. Financial intermediaries such as J.P. Morgan stand between those entities that want to offload risk, typically in the over-the-counter markets, and those entities who wish to assume risk.

Intermediaries like us aggregate risks and manage the net resulting positions on a portfolio basis. And typically we flatten out our net resulting positions on exchanges. Thus, for risk management purposes, exchange and OTC markets are used interchangeably, and the ability of a financial intermediary to use exemptions to position limits to effectuate the OTC transactions is key to being able to provide risk management

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tools to end customers. The most active commodity hedges are companies like producers, manufacturers, utilities, airlines and the like that face material risks to their financial performance arising from commodity price fluctuations and the effect of that on day-to-day operations.

Hedging for these companies often represents the only meaningful way for them to protect against adverse price movements and to lock in their margins. For example, airlines frequently hedge their jet fuel costs using OTC jet fuel swaps. Many of these activities can't be done on exchange because the exchanges don't offer the customized contracts that are needed. For example, there is no jet fuel contract on a futures exchange.

Firms with good hedge risk management practices can reduce the cost of and increase the availability of funding to run their day-to-day operations, and/or they can lower their ultimate prices to their own customers. And time and

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again, we see that the difference between hedging or not hedging has been the determining factor in the viability of plans to develop major new investment projects. On the other side of such transactions is often an investor who enters into OTC transactions to obtain exposure to price movements of commodities. Commodities offer diversification to investors, and with respect to inflation, a more correlated hedge than most other investments available in financial markets.

In a recent survey of inflationary expectations among J.P. Morgan's institutional client base, some 20 percent of 1800 respondents confirmed that they had used commodities to hedge against future inflation.

Investors are an important part of commodity markets and their participation has been beneficial because often more producers of commodities are interested in hedging than purchasers. Investors fill these gaps, and so they facilitate the efficient and smooth price discovery process.

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Importantly, these investors do not take physical delivery of the underlying commodities and they have no mechanism for withholding or hoarding supplies from the end consumer. For every buyer of a futures contract, there is, by definition, a seller.

Furthermore, once an investor's initial investment allocation has been made, positions are typically rolled forward each month with each contract being sold prior to expiration and rolled to the next month. For sustained upward price pressure on prices to occur, investors would have to continuously add to their allocations through time. In fact, our experience shows that more typical behavior is for investors to sell following price appreciation and vice versa in order to maintain a constant dollar amount of funds invested. This tends to stabilize price action rather than driving it.

We are aware of no credible academic study or analysis that demonstrates the presence of non-commercial interests in commodity markets

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to have been detrimental and many that, in fact, reach the reverse conclusion.

Over-the-counter markets and exchanges work in tandem and facilitate the efficient risk transfer within our economy. Swap dealers use exchanges to hedge their net economic positions arising from both physical and financial activities.

Importantly, managing risk on a portfolio basis in this way requires the intermediary to assume basis risk. Basis risk occurs when a position is hedged with offsetting position that is expected to approximately, but not exactly, offset the risk of the underlying. For example, it's common to hedge power prices with natural gas.

CHAIRMAN GENSLER: Okay. If you want to try to summarize up, because -- and I just want to say for all the panelists, your full written reports will be in the record.

MS. MASTERS: Understood, sir. So it's common for dealers to hedge power prices with gas

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or fuel prices with WTI and the like. As entities transacting on the exchange, dealers are subject to position limits. And hedge exemptions are critical because they facilitate over- the-counter activity for customers. These hedge exemptions are granted for specific purposes, limited size, limited application, and a dealer is held to those standards. A dealer acting in its own speculative capacity has no ability to avoid any such limits.

We have three specific recommendations that derive from work already commenced last year by the CFTC in conjunction with its special call for data relating to futures and over-the-counter markets. That data requires us and other dealers to disclose for both index and non- index activity, gross long and short positions by activity type, by counterparty type, by counterparty name, for large positions, by futures equivalent contract. In short, everything about our over-the-counter business is disclosed. Though setting up that information was expensive and time consuming, we have found it useful above

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and beyond the regular application. And we believe it sets the CFTC up to use that information to impose more useful and informative and effective limits going forward.

CHAIRMAN GENSLER: I'm fearful; to be consistent, I need to apply consistent limits, so why don't we make it one more minute, if we can?

MS. MASTERS: Okay. So three specific recommendations; first, imposing a large trader reporting system for over-the-counter positions, just as you do for exchange base positions. The information in the special call would allow you to do that and make that information at an aggregated level public. That would be valuable extra transparency across all OTC activities.

Secondly, we believe it would make sense to impose position limits across all markets, both OTC and exchange base markets, and looking through to the end market participant as you evaluate whether that participant's position is over or under a particular threshold or position limit level. I'm not a lawyer, but my layman's read, if

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your existing authorities would suggest, you have the power to do this, and if not, we would be supportive of legislation needed to achieve that. Finally, we do believe that it's vital that exemptions from position limits are maintained for those who act as aggregators, and that you look through those aggregators activities to the end position held by the underlying customer in order not to prevent those customers from conducting their necessary investment and risk management activities in over-the-counter markets. Thank you.

CHAIRMAN GENSLER: Doctor Jarecki; thank you.

DOCTOR JARECKI: Thank you, Chairman and Commissioners.

CHAIRMAN GENSLER: Just to help a little bit, I'm told that when that light starts flashing, I mean you don't have to think like it's politics or anything like a debate, but when that light starts flashing, you're getting close to the two minute warning.

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DOCTOR JARECKI: Thank you, Chairman and Commissioners. My name is Henry Jarecki, I'm the Chairman of Gresham Investment Management, a company I formed to implement TAP, a conservative long-only tangible asset portfolio which we developed more than 20 years ago. We presented you with a number of charts, and this shows the portfolio composition. We've been managing this strategy for ourselves and others since 1987, and we've, over that time, provided better returns than the S&P 500, with less volatility, and we've improved the performance of the stock and bond portfolios into which it's been introduced. We do these diversified commodity investments by buying futures for our customers, not by engaging in commodity swaps, and not by netting other positions. We've applied for the appropriate regulatory permissions when appropriate.

I, myself, have been in the futures industry for over 40 years, and during that time I've seen one market drama after the next. As a matter of fact, I was on the Board of the

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Commodity Exchange when it had to address one of our market's greatest manipulations, that of the Hunt Brothers, who bought large quantities of physical silver which they hoped, after moving the market upwards, to sell.

What folks like us do is not only good for diminishing an investor's global portfolio volatility, but also, as said, for protecting him or her against the ravages of inflation, which is of increasing importance to people who want their pensions to keep pace with the cost of living. Our clients include numerous state and Fortune 100 and union pension plans, insurance companies, and a host of foreign enterprises. The customers are stable, well financed entities that decide to take part only after they study the idea for a year or two, not because they think there's some special goody in the markets. They do not, any of them, use leverage, any of them speculate or take delivery of physical commodities. They maintain their core positions even when the markets fall, and they provide stability and trading liquidity

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to the market in general. What better market participants can there possibly be?

Our activities are tiny compared to the size of our two big competitors, the Goldman Sachs and the UBS indexes. We undertake trading in accord with simple rules we established over 20 years ago, in which we articulate afresh to our clients annually. And I'm here because I'm naturally fearful that our business will be throttled in the false understanding that commodity futures index purchases can cause prices to rise.

Because of my 40 years of experience in these markets, I'm surprised to think that high prices can be attributed to commodity futures acquisitions. Prices are made on the factory floors, and at the gas pumps, and the level of the farmers who grow wheat, and the consumers who eat bread, and the oil companies that take oil out of the ground, and the car owners who buy it at their gas stations. Futures markets are proud of themselves and have a lot to be proud of, but the

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idea that they make the prices rather than reflect them I think is absurd. The amount of buying and selling that's done in the real physical markets is typically ten or 20 times as much annually as the open interest is.

Now, this hearing has been called on the topic of position limits in the energy markets. That seems, to me, to be a euphemism for what can we do to make sure that Crude doesn't trade over $140 again. And oil prices were very high last year, but the high prices were also found, and I show this in this chart, which I think is quite significant, in steel, in coal, in cobalt, and they don't trade on futures markets at all.

Also, if it was clear that the prices were so high, why didn't the folks who know the most about oil, who have the best oil economists in the world, the Middle Eastern oil companies, show many years worth of production when the price hit 147, or the U.S. government did believe the oil prices are too high, why doesn't it just sell some to lower the prices for the benefit of

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consumers? Or if it's so easy to manipulate the prices by acting on the futures markets, why doesn't OPEC simply go in there whenever they think the prices have gone too low? One important question which I recommend to you is to be found in chart 12, which is the showing that the flows into index funds do not correlate with oil price rises. In some periods, as these charts show, the correlations are, indeed, negative. That is to say this is relevant because the Commodity Exchange Act talks about actions that the Commission ought take to prevent things that cause fluctuations in the price of a commodity. And the flow data that we are showing here shows that this causative element does not exist.

So for all of these reasons, I think it's inaccurate to believe that index providers are the cause of high oil prices. Money-printing and money-spending is one cause; fears of shortages and of inflation are others. Special circumstances, like public subsidies of the petroleum in China and India, the high cost of new

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production are further elements.

I appreciate, however, that the idea that commodity futures purchasers cause high physical market prices is superficially appealing. And I accept that the Commission may, in response to public concern, decide that something should be done. Ut aliquid fiat, we used to say when I practiced medicine, in order that something be done. When the relatives were --

CHAIRMAN GENSLER: Doctor, you might want to try to summarize or finish up.

DOCTOR JARECKI: When the relatives were pushy and asked us to do more, we gave very large and very colorful pills. Ut aliquid fiat videatur, we said, in order that it be seen that something is being done. The position limits something that the Commission may well do should, however, be directed at those who actually engage in excessive speculation or undertake large purchases. It's illogical to apply position limits at the level of firms like ours that passively implement the investor's decisions, and

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it's actually counterproductive --

CHAIRMAN GENSLER: I'm going to give you one minute, and I'm actually going to do this for all of you. I'm going to cut you off, and I apologize, but I really mean we're going to move on. Thank you.

DOCTOR JARECKI: I'd like to say finally that it is counterproductive and would be manifestly unfair to have long-only diversified commodity funds such as ours who openly identify our intended proportions a year in advance, and openly trade and register our positions on each exchange and its clearinghouse and fully how the price of every trade that we do on the long side, the short side, and the hedging side to anyone who looks. If people like us aren't permitted on exchanges, and only swap exemption folks were to be called hedgers, it would encourage secrecy, and that is not what the exchangers, the regulators, or the public want.

Indeed, before thinking about position limits themselves, the regulatory body should

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revisit the question of swap exemptions, and, if necessary, require all those currently enjoying such benefits to request the exemptions we have asked for and been granted.

Finally, I would say it would be grossly anti- competitive and would put out of business small enterprises like ours if what we do were banned or limited in any way before the same effective constraints are placed on those who assert swap exemptions. Thank you, Mr. Chairman; thank you, Commissioners.

CHAIRMAN GENSLER: Thank you, Doctor Jarecki. Mr. Slocum.

MR. SLOCUM: Mr. Chairman, members of the Commission, thank you very much for inviting Public Citizen here today and for holding these hearings. My name is Tyson Slocum, I direct the Energy Program at Public Citizen. We were founded in 1971, we're America's largest consumer advocacy group, and I focus on FERC jurisdictional and CFTC jurisdictional energy market regulations.

My constituents are the American people.

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We are directly funded from the contributions by over 90,000 dues paying families across the United States and from private charitable foundations, and so we are advocating policies on behalf of our constituents, working families across the United States.

And there is no question that the era of deregulation has eroded consumer protections and removed effective transparency from energy markets. And our economy and our families in this country have been paying the price for these bad decisions to limit transparency in these markets.

Public Citizen's reform proposals are going to sound a lot more in common with Adam Smith than with Hugh Chavez, because we are calling on increasing transparency in these markets because we understand that a market that is adequately transparent is a better functioning market and a more competitive market, that when you allow huge over-the-counter derivative markets that are free from effective oversight by the federal government, you are encouraging

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anti-competitive collusive practices that result in higher prices to end consumers, my constituents.

I have been very encouraged by recent pronouncements and actions by the CFTC to address the role that speculation has played in contributing to higher prices and making some early concrete steps to begin the long process of re-establishing effective transparency and regulations over these markets.

I am going to address four basic areas where Public Citizen would like to see the CFTC take further action. One of these is absolutely establishing strong effective position limits across all markets and for all products, reaching into swaps dealers and index funds.

We believe that the lack of effective position limits over these entities has allowed the accumulation of too much market power and has limited effective competition in these markets and allowed a hand full of very powerful entities, two of which are seated here at the table today,

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Goldman Sachs and J.P. Morgan, to take very large positions in under regulated format. We would like to see those trading position limits across all months, and only provide exemptions for bona fide commercial interest, only allow those types of hedge exemptions for folks that can demonstrate that they have a direct financial interest in hedging their risk.

Secondly, I think it's been clear that deregulatory actions by Congress and by the CFTC over the years has greatly expanded the reach and the size of the OTC market, and as a result, swaps dealers have been replacing traditional pit exchanges as an avenue for entities to get access to hedging their risk.

And so I think that the CFTC needs to make adjustments, recognizing the large expansion of these OTC markets, and increase regulations accordingly. The CFTC has the authority to declare an emergency in these markets if market prices do not reflect the underlying supply demand fundamentals.

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And I believe that the CFTC should explore whether or not it can use that existing authority, that emergency authority to reach into the OTC market and try to effectively regulate that market by going the route that Obama Administration has proposed in terms of requiring standardized OTC contracts to be cleared on exchanges regulated by the CFTC. And for those contracts that are non-standardized, the CFTC should impose strong margin requirements to dissuade trying to classify standardized OTC contracts as non-standardized, and that the CFTC should be making the determination. Also, it should be the CFTC making the determination, not the exchanges, about the position limits.

The third main point is, to the maximum extent possible, the CFTC ought to ensure that exempt commercial markets like electronic exchanges such as ICE and swaps dealers are providing data to the CFTC in formats that are compatible with your software that your market monitoring staff is using.

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I know that there might be some gaps in the ability to easily process data and make data more useful for the Commission, and ensuring that entities in these markets are supplying data that is as useful as possible to the Commission ought to be a priority.

And fourth, I know I'm out of time, but the CFTC ought to commission several reports, one of which examining any potential market problems associated with the combined role that some entities have in operating simultaneously as swaps dealers, operating as managers of index funds, while also engaging in significant proprietary trading. And also the Commission ought to take a look at the role that some financial firms have in acquiring or controlling access over energy infrastructure assets, and how communications with energy infrastructure affiliates facilitate proprietary trading operations. Thank you very much for your time and I look forward to any questions you may have.

CHAIRMAN GENSLER: Thank you; our last

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panelist.

MR. CASTURO: Chairman Gensler and fellow Commissioners, my name is Don Casturo and I'm a Managing Director of Goldman Sachs, where I am responsible for the firm's commodities investor trading desk. Thank you for the opportunity to share our views regarding important issues in the energy markets.

Increasing in volatility and the outright prices of energy commodities have raised concerns at the CFTC and among policymakers about changes in the marketplace. Some have questioned the role of index investors, other financial participants, and intermediaries such as my firm that are commonly referred to as swap dealers, hence our participation in these hearings.

During my 14 year career, I observed an evolution in the commodities markets which has yielded two noteworthy trends. The first is increased participation by financial investors, which has brought new capital to the commodity markets. This, in turn, has facilitated efficient

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hedging by commercial participants. The second is that swap dealers have become the predominate source of liquidity for both commercial and non-commercial entities, 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. An assertion that was confirmed in the testimony yesterday of two of the commercial participants on yesterday's panel.

Futures markets allow commercial entities to mitigate their exposure to commodity price fluctuations. For a producer, hedging frees up expensive equity capital and allows it to focus on its core competency of operating its business. Index investors are well suited to bear the commodity price risk associated with this producer hedge. They regard this exposure as a source of portfolio diversification and a safeguard against future inflation.

There has been much debate recently over

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whether this financial participation has distorted prices away from fair fundamental price. In order to address this concern, I would note that financial participation takes place in the futures market and not on physical markets. Futures, as the name applies, 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.

The second trend I would note is the increasingly central role of the swap dealer in commodity markets. Swap dealers have successfully developed risk management products tailored to absorb specific risk with a level of precision beyond that which is practical in the futures markets.

Additionally, they have established

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credit lines with end users that recognize the relationship between credit exposures and the ability of the end user to meet obligations under hedging arrangements. Again, the Commission heard commercial participants identify both of these benefits in their testimony yesterday.

While it might often appear that a swap dealer has taken a large position in the futures market, in reality, the swap dealer is using the exchange to manage the risk incurred in their capacity as an important intermediary in the OTC markets. First and foremost, the swap dealer is a market maker that maintains relationships with producers, consumers, and financial participants in order to provide more competitive pricing and tailored products to each.

In order to perform this role efficiently, the swap dealer may require access to futures markets beyond existing position or accountability limits. This is the rationale for the swap hedge exemption. One concern with this policy, however, is the so called swap loophole or

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the notion that end users in the OTC markets have the ability to accumulate exposure beyond what we permitted under future position limits.

We acknowledge this as a concern. At the same time, we do not believe that eliminating hedge exemptions or limiting them to situations where the dealer is only transacting with the commercial hedger will address the core issue.

We do, however, believe that such an approach will have unintended and undesirable consequences. These would include, one, commercial entities paying a higher price for their customized hedge; two, encouraging more transactions to be executed all futures exchanges and away from existing regulatory oversight; three, splintering the market; and four, driving a large number of index and other investors to non-U.S. commodity futures exchanges. From our point of view, the swap loophole is better addressed by looking to swap dealers for information regarding counterparty positions, as it has done since establishing the special call

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procedures, and looking through the swap dealers to apply limits at the end user level across derivatives and futures.

In this manner, the CFTC would effectively establish aggregate position limits at the end user level across the full spectrum of traded markets.

Lastly, I would like to comment on the appropriate size of these position limits. The Commission is focused on establishing limits to prevent and eliminate excessive speculation. Given that Chairman Gensler's previous testimony acknowledges the role of some speculation in the markets, the challenge is to determine what size limits should 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 to not restrict the level of speculation that is necessary to balance between producer and consumer hedging interests. While this may be a complicated process, we believe that

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the CFTC is the appropriate authority to engage in the exercise and support the idea that the Commission establish a consistent methodology to set limits across all commodities.

In sum, we appreciate the focus that the Commission is bringing to important energy issues in the energy markets and look forward to continuing to work with the Commission on these issues.

CHAIRMAN GENSLER: I want to thank our witnesses. I want to thank you for being within the five minutes, impressive. We're going to try to do the same five minute clock here, and I ask for your purveyance, because it may be three rounds, it may be just -- there's a lot of substance here and this is a very important set of witnesses, and the next set of witnesses, we might go three rounds, as well.

I just wanted to first comment on something Doctor Jarecki mentioned. And there was a lot of Latin, and I never took Latin, but I think it translated, in lay terms, you were

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suggesting this is just sort of a political thing here, and it's not for this Commissioner, this Chairman. I really think, and Congress laid out in our statute very clearly that we have an authority and that we shall use that authority to best promote the fair and orderly functioning of markets. We are not a price setter as an agency, and under this chairmanship, I don't see us as a price setting agency, but we are about making sure that markets are fair and orderly and work for the American public.

As I was rightly quoted, speculators are a very important part of the functioning markets and have been for well over 100 years. Hedgers, whether they be a farmer, a grain elevator operator, an oil producer, somebody down the line, a purchaser, a miller, or ultimately the American public benefit that risk can be hedged and then commercial enterprises and farmers can focus on the risk they want to retain, whether that's employment or within their business, but we are trying to protect the markets.

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And so that leaves me a little bit to my question to, if I can direct it to Ms. Masters and Mr. Casturo. I take it from your testimonies, they're somewhat similar in approach, that you both support the CFTC setting position limits, aggregate position limits, but if I may use the term, on end users, looking through the swap dealer community; is that correct; do I read the testimony correctly?

MS. MASTERS: Yes, sir.

MR. CASTURO: Yes.

CHAIRMAN GENSLER: And in setting those position limits on the end users, how would that benefit the functioning of the markets?

MS. MASTERS: I think that the suggestion made by Don Casturo, which is that the objective, if to impose position limits is to avoid excessive speculation, then you need to size those limits in a fashion that enables the market notwithstanding those limits to balance the imbalances between producer and consumer flows.

If that is the objective, then the role

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of the aggregator or intermediary plays no net economic effect on that, all it does is facilitate buyer aggregation activity, the meeting of the buyer and the seller.

The benefit of having additional investors or speculators is, you're more likely to be able to have those buyers and sellers met through time with less results in volatility. So the logic for exempting an aggregator, only on its net, flat positions, and imposing those limits on the end user is that ultimately it is the end market participant who has a net economic position.

CHAIRMAN GENSLER: I'm sorry, I do want to hear from Mr. Casturo, but just so I clarify, my question is, that was helpful, but my question is, what benefit comes to the market from setting the position limits on the end users, not what benefit in exempting the aggregator.

MS. MASTERS: Well, I think -- we have -- we see in our data, which is only a portion of the market, obviously, no situations where the end

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activity of either a producer, a consumer, or an investor is so significant that it is affording that entity the opportunity to manipulate or abuse prices. However, at least in theory, we certainly appreciate the potential for that to exist. And so if you were to impose those limits, you would have insurance against that eventuality, and, of course, the ability to monitor against those limits.

CHAIRMAN GENSLER: Okay.

MS. MASTERS: I think, personally, the monitoring is more important than the limits.

MR. CASTURO: Yes; I think the primary point to be made is that if you're looking for possibilities of excessive speculation, as you've heard in testimony all over the panel, the markets are broader than just the future markets, and to look at the entire spectrum of trade in markets for any single entity that may accumulate an exposure that may be deemed as excessive, and the only way to do that is to go to the end user level.

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One other point that I'd like to make, that, in our discussion of how we think these positions limits should be set up at the end user level, we are not advocating that Goldman Sachs have any special treatment, we should be held to the same at risk level of position limits as any other end user. We're only taking futures to facilitate end user activity, and that our net exposure, our net at risk exposure would be subject to the same limits.

CHAIRMAN GENSLER: I fear I see my yellow light, but I'll make a statement. You can be thinking about it while you answer other questions. I noticed in earlier Mr. Casturo's oral statement, you mentioned about splintering of markets, and someone else, and it may have been Doctor Jarecki, used fragmenting, I think was the word maybe, but one person splintering and another person fragmenting might be a -- somebody else's diversity in markets. And so I'd like to come back when we get to the next round and understand your view on this, because I do think there is a

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logic to avoid concentrated economic power in any market. But, of course, if you avoid concentrated economic power, you might call that splintering. So Commissioner Dunn.

COMMISSIONER DUNN: Thank you, Mr. Chairman. I don't with to pick on Mr. Casturo and Ms. Masters, but I will. Your testimony, if I can paraphrase it, you, in essence, said that things have changed in the marketplace, and, in fact, over-the-counter has really replaced pit trading to some extent, and that instead of going through a clearinghouse, there should be the residual net worth of those folks that are the counterparties and the swaps that protect the sanctity of those trades.

It occurs to me that that's exactly what got us into the financial meltdown that we have. And, Ms. Masters, you even make the point, in your last paragraph, where you say that 85 percent of those are based upon ratings, and again, the problems you say, of the remaining 133 billion of exposure, 85 percent of the entities that were

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rated investment grade, and some of this exposure was secured by the kinds of collateral that I mentioned above, property, equipment, reserves, et cetera, all across the line.

MS. MASTERS: That refers to J.P. Morgan's internal ratings, not rating agency ratings.

COMMISSIONER DUNN: That's an internal one then and not one of the external ones that we have had concerns about, got you on that. The problem I have, going back to what I know, the old agricultural pits and looking at those, is, we had very specific supervisory and compliance requirements of those exchange. There were cameras looking over the shoulders of the pit traders as they traded. There was immediate and -- calculating who made what trade and reconciling that at the end of that trading period.

That type of openness with compliance and somebody following up when there was a problem is not there in the over-the-counter. Who will do the surveillance and compliance?

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MS. MASTERS: In the latter part of my written testimony, I made reference to J.P. Morgan's belief that there is an important role for a systemic risk regulator whose authorities would include the oversight of transacting in the over-the-counter derivative markets, as well as setting capital requirements, as well as setting collateral requirements and the like. I do agree that over-the-counter derivative activities should be regulated and supervised in some form. I don't agree that the only way to achieve that is by forcing transactions to be conducted on a centralized exchange.

MR. CASTURO: I would echo those comments and mention that it also agrees with the comments of Mr. Slocum, that we're also supportive of additional regulatory oversight into that over-the-counter space because it is as important as we've identified, and not just we've identified, even the commercial participants that have given testimony have identified the benefits of transacting in the over-the-counter space.

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COMMISSIONER DUNN: All of you have indicated that at the end of the day, we ought to know the aggregate position of those participating in the market. Mr. Slocum says, well, we could use our existing software, I wish it were true. The amount of effort went into our special call, it took up about a third of the time of our surveillance staff.

We did get some of that stuff down to the point and we are in the process of trying to establish IT programs that will do the type of evaluation and raise the red flag, but, you know, every day there are millions of transactions that are taken, and that is going to require, on behalf of all of you in the industry, to respond to the needs of giving us information in the format that we are going to require. Is the industry ready to do that? And I really appreciate J.P. Morgan and Goldman Sachs offering solutions here.

MR. CASTURO: Yes; we recognize that there's a large burden and expense involved in what we're proposing, but we believe this is the

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right approach and are prepared to meet those burdens and expenses and work with the exchange in getting you the data that you require in the right format.

My belief, as I've stated to the Commission before, is that your special call last year was remarkably accurate given the short time frame that you had to enact it in terms of what it was seeking, and we look forward to working with you more and refine that process even further if so needed.

MS. MASTERS: I hate to say it, but I agree.

COMMISSIONER DUNN: You indicated that you got some good out of that special call; could you elaborate on that?

MR. CASTURO: Yeah; I just think that, in terms of examining our business and what the makeup of our over- the-counter participants is, I mean, broadly I understood, obviously, what they were because that's my role on the desk every day, but to actually look at the data in the format

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that you requested gave me additional insights as to where these flows came from, none of which did I feel there was any damaging -- was damaging to the markets in any way, but was just useful analysis of how our business operates.

CHAIRMAN GENSLER: Commissioner Sommers.

COMMISSIONER SOMMERS: Thank you, Mr. Chairman. I'm going to follow a line of questioning that I had yesterday with some of our market participants and it's regarding the formula that we use to set the position limits and what we look at as the entire marketplace. And as you know, we don't have the current authority over the OTC markets right now, but through our special call, have been getting information. To all of the panelists, do you feel that it's important for us to look at the total open interest, including OTC positions, in order to set the position limits on these markets, and how difficult is that going to be to achieve accurate numbers?

DOCTOR JARECKI: I'd be happy to comment briefly on the question. I think you do need the

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entire quantum, but you also do need the look through to be individual holder. And I want to just respond briefly to your question, to also touch on the Chairman's question of what the importance is in identifying the position, the final position holder is, because it's the final position holder that is the -- that is the swing element.

Index operators and folks like ourselves are simply passive mechanics of implementation. It's the customer, not we, who decides to purchase. And I'm speaking here of investors. So one speaks here of disaggregation, that is, not pulling it together in the sense that you mean, but identifying what the position is of each individual long holder.

He's got to save his position anywhere near position limits, otherwise, an investor could buy five wheat directed funds, he could own a billion dollars worth of wheat futures and yet not be subject to position limits at all. Making the investor, not the aggregator, responsible closes a

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giant unintended loophole, and that loophole exists under what is currently foreseen, one doesn't get to the end user, the end long user. So I think it is -- I think the overall position, including the derivatives and the over-the-counter trades is important, but the end user's position is where the most important activity is, that's where the abuses can occur, our colleagues claim they have not occurred, and I have no data on that.

COMMISSIONER SOMMERS: Just to clarify before the rest of you answer that question, do you disclose to anyone the positions of your individual investors?

DOCTOR JARECKI: We have -- we are asked about it and we do provide large holders, we provide information on large holders, yes.

COMMISSIONER SOMMERS: Thank you.

MS. MASTERS: So in answer to the question, do I believe that limits should apply to over-the-counter positions, as well as exchange positions, yes is the answer. Had you asked the

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question, how feasible is that a year ago, I might have paused before answering. But I do think that in the form of the special call, rushed and exhausting as it certainly was for all parties, the CFTC has set an important precedent and could institutionalize that process, higher frequency, more standardization, hopefully rendering it more a lot electronic, which would require work from both sides, obviously, I think it's very feasible, because you have the makings of all of the necessary information there.

COMMISSIONER SOMMERS: I just want to clarify that we're getting all of your positions, your entire book in OTC positions so that we could take all of that into consideration for what we would clarify as the whole -- the entire market?

MS. MASTERS: Correct.

COMMISSIONER SOMMERS: Okay.

MR. CASTURO: Yes; I would again echo that, looking at the entire traded spectrum is the proper approach, and only then do you get to the true answers on who's holding positions that may

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be deemed excessive. I think it's very feasible. Again, the special call data is certainly -- I can accurately comment on Goldman Sachs, you're getting all and accurate information.

MR. SLOCUM: Yeah; the Public Citizen supports, you know, considering the position limits across all the markets, the OTC markets have a lot of action in them now and it's crucial that the action in that market be taken into account when setting the position limits.

COMMISSIONER SOMMERS: My other question is a little bit off of the topic of position limits, but it goes back to something that one of our participants yesterday talked about. Commercial participants that use swap dealers or use the OTC markets to hedge their risk indicated that they post no margin and that it is cheaper for them to use swap dealers to hedge their risk, and I'm assuming that some of these large commercial participants are your clients, and maybe some of these people are both of your clients. How do you know that you are not both

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using the same collateral to back up the positions that these commercial counterparties have with each of you at the same time?

MS. MASTERS: So, first of all, there are certain customers, commercial customers of J.P. Morgan and any other major bank in this space who have unsecured lines under which to do the hedging activity. There are many others that have secured lines where the collateral, the margin can range from cash and government securities all the way up to property, plant, equipment, commodity, molecules in the ground, et cetera.

When it comes to evaluating whether or not and how much of an unsecured exposure to take to a commercial counterparty, any bank, J.P. Morgan certainly, would first conduct a thorough credit analysis of the credit worthiness of that company. So we would look at the totality of its assets and liabilities, its cash flows situation, et cetera. And very often we find that when hedging activity is being undertaken, there's a component of what we refer to as right way risk.

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Right way risk reflects a situation where someone is buying protection, for example, a gas producer hedging his gas production, buys a gas swap from J.P. Morgan. Under the mechanics of that swap, our exposure to him increases as gas prices rise.

Of course, a gas producer is a more credit worthy entity, it has higher enterprise value if gas prices are higher. So just as our exposure rises, so does the credit worthiness of that company. So we are able to make value judgments along those lines to decide how much exposure we have.

As it relates to how can we be comfortable that a company is not doubling up and tripling up on all of its activity, that's all about knowing your client and having a deep and confidential credit relationship with your customer so that you understand the nature of their business, the nature of their hedging activity. And just as you would evaluate when you're making a loan to the company, that they're not quietly taking loans from many others that you

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don't know about, you would have the same dialogue about what their hedging activity is, too.

DOCTOR JARECKI: I'd like to just add, if I may, that in the businesses that we do, we do not have any customers with unsecured lines. Our customers don't even put up margin with us, they put up 100 percent of the amount of money that is required to purchase their commodity. So it's not -- they get far less leverage with us. They don't even get the five or six percent they would get with the exchange, which purports them to sell out when the market falls. They put up with us 100 percent.

And this is -- therefore, it's not surprising that our kind of customers, and I'm not familiar with the folks who take and give unsecured lines because our company is too small to tolerate this, but they don't go anywhere when the markets fall, they just stay there and say, okay, we'll wait until it goes back up.

CHAIRMAN GENSLER: Thank you.

MR. CASTURO: I would just like to add

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that the special call data also gives access to over-the-counter trades that are enacted by our commercial client. So to the extent that a large commercial client may be having exposure that is even beyond what their commercial or physical exposure is, you would have access to that data, as well, so it would re-enforce knowing your client even at the regulatory level. And secondly, the notion of unsecured lines in right way risk really is our credit department's practice in evaluating commercial clients. It's not the practice to evaluate non-commercial clients in the same manner, those are largely 100 percent collateralized.

MR. SLOCUM: If I may add something, I think that I have a public policy problem with allowing entities like Goldman and J.P. Morgan to subsidize their very lucrative swaps business by using the regulated exchanges essentially to hedge their own risk. And I think that that's why it's so crucial that Congress and the CFTC get control over the OTC market.

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I don't think I need to talk to the CFTC about the role that counterparty risk played in the current economic crisis. My esteemed colleagues wouldn't be here today but for the generosity of Congress using the outstanding debt of the American people to bale out AIG and other entities when they got in over their heads in deregulated markets. And so I think that's the crux of the issue here, that a very lucrative business line for these banks, they're hedging that for themselves in the regulated markets while wanting to preserve all of the benefits that an unregulated OTC market provides for their bottom line.

CHAIRMAN GENSLER: Commissioner Sommers.

COMMISSIONER SOMMERS: I'll go back to that.

CHAIRMAN GENSLER: Thank you. I suspect we'll have a few rounds here. Commissioner Chilton.

COMMISSIONER CHILTON: Thanks, Mr. Chairman. Doctor Jarecki, you mentioned as part

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of your reason that you didn't think there was an impact on oil prices, that coal and steel were increasing, not traded, et cetera, but don't you think that coal and steel are impacted by oil prices?

DOCTOR JARECKI: Well, there's an awful lot of things -- you would have to take -- to believe that, you would have to look at things like real estate prices that were moving upwards at the same time, and at many other objects. If you looked at the general level of prices during those dramas, you could say happened at the same time, I guess it was caused by, but I'm so fearful of talking anymore Latin here that I won't say post hoc ergo propter hoc. But the --

CHAIRMAN GENSLER: I assure you, I understood your Latin, but it wasn't in Latin, I understood it.

DOCTOR JARECKI: But it's true that things move together, but you don't know which is the chicken and which is the egg. What is important to see is, in the chart on page 12 which

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I've shown, which is, as money poured into these funds, that was not coupled with the increase in prices. It's, in many cases, negatively correlated, and there would be -- I think a burden would be on somebody to demonstrate the causative issues. I'm not arguing that they hung out together at some times, but there were many times that they didn't hang out together.

COMMISSIONER CHILTON: So you think that the passive longs, and you'll agree that there has been an increase in passive longs, but you don't think they have any impact on the market, and you think the only ones that we should be concerned about are those who take physical delivery of products?

DOCTOR JARECKI: I'm not familiar, and I know the history of markets for 100 or 200 years. I'm not familiar with speculations or manipulations that act solely in the futures markets without activity. In the physical markets, the world I knew best in this manipulative thing were the Hunt Brothers, who

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took billions of dollars worth of silver, hid it from the public, moved it out of the exchanges so that they could pretend that there were -- that there was a diminished physical supply, then took a broker in a loud, red, check jacket, had him go on to the exchange floor and say, limit up bed for 1,000 lots, that was a manipulation, that was an effort to cause the price to go up so they could take their physicals and back a whole bunch of silver back bonds with it.

But there aren't histories. Whether you go to secreten curio (?) I could name you, I'm sorry, these are all the people that have done the great dramas, Sumi Toma, they've all done their things in the physical markets.

And you can have a short manipulation, a week, a day, an hour, somebody can go into the exchange with a loud check jacket, and sure enough, the markets went up, limit up, because he was bidding limit up for 1,000 lots, but it's not something that can last, and it's not something that can last over the extensive period of time

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that that bubble lasted.

COMMISSIONER CHILTON: Okay, thank you. Mr. Slocum, you mentioned that you thought we should have position limits in all markets, and since Doctor Jarecki just raised silver, I'll ask about the metals complex. And I know that's not your specific area of expertise, but you're an expert in these markets in general, and it's my view that, you know, what's good for the goose and that it would make sense to do it for all of these; do you have an opinion on that?

MR. SLOCUM: Yeah, I think I agree with you. Like I said, my area of focus is on energy markets, but it would make a lot of sense for the Commission to be consistent with all commodities under its jurisdiction. You know, I have particular concern in the emerging pollution derivatives markets, and I hope that the Commission embraces its hopefully new authority over those markets.

But, yeah, I think that all of these anti- speculation and pro-competitive regulatory

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actions by the Commission should apply to all of the commodities under your jurisdiction.

COMMISSIONER CHILTON: Let me just -- I'm going to run out of time, so I'll just go back to you still, Mr. Slocum. I think there's some merit in the argument that some of the exchanges gave us yesterday that if we just do position limits here, and I'm not prejudging what we will or won't do, but if we just do that, there is some possibility that, theoretical at least, that positions could move OTC and that it would be less transparent. That's not what we're trying to do, we're trying to create more transparency. So I've said that I think, you know, Congress needs to act to give us this OTC authority, too, but I wanted to know your view, and maybe you can elaborate on that point.

MR. SLOCUM: I think that any time that industries or businesses or individuals throughout history have been threatened with enhanced transparency measures, the first line of defense is always the I'm going to flee defense, and I

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don't know that I fully buy that for commodity markets.

I think that given the precarious state of financial markets in general, I think that those entities that try to become the Cayman Islands of commodities regulation are not going to be looked upon favorably.

I think that given the fact that the global community is acting fairly aggressively finally over tax havens, I think that you see that there is a recognition among countries, even developing countries, that a race to the bottom from a regulatory perspective is not conducive to long term economic development. So I do not buy the argument that if we employ sensible regulations that folks are going to flee to some other country, I'm not convinced of that.

COMMISSIONER CHILTON: I know my time is up, but I did want to make sure that people understood. But you do think that Congress should approve greater oversight of OTC markets for the CFTC?

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MR. SLOCUM: No question.

COMMISSIONER CHILTON: Okay.

MR. SLOCUM: And we have been communicating that very loud and clear to Congress.

COMMISSIONER CHILTON: Thanks.

CHAIRMAN GENSLER: Thank you. Doctor Jarecki mentioned that he thought -- and what he does, and he's a passive mechanic, so my question for Ms. Masters and Mr. Casturo is, in running your commodity swap businesses, are you just passive mechanics at J.P. Morgan and Goldman Sachs?

MR. CASTURO: Well, to the extent that we offer swaps to index investors, we largely have a similar profile as an investor in an index fund. They make the decisions, we don't, and we -- while we make them a risk price to engage in that transaction, we, in most cases, immediately hedge that risk either by offsetting it with some of our commercial participants, and that's actually quite common, or by using the futures exchanges in the

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interim to offset that risk. But it's largely passive from our perspective. We're just a pass through.

MS. MASTERS: I think if you take our business as a whole, there are a number of different components, and facilitating index investors is one area where I think you could accurately characterize the business as being closest to a passive facilitation role. Can't quite get to the passive mechanic phraseology, but you know what I mean.

I think, however, there are other areas where we're acting more in our own capacity, and in those -- just to be clear, I think our position is that while we are acting in our own proprietary capacity, we should be subject to the exact same restrictions that any other entity for any reason is subjected to by the CFTC or an exchange or any other authorized body. So we're not asking for special treatment other than in the situation where we are facilitating business for others.

CHAIRMAN GENSLER: See, I think this

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might be at the core of, frankly, our difference. I don't see a Goldman Sachs swap desk or a J.P. Morgan swap desk as a passive mechanic, and the billions of dollars of transactions that you do just as a passive mechanic, or the billions of dollars of profits, or the billions of dollars of compensation wouldn't be a passive mechanics. I mean it is a highly sophisticated risk business, and it's an important component of our financial markets, a very important component of our financial markets, but not a passive mechanics component.

And so that's why, when I think about your earlier question or comment that I'm going to now question, is, you thought that we should apply position limits on end users, which is very encouraging, and there's some common ground here, but then you thought it shouldn't be applied on the aggregators, the aggregators of risk, the swap dealers, and so I want to come back to that and ask why that is, because I don't think it's just a passive business, you know, I don't think the

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American public thinks it's just a passive business either.

MS. MASTERS: So to clarify, I'm not suggesting that an entity because it is in the swap dealing business should be entirely exempted. I am, however, suggesting that, with the benefit of full transparency, which rules are recommending here, you will be able to clearly identify and delineate those situations where we are seeking to lay off risks that we are assuming from one customer and intermediating. And to the extent that we're unable to convince you of that, then you can classify it as non- passive or non-intermediating business and apply limits or other rules as necessary.

We are offering and have provided the necessary transparency for you to be able to evaluate that in the special call and on a hopefully continuing basis. So I think you will be in a position to, in your own rights, evaluate, rather than just taking our word for it.

So I think it is absolutely the case

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that we do play a major facilitating role for hundreds, if not thousands of clients around the globe, it is a complex business, we hedge options with futures, we hedge power with natural gas, we hedge jet fuel with WTI, et cetera, and so we're going to have to have some language whereby we explain to each other what do we mean by intermediation because it's not just plus one and minus one, it is more complicated than that, as you correctly point out. But it is not so complicated that it cannot be conveyed. And with the transparency that you will have, i.e., total transparency, I have no doubt that we would be able to achieve the needed goal. But again, where we're not intermediating, we shouldn't be exempt from anything.

MR. CASTURO: Yes; I'd just like to clarify my earlier comments here that we might be seen as being on a different side of the issue here. I was only referring to our capacity as providing a swap to an index investor in terms of that particular activity being relatively passive,

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right. Our broader business, I would agree, does involve us taking some risk. And the suggestion by Ms. Masters, I would agree with, as well, that our capacity to engage in that speculative risk element of our business should be limited, like every other counterparty, and that's every other entity in that space by the position limits that we're proposing.

CHAIRMAN GENSLER: I appreciate both of your comments because I'm really grappling with the common ground of applying position limits on the end users and aggregating, and I think it would be very tangible and fruitful suggestions about using the special call. But I'm still personally grappling with why the swap dealers would be outside of that, and I'm hearing, well, maybe they wouldn't be outside of it, but maybe you're suggesting part of your business would be outside of it. I'm sorry.

MR. SLOCUM: Mr. Chairman, if I can just add something very quickly. I had the pleasure of reading through Goldman Sach's 10K report for its

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GSCI index, and not to pick on you, but -- and it was a page turner, but in the disclosure for this 10K annual report, because it's to the SEC, which is a shareholder rights agency, it has a disclaimer in there for potential investors in the index fund saying, you know, we invest as a passive investor in this basket of 24 commodities, but, by the way, Goldman Sachs has other affiliates that will be taking active proprietary trading in these same commodities, and we need to let you know that, that we are -- we have a large business involved with that.

And so looking at these activities in isolation I don't think provides an accurate reflection of a company's footprint in the marketplace. And I think that's why, in my opening statements, I talked about the CFTC examining the totality of banks and other financial firm's involvement in these markets, in all of these different affiliate components.

DOCTOR JARECKI: I'm so relieved to hear that there is unanimity here about the

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appropriateness of considering our business only an end user business. Our firm has no trading profit. We do 100 percent of our trades for our customers, and that is the only group for whom we trade. So apparently there is now a unanimity, if there's not a trading profit, then surely one would not be involved in position limits, and I'm very grateful for that unanimity.

CHAIRMAN GENSLER: I can only imagine you're speaking on behalf of the panelists because you cannot be speaking on behalf of the Commissioners. I am probably -- I know I have some more questions, so with the patience of the panelists and the next panel, I'm turning to Commissioner Dunn, but alerting that we'll have at least a third round.

COMMISSIONER DUNN: I thought you were implying it would take a great deal of patience for me to answer a question. I'm kind of -- I think this is a great panel, we're learning a great deal here. Doctor Jarecki, I hope we don't end up prescribing a placebo, but even if we do,

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we know placebos have an impact on the patient, and it takes constant re-examining of what goes on, and that is, again, something that's going to take a lot of time, and some of your suggestions on what we ought to be doing is that there's a follow-up, that anything that we do will have an impact on the marketplace, and we must be assured that we go back and revisit that, that's the reason why Congress reauthorizes every -- periodically, five years or so, and so -- and that's why we get new people on the Commission, as well.

But I'd like to hear from all of you about what drives the passive or speculator investor. Mr. Casturo, you talk about they push the market back into balance, and you delineate between a macro and a micro.

Doctor Jarecki, you talk about a hedging really for inflation, and the fact that there are -- we think there are going to be better times there, and so we think that commodities like oil and metals, et cetera, are going to go up in

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price, and there are optimists that we might call on that that are investing for the long term or they're hedging their concerns about inflation.

But often times when we see some of these hedge investments that were out there, they may be only relegated to the sophisticated investor that's out there, and I'd like to understand, Mr. Slocum, what do you see the role for the mom and pop type investors, the kind that the doctor represents? So if I could hear from all the panelists on ---

DOCTOR JARECKI: May I start with that? At the risk of appearing excessively academic, I have to go back to Lord Keynes, who spoke about -- who spoke exactly about the topic that you're talking about. And he led us to believe that there was a natural profit in the commodity market for the speculator, for the group -- the aggregate of all speculators, because, he said, the farmer looks out at his land and he's planted it, and he's kind of happy with how it is, and the weather is good, and the prices are high, and he becomes

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panicky that he's going to -- that the prices will go down and he'll lose, and so he's willing to sell at a -- sell for a one year delivery, that is, sell for when he gets harvested.

The baker has no interest in buying wheat at that moment, he wants to buy it a week or two before he uses it because if grain prices are excessively high, he'll bring bread prices up.

Keynes said that this was the normal condition and said that there was a normal backwardation, that is, that forward prices would be lower than expectation because of the farmer and the producer's desire to sell. That means that there is naturally the commercial --- the producer is short, and the commercial who wants to buy something is -- he is long only in the nearby. That time period, somebody is paying for. And that payment, which is the payment of backwardation, and I don't mean price backwardation, but expectation backwardation, I don't want to get too technical, that is what comes out of the market.

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And it is -- the speculators are being paid to diminish the anxiety of the producers. This is true in the oil markets, it's true in every market. And I don't know if I've been useful in making that comment about that distinction between the natural speculative long and the natural producer short. Thank you.

MS. MASTERS: Today's investors are accessing the commodity markets through a number of different channels. The one in which you most regularly see, the smaller retail investor represented is by our ETF's. And as you know, ETF's have grown wildly in popularity in recent years, and specifically, ETF's reference in commodities, natural gas, crude oil have been amongst those and so the strong representation of the individual investor in those areas.

As it relates to index or swap investors that are facilitated by the swap dealers, generally speaking, those investors are large institutional investors who very often represent the interests of the retail individual in the form

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of, for example, they might be a pension plan, or an endowment, or some other institutional money manager managing money on behalf of a pool of individuals. There are also other sophisticated investors in the form of Sovereign Wealth Funds, for example, who have used the same investment vehicles, so there's a whole spectrum.

And then at the most sophisticated end of the spectrum, where you very rarely find activity in the passive index type of strategy, and rather you see much more directed and individualized strategies, both long and short, in the hedge fund community. So there's a whole spectrum of different types of investor at play here, and each of them provides liquidity in their own way.

MR. CASTURO: Commissioner Dunn, I'm glad you asked that question because I think this is the basis for a lot of the misunderstanding about how these markets work. I've done a lot of thinking about this. To go back to Doctor Jarecki's mention of Lord Keynes and his theory,

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really what's going on there, there is an imbalance between the producer's desire to hedge and the consumer's desire to hedge on a forward basis, and that's because the consumers are very diversified, they're individuals like you and I that are not organized enough to think about how much their commodity prices are going to be in a year, or big enough to act individually to do that. The case of the index investor is almost like representing a collective group of those consumers, particularly if you look at who makes up these index investors, they're largely endowments and pension funds that represent a larger group of people, who actually have all the shorts in the commodity markets, they have the exposure that if prices go up, they're the ones that are going to have to bear the cost.

In the wheat example, the baker just passing onto the consumer. So those entities, in a sense, represent the hedging interest of a broader group of consumers that are required in the marketplace to offset the producer's desire to

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hedge price risk to the down side. So I think that's the key point that you want to consider in terms of what they make.

Now, with regard to my testimony, we're distinguishing that group from what we would call true speculators, which are those that are more price sensitive and try to take advantage of perceived distortions from fundamentals and bring the market back into line. That's a group that will enact -- again, in the futures space, they're only talking about future perception of fundamentals, which is, again, hard to quantify. But that speculative interest is more -- is where you get into the balancing that I'm talking about in my written testimony, where if there is any perceived distortion that there might be in a futures market in terms of prices and fundamentals, the speculators come in and bring that market back into line.

Now, ultimately, all these groups are governed by true physical spot fundamentals when a contract goes into expiration and converges to the

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cash market price. Where there is true consumer -- end user consumer and produce -- and producers meeting in the cash markets.

MR. SLOCUM: Again, I want to reiterate concerns that Public Citizen has when entities like large, sophisticated financial institutions wear a lot of different hats at the same time and pretend like different affiliates have no communication with other affiliates.

I started my career at Public Citizen in the year 2000, and something called the California Energy Crisis was going on, and I learned what derivatives were from sifting through Enron's financials. And one of the things that Enron did was, it created this electronic trading platform called Enron Online, and it said to all of its competitors, here, look at this fun, new exchange, let's use this instead of those old, rickety, out dated pit exchanges, and what Enron was doing was, collecting information on what its competitors were doing in the markets, and its competitors didn't know that at the time, and Enron was making

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corresponding bets.

I find it hard to believe that banks as successful and as sophisticated as these are not sifting through the mountains of data that they have access to as part of their brokering activities, as part of their handling passive investments in these markets, and that they are not communicating that with proprietary trading operations.

When you have affiliates doing a lot of different things, you've got lots of opportunities to benefit from all of that different information in the marketplace. And I think that we ought to have regulators take a look at that and determine how much of a concern that is to market integrity.

CHAIRMAN GENSLER: I thank you, Commissioner Dunn. I noted there was one question across the panel. I have to ask if we can try to just help us out, get our questions in. But, Commissioner Sommers.

COMMISSIONER SOMMERS: Thank you, Mr. Chairman. I just want to clarify back to my last

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line of questioning something that Mr. Slocum said in an answer, that you have a problem with swap dealers using the futures markets to hedge their risk, and I want to dig a little deeper there. You have a problem with them internally netting or you have a problem with them acting as an intermediary between these commercial participants?

MR. SLOCUM: From my understanding of the market, there are risks associated with them accepting bets from entities, particularly those entities that are not posting any collateral, and that the corresponding bets that are being placed in a regulated exchange are to shield the swap dealer from the risks associated with that trade. Is that an accurate description of what's going on? I've got folks at the table that probably could give me an accurate description of that.

MS. MASTERS: I don't understand the point, but that isn't an accurate description of what's going on. To reiterate, when we take unsecured exposure to a counterparty, after

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careful analysis, J.P. Morgan is at risk to the consequences of getting that analysis wrong, first of all, and not the exchange, and not a regulated market. What we are doing when we hedge our market risk position on the exchange is, we are laying off our exposure to, for example, the oil price. So our market risk is transferred to the exchange, the counterparty risk is retained between us and our over-the-counter derivative counterpart.

COMMISSIONER SOMMERS: Thank you. I also wanted to talk a little bit about both of your suggestions that we look through to the end user or your counterparties, and thought maybe it would be helpful if you compared it to on exchange business, and to ask you if what you're asking for is the same treatment that floor brokers get on exchange?

MS. MASTERS: Can you run that one by us again? Sorry.

COMMISSIONER SOMMERS: So that a floor broker on exchange is just acting as an

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intermediary, so they're not carrying positions and they're not subject to the position limit the end user, that they're acting as an intermediary for.

MS. MASTERS: Okay, now I understand, sorry. Just to clarify, we are not acting as agents, we are acting as principals when we operate in these markets. And the distinction here is that very often we assume basis risk between the risk we take on and the risk we lay off in the futures market or on the exchange, for example, the basis between long dated or short dated exposure, between jet fuel and WTI and so on. So we would have to use a language to translate our exposures that we assume in the over-the- counter land into futures equivalence.

Indeed, today, in your special call, you ask us to do that. So, for example, all of our business with airlines, for example, which is usually denominated in jet fuel over-the-counter, will be asked to be translated into futures equivalent contracts in either WTI or gas/oil, for

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example, and that is one translation mechanism that can be used.

So it's not quite the same treatment that somebody who's a pure agent would receive, it requires some translation, but there's an economic analogy, I guess.

MR. CASTURO: Yes, I would agree with that entirely. I really have nothing significant to add.

DOCTOR JARECKI: I'd point out for -- sake that those who like us buy only futures for our clients, while the fund that we do it in may have its own separate existence. We are fully, from an economic standpoint, fully agents for our clients.

CHAIRMAN GENSLER: Commissioner Chilton.

COMMISSIONER CHILTON: Thanks, Mr. Chairman. Do any of you believe that large OTC contracts don't impact or can't have a possibility of impacting the exchanges that we currently oversee, the regulated exchanges? Everybody believes that they can't have an impact, okay. So

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some of you, most of you I think, have called for OTC clearing of standardized products; how do we come up with that definition? What is a standardized product? And what sort of thing should we be careful about in developing such a definition? All of you.

MS. MASTERS: I'll take a stab at that. I think the risk of getting the definition wrong is that you encourage or force, in the worse case scenario, contracts that a clearing system or an exchange doesn't really have the tools to risk manage, to be accepted into that forum, and thereby, you undermine the stability of the clearinghouse itself, which obviously defeats the purpose and will create more systemic risk than you're avoiding in the first place.

So we need to start at a point of contract definition from the perspective of, are the sources of risk in that position adequately understood by a potential clearer, such that they are able to offer clearing services with credibility. And I think that it -- off the top

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of my head, I don't have the perfect definition, but I can conceive of coming up with definitions that would define standardized products as those where clearing services are offered by one or more central clearinghouse, where prices on those contracts are quoted by, you know, more than one entity, perhaps visible electronically or quoted by multiple parties.

Those types of definition would I think lead you in roughly the right direction. There's a lot more detail and work that would need to be done, but that's I think the sort of thing that would be feasible.

MR. CASTURO: I would add that the exchanges that were represented here yesterday, it's in their interest to try to define what standardized is and create futures contracts for anything and everything that would make sense to be cleared already. They've probably undergone that exercise and tried to do it, we know that they have. The risk is to try to force more things into that system that the exchanges already

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haven't tried would be at the detriment of taking away the flexibility, beneficial flexibility that we heard the commercial participants identify in using somewhat non-standardized approaches that are possible through the OTC markets.

MS. MASTERS: I would add just one quick thing, which is, by comparison to other asset classes in which derivatives are traded, as a general observation, commodity markets already use a higher degree of central clearing between counterparties than most other derivative markets have done historically, so we're well ahead, for example, relative to the credit derivative markets.

Perhaps that's a function of the volatility inherent in commodity prices, the less than stellar credit worthiness of certain commodity market participants because of their small sizes and so on. I can't give you a definitive answer, but it's certainly the case that a significant amount of clearing already goes on today.

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COMMISSIONER CHILTON: I want to just, and I'll get to Mr. Slocum, but Mr. Casturo, so are you suggesting that it would be a poor idea to let the exchanges determine what standardization is and clearinghouses determine what standardization is?

MR. CASTURO: No, on the contrary. I actually think it's a good idea. I think that's been there traditionally ---

COMMISSIONER CHILTON: Will that capture everybody that ---

MR. CASTURO: -- and they -- they're in the industry of trying to evaluate what makes sense to bringing an exchange.

COMMISSIONER CHILTON: But will that capture everybody that you think we need to capture? I mean they're going to do it only if it's economic for them. You know, we would be looking at it from a transparency perspective, a counterparty risk perspective, you know, we've got a little bit different motive that doesn't involve the world profit.

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MR. CASTURO: Yes, I recognize that, and I think from a regulatory perspective, your role is going to be very much enhanced by what we're proposing in terms of having access to the trades that are non-standardized that occur in the OTC space. You'll still have the reporting and the ability to monitor those activities even if they are not on an exchange.

COMMISSIONER CHILTON: Okay. Mr. Slocum, I'm sorry.

MR. SLOCUM: Yeah -- no; I think that it's very important that the CFTC be the entity making that determination of what a standardized versus a non- standardized OTC contract. I think that the potential for classifying contracts to avoid transparency and regulation is too important to leave that decision to exchanges. I would like to see the CFTC make that determination. I think that the basics of the administration's policy on this issue is an excellent beginning.

You know, I maintain that one way to create an economic disincentive towards finding

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complex ways to structure OTC contracts to make them non-standardized is to play some sort of margin requirement on non-standardized OTC contracts so that you don't have this issue where, as we've heard today, folks can go into the OTC market, put up no collateral, and become a market participant.

I also think that in terms of enhancing disclosure, I think that one thing I neglected to mention in some of my opening comments is adding more detail, or adding swaps and indexes on a company specific basis in the commitment of trader reports that the CFTC releases each week. I know that there are considerations now about enhancing the type of disclosure, and I think that that would be an important addition to those weekly reports.

COMMISSIONER CHILTON: Thank you.

CHAIRMAN GENSLER: Thank you. We are going to go a third round. I'm going to try -- I have five questions, I'm going to try to do two of them that you're going to maybe just follow up on.

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But these are really going to be, with all respect to Doctor Jarecki and Mr. Slocum, I want to just turn and take the opportunity to talk about over-the-counter derivatives regulation, because we have these two swap dealers in front of us.

I was encouraged, there's a lot that we believe working with Congress we have to do. We have to regulate the dealers and have a full regulatory regime. And I think I heard earlier, if you want to disagree, tell me, but that you're supportive of Congress moving forward and regulating the over-the-counter derivatives marketplace for capital and margin requirements for the dealers.

We are also calling for business conduct standards and transparency and record keeping and reporting, where the SEC and the CFTC would have a lot of authorities there.

We are also, though, calling for standardized products to come into centralized clearing and onto exchanges. And I'd like to -- my first two questions are focusing on some

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differences I think I heard. I think I heard generally support for a lot of that, but where there are two differences I'd like to get some thoughts on is, I think I'm hearing and reading in your testimony that you think on posting of collateral, that the dealer should do that, and maybe the dealer should do that possibly with some end users, but a lot of end users corporate customers shouldn't have to post collateral.

I think that -- and I'm particularly concerned because that seems like it might be a very significant motivation that everybody would try to say it's a customized swap with an end user and that we would not lower risk in the system.

And on that point, Ms. Masters, you actually said J.P. Morgan was at risk of getting it wrong when I think Commissioner Sommers might have been talking about this, but ultimately the America public are at risk of J.P. Morgan getting it wrong. Both of these institutions are large financial institutions that -- we can debate whether they're going to be systemically relevant,

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but I think most Americans would say if J.P. Morgan gets it wrong, the American public might be on the hook in some way. The second difference that I heard was something about exchange trading. I don't know if I really understood the point, but I heard Ms. Masters say at one point you're not sure the benefits of exchange trading for swaps, so I'd like to just hear that a little bit more if I misunderstood it. But I, for one, think there's a huge benefit for tens of thousands of end users to get the transparency from exchanges and seeing the standardized product and the pricing on a real time basis to see that.

It may shift the information advantage away from Goldman Sachs and J.P. Morgan to tens of thousands end users, but I see an advantage.

My third question, just for now, and then I do have two follow-ups then, is when credit default swaps. And, Ms. Masters, I understand you were actually at J.P. Morgan when these products were first formed and founded, so you have a personal and distinct history; I don't know if you

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would say you're a co-originator or innovative, but you were at least at J.P. Morgan when it was originated.

In these days, I don't know how much, you know, you want to take into the birthing of that product. But my question really is, beyond everything else we're doing, do you think credit default swaps have such unique characteristics that when we're working with Congress, there should be additional safeguards beyond everything else that we've talked about? So those -- I know it's a lot, but however you want to try to help us on these three questions.

MS. MASTERS: Okay. So if I understood it, the first question related to whether or not we agreed or fully supported the notion that all standardized contracts should be traded on exchange and/or centrally ---

CHAIRMAN GENSLER: That's correct.

MS. MASTERS: -- and/or centrally cleared. Speaking for J.P. Morgan, I can certainly reflect that we do support the mandatory

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clearing of standardized contracts between dealers and any other systemically relevant entity, whether they be a corporation, a hedge fund, or anyone else, to be determined as to whether they are systemically consequential by the appropriate regulator.

That makes sense to us, and that would attack and tackle and reduce the vast, vast, vast majority of the systemic risk in the system, certainly would have tackled the risks that have subsequently become infamous over the course of the last 12 months. We do have a point of difference, and that is that we do not believe that end users should be forced or mandated to centrally clear their business. And the reason for that -- they should certainly have the right and the ability to do that. But the reason for not mandating that is that many of our end customers, corporations, small and large alike, simply do not have the business model that accommodates exchange trading as a way of life.

And the most obvious area in which

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there's a difference is that typically, as I describe earlier, those companies need to pledge as collateral things like plant, property, equipment, commodity, molecules in the ground and so on, and those are just not acceptable forms of collateral for central clearinghouses or exchanges, and likely never will be.

If you remove the ability for those companies to tap into that sort of liquidity, you force them to curtail their business activities, they will have less access to credit, and generally this is a sector of the economy that is not overly leveraged presently.

CHAIRMAN GENSLER: If I might, isn't it true that they're currently being charged --- in their current swap business, they're being charged for the risk and also the credit, so they are being charged for that currently?

MS. MASTERS: Yes, absolutely.

CHAIRMAN GENSLER: Absolutely, that's what you -- but -- so what we're really just saying, as regulators and working with Congress,

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is, we want to lower risk on the standard product to be posting margin, like the futures exchanges, but on the customized products, then they would be posting margin, of course, with their counterparty, the swap dealer, or maybe it is non-liquid collateral, but having some lowering of risk through collateral arrangements?

MS. MASTERS: For the corporate end user, the distinction between a customized product and a standardized product in this context really doesn't make that much difference from the point of view of how easy it is for them to pledge liquid cash and government securities as collateral.

CHAIRMAN GENSLER: Did you have a view on credit default swap before Mr. Casturo? I'm giving myself luxury because I'm trying to avoid a fourth round. And I'll give all of you luxury, too.

MS. MASTERS: I think I understood the question to be whether credit default swaps have unique characteristics that ---

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CHAIRMAN GENSLER: Is there anything in addition that we should consider? Some people same ban them all together, some people say ban naked credit default swaps, some say you have to have insurable interest, but maybe there's some -- and again, it's just the coincidence that you were at J.P. Morgan when these were founded and I thought I'd ask you.

MS. MASTERS: I think that -- my view on the subject is that credit derivatives are a product that have enormous benefits and should not be ruled out of existence. And we need to be careful in distinguishing between the value of a tool itself and the propensity for individual companies to misuse that tool.

We definitely saw some instances of those tools being used very inappropriately from a risk and a systemic risk point of view during the course of this crisis. In my view, the way to tackle that is to ensure that major market participants, whether they're dealing in credit default swaps or any other form of derivative are

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appropriately supervised and regulated, and hence, our support for a systemic risk regulator, whoever that may be, to be determined, but someone to oversee the activities of systemically relevant companies in the over-the-counter derivative markets. I think that statement applies just as equally to interest rate swaps as it does to credit derivatives I don't think there's anything inherently or uniquely different about a derivative applied to credit as opposed to a derivative applied to equities or commodities or anything else.

MR. CASTURO: Yeah; two points I'd like to make. First of all, regarding non-standard products and whether they should be on exchanges or forced on exchanges, I want to make the point that we're not solely or even primarily arguing for our own self-benefit that these things should remain an over-the-counter transaction.

We heard the testimony of commercial participants yesterday that identified that the benefit the commercial participant gets by having

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this arrangement, and again, reiterate the notion of right way risk, that it's not introducing a greater systemic risk to the system because the capacity for these commercial participants to be able to make payment is in line with the way the market moves.

And, in fact, even though there are some charges involved with the way we treat these, they are lower than what they would be in a standardized exchange model, which actually benefits these commercial participants and ultimately benefits the users of the commodities that they produce, because lower cost to them equates the lower cost to the consumer. The second point I want to make is regarding the exchange trading for swaps and a potential information advantage the dealer may have by maintaining that environment.

I think we've heard the testimony here from just about everybody that we're all in favor of increased transparency. So to the extent that that swap activity has been shielded from public

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domain, we're offering that up in terms of special call data to be more frequently gathered and disseminated.

Although one point I would make is, we would -- we maintain that the confidentiality of any individual client always be maintained.

CHAIRMAN GENSLER: I fear my time is up, I'm going to hand off to Commissioner Dunn.

COMMISSIONER DUNN: Chairman has a great deal of prerogative when it comes to his own time.

CHAIRMAN GENSLER: You have as many minutes as I had, or more if you want.

COMMISSIONER DUNN: How many was that Jas, did you keep track? Let me zero again on Mr. Casturo and Ms. Masters. And Mr. Slocum had brought up the overlapping of activities of being a CPA, of being an advisor, predicting what's going to happen in the future, of having a trading arm within institutions, and then trading on behalf of counterparty ---

MS. MASTERS: There are several areas where firewall type concepts are applicable. The

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first of these is relating to research. So there's been some commentary around whether or not investment banks put out research and might have privileged access to that ahead of time, position themselves accordingly and so on.

As you know, there was a research settlement impacting the equity market some years ago. While those rules do not explicitly apply to commodity markets, certainly the practice at J.P. Morgan, and it is my understanding that it is the practice at other major investment banks, that similar rules are, in fact, imposed on the separation of research in commodities just as they are in equities. So, for example, our research ---

COMMISSIONER DUNN: Who oversees those?

MS. MASTERS: Internal compliance; so if our research department publishes something, it goes to the customer and does not go to the trading desk until after it's gone out to the broad customer base. One main area, as it relates to proprietary trading activities, those are

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walled off and separated from the client facing or market making desks. So, again, that is monitored or imposed by internal compliance to ensure that those separations are kept there. And there are separations and systems and other things, not just a physical separation of individuals.

MR. CASTURO: Goldman Sachs operates under the same principals. And with regards to research, that distinction and firewall separation between the research arm and the trading arm, though it's not currently mandated, it's been withheld at Goldman to the same standards as it is within the equity markets.

MR. SLOCUM: May I just add something? I think that, with all due respect, I think that internal controls like that are completely meaningless. With no penalties for non-compliance, with no third party assessment of these internal controls, I think that there are serious risks to the public and to market integrity unless we've got government regulators drawing up these rules, enforcing these firewalls,

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again, with all due respect. But I just do not think that internal firewalls have a history of being effective in industries.

MS. MASTERS: You've obviously never experienced them, but to the extent that they were regulatorily imposed, I don't think that would be a problem.

MR. CASTURO: Agreed.

COMMISSIONER DUNN: When we did our special call, we found that some of those folks that we had categorized in one area were, in fact, should have been categorized in another area. Who do you feel should be responsible for the delineation of what category you fall in; should it be the CFTC, should it be the -- if you're representing a group of folks, the persons that represents them, or individually? And I'd ask for all of you on that.

MR. CASTURO: I think the regulator is in the right position to make that distinction. Obviously, it would be done on a basis where they would need to quality by certain criteria to be

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classified in a certain category or not.

MS. MASTERS: I agree.

DOCTOR JARECKI: There is a bit of a problem, I think, because there is an effort, I know, on the part of the administration to harmonize the activities of the securities regulators and the commodities regulators. And even in these concepts, we have here the concept that the non-commercials are speculators, whereas in the SEC definition, there is a distinction made between speculators and investors.

The general -- of course, we recognize we're in a funny world, I appreciate the Chairman's concern that this not be seen as a price control discussion, but we really can't ignore the fact that the stomach of probably everybody is, wouldn't it be nice if commodity prices were low and security prices were high, and how can the human race, when it has that feeling in its stomach, really ignore that when it's trying to regulate?

I apologize, I'm not trying to argue

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with the Chairman, but recognize your own stomachs and you will see the merits of that worry.

COMMISSIONER DUNN: I argue with him all the time, that's fine. I just got a statement here that Mr. Slocum, in your prepared testimony, say Public Citizen was similarly encouraged by the Obama Administration's plan, developed the support of the CFTC to establish regulatory proposals for over-the-counter derivatives markets that would require other things, all standardized OTC energy contracts to clear through the exchange related by the CFTC. Well, you're saying it's the CFTC support. What we have was a letter from the Secretary, the Treasury, to some members of Congress that outlined how we might operate.

We are an independent body here. Each of these Commissioners may have different thoughts on that. I happen to set on the dias as the Acting Chairman with Chairman Shapiro and Secretary Geitner, release that, now that, after the fact, I can tell the rest of the story.

I got a good deal of encouragement and

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information on derivatives from our now Chairman, and I appreciate that. In exchange, I let him in on the intricacies of the wheat convergence, so it worked out. But please keep in mind that the Commissioners all have their own thought on these things, and when things come out and says the Commission says this, the Commission -- find out who the Commission is.

MR. SLOCUM: My apologies. I should not have indicated that the independent Commission was in lockstep with the administration, but rather in consultation with the administration on providing maybe input and feedback on the development of policies.

CHAIRMAN GENSLER: I again find myself in association with Commissioner Dunn, as I did yesterday, on the subject of co-location, which was my fifth question, but he got my fourth one, so hopefully somebody will get it. We'll get back to co-location. Commissioner Sommers.

COMMISSIONER SOMMERS: Thank you, Mr. Chairman. I wanted to ask both Ms. Masters and

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Mr. Casturo about global standards, and when we are looking at all of these different issues, not just position limits, but looking at standardization of OTC derivatives and just the overall regulation of OTC derivatives, I'm assuming you both operate globally, and if you could just comment on the importance of global standards.

MS. MASTERS: They're critical. If you have inconsistent rules, business will, like water, flow to the easiest way out. And if you have certain regimes overseas that are not as transparent, but easier to execute in, because of the absence of limits and regulation, whether we like it or not, and this is not a threat, it's not if you do this, then we will go there, it's a prediction, the business will flow there. And there are a number of commercial entities around the world that are eyeing with interest these developments, with a view to seizing the commercial opportunity to essentially steal away the lead that the American futures and derivatives

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markets have if there is inconsistent application. So I think it's -- and the negative of that would be that business would end up being done in jurisdictions where there's much less customer protection and less transparency, and it may end up being done by non-U.S. persons, depending, which would obviously be a massive competitive loss for this economy.

MR. CASTURO: I would agree that it's critical that there's a consistent approach. It's very much akin to the situation between the futures market and the OTC markets. If you have two different venues to which trading can occur, whether that's in format, like futures or OTC, or in location between different jurisdictions, it's not a good situation if there's different policies applied to them.

DOCTOR JARECKI: -- one last comment on that, which is that you can't ignore the fact where the customers come from. We've given a list of the categories of our customers. Forty-five percent of our customers are foreign. For foreign

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customers to use foreign exchanges, with that reference to the United States, it would be trivial. It's sort of a fluke almost that so much of this business today moves through American enterprises, and that risk exists. And, as Ms. Masters says, it's not a threat, it's just reality, if they can't do it here, they'll go do it somewhere which doesn't touch the United States, because the foreigners themselves are involved.

CHAIRMAN GENSLER: Commissioner Chilton.

COMMISSIONER CHILTON: Thanks, Mr. Chairman, thanks for doing the last round, and I don't have anything after this. And I also ask my colleagues' indulgence to some extent. I want to go a little bit off subject here; first Mr. Slocum.

You've talked about the need to do -- have congressional statutory changes also in the OTC market. One of the things that was included in the House bill out of the AG Committee, it was approved by a bipartisan basis, was the ability

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for the CFTC to have criminal authority. And, you know, it's very difficult, these are complicated markets, and when we have to take a case, bring a case to court, we often go to the Department of Justice or other criminal authorities and they reject roughly two-thirds, roughly two-thirds of the cases are rejected, not because they're not meritorious cases, in fact, 100 percent of those cases, 100 percent we win, but they're just very complicated, and you have these U.S. attorneys and others who maybe don't understand all these laws, et cetera, so that's a change that they put in the House AG Committee bill, and I'm wondering whether or not you've taken a look at this and if Public Citizen thinks this is a good thing for Congress to do also.

MR. SLOCUM: Yeah, Commissioner Chilton, we have taken a look at that provision, and we strongly support granting the CFTC criminal authority in that. I think that, in addition to the fact that too many referrals to the Department of Justice are rejected, not because the case is

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meritless, but because the DOJ does not fully understand the issue, but also, it would vastly strengthen the hand of the CFTC and your market monitoring staff.

If you confront entities that you suspect of violating the law, and you come to the table with criminal authority, that is a very strong negotiating tool, understanding that not all prosecutions end in a trial or -- but are often settled, I think anything we can do to strengthen the hand of regulators in dealing with, you know, often what are very sophisticated, deep pocketed entities, I think is required.

COMMISSIONER CHILTON: Thanks; do any of the other panelists disagree with the general thrust of what Mr. Slocum said? Everybody agrees? Okay. The last thing I wanted to say is, you know, it's tough, Doctor Jarecki, at times to be commodity blind and to be price neutral, but maybe not as tough as people would think.

I mean, you know, we all fill up our cars with gas and everything, but people make a

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living, farmers like high prices. I've worked for farmers before, dirt farmers, people who barely make a living, so they wanted high prices. You know, in the job that you're in, you have to make those distinctions, and I found it a lot easier than I thought actually.

And so what concerns me is not whether or not as much as they're high or they're low or if it's this commodity or that one, but ensuring that the markets are operating efficiently and effectively, that we're doing everything we can, not just to react to problems that we see, not to get a report and then react to it, but to look around the corner, to be nimble and quick, and I don't think we've done that as regulators, not necessarily anybody on this panel, but in general, in the last, you know, dozen years. I think we've been a little bit more lax, and maybe there were some good things that came about of that, but there's also collateral damage that lays all across the economic landscape from that sort of approach. So I think what we're doing now is

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being a little bit more proactive, I think that is a shift in general, not necessarily just here, but in government.

I do support many of the things the administration proposed with regard to the Reg Reform Proposal, and I think it's a good thing. I think it's a good thing for markets and I think it's a good thing for consumers, too. Thanks.

CHAIRMAN GENSLER: Thank you, Commissioner Chilton. We're not going to have a fourth round, but I've gotten permission from a number of my Commissioners, I didn't ask Bart. I just want to mention the fourth question I had Commissioner Dunn raised, and I think it's a very important one about firewalls, and I was encouraged by what at least two large banking institutions said on that subject.

But I think that the Commission will probably move forward and sort of think more about this and whether, in a regulatory context rather than a voluntary context, we try to put something appropriate under our statute in place. And the

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fifth one is just -- is a follow-up, if you can come back to us, and it's really to the two panelists in the middle. But yesterday, again, Commissioner Dunn had raised it, but it was something very much in the newspapers, as well, about the location, it's a very technical thing, the location of terminals, or the co- location of servers for big investment banks and banks near the servers of the exchanges themselves, what's called co- locations, so that you could get advantages and rapid advantages that might be down into the milliseconds, and so that markets are fair to all participants and not just the one that has the computer three inches away from the server instead of 100 feet away from the server.

I certainly associated myself with Commissioner Dunn yesterday, and I think this Commission is going to want to talk to the exchanges and talk to the market and really understand whether it's appropriate and whether there needs to be some standards set so that there's, you know, in the concept of what's called

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co-location or rapid transaction.

MS. MASTERS: That was actually news to me for the record.

CHAIRMAN GENSLER: News?

MS. MASTERS: The existence of, or the embracing of co-location opportunities.

CHAIRMAN GENSLER: Well, maybe one of your competitors had something on you there, Ms. Masters, I don't know.

MS. MASTERS: They -- apparently it explains a lot.

CHAIRMAN GENSLER: I see; I don't know if Mr. Casturo wants to respond to Ms. Masters on that.

MR. CASTURO: No, I have no comment.

CHAIRMAN GENSLER: I see; that maybe explains a lot.

MR. CASTURO: As you suggested.

CHAIRMAN GENSLER: Well, we'll be looking into that then. But I think this has been enormously beneficial to the public, to the Commission, it was to inform the public, inform

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the Commission. There are a number of areas where there's support for moving ahead from position limits, and as we know, there's a number of differences, but it's all in all very helpful. We're going to take a short break, five to ten minutes, but no more than ten minutes. We just need to give everybody a chance, but then if our other witnesses can come up and -- we thank everybody for their patience.

(Recess)

CHAIRMAN GENSLER: I thank you for that recess. I'm going to call the Commission back in order or whatever our lawyers tell me I'm supposed to say somewhere here, David usually tells me. If we might turn to our next panel of witnesses, as I did earlier, and I thank you for having the patience to sit through a full, but a very helpful panel. Your written statements will be in the record and we'll keep the record open, as well, through August 12 for any additional follow-up, but if you could try to help us and summarize your statement. We've all had an opportunity to read

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it even if it was a little late last night. But summarize in five minutes and then we'll see how many rounds we need for the Commissioners. But Mr. Lothian.

MR. LOTHIAN: Lothian.

CHAIRMAN GENSLER: Lothian, thank you, all right.

MR. LOTHIAN: My name is John Lothian and I am here as a participant and observer 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. 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 the 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 percent of the volume of all yearly futures traded globally.

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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.

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 of 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

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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 the 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

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goal, thus reducing demand for the high priced 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 competing substitutes. The best cure for high prices is high prices; 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 that they are intended to be.

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

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Carter's administration shut down trading for several days and 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 trade 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 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

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market of the 1860's simply moved to an over-the-counter market.

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 1800's.

Finally, 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 the true limits of speculation on commodities with a finite supply.

CHAIRMAN GENSLER: Thank you, Mr. Lothian.

MR. LOTHIAN: Like Midlothian.

CHAIRMAN GENSLER: Lothian; that works, too.

MR. LOTHIAN: Yes.

CHAIRMAN GENSLER: Mr. Krenkel.

MR. KRENKEL: Mr. Chairman and members of the Commission, my name is Peter Krenkel, I am

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the President of Natural Gas Exchange, Inc., also known as ---

CHAIRMAN GENSLER: You might want to move the mic a little bit closer.

MR. KRENKEL: Is that better? I am the President of Natural Gas Exchange, Inc., also known as NGX. We are a Canadian company based in Calgary with an office in Houston and have been operating in electronic trading and clearing facility for energy products since 1994.

We are a wholly owned subsidiary, the TMX Group, which is a leading integrated multi class asset exchange group with a history that dates back over 150 years. The group subsidiary operate cash and derivative markets for multiple assets classes, including equities, fixed income, and energy, and provide trading markets, clearing facilities, data products and other services to the global financial community. On behalf of NGX, I want to express our appreciation to the Commission for providing us with an opportunity to participate in the hearing here today.

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As I mentioned, we provide trading and clearing services for natural gas, electricity, and oil products at various markets in North America. The focus of our business is in the physical energy space, specializing in physical clearing of natural gas contracts. Our products are designed to be fungible with the OTC markets.

We have a combination of reasonably well established, but also operate a number of emerging marketplaces. In terms of size, we're a relatively small player in the overall North American energy markets, but are very significant in the Canadian physical markets.

Our traded and cleared volumes are currently 1140 BCF a month of natural gas, which we're very proud of, and it's a big number by Canadian standards, but represents about one day of activity on the CME or ICE. In addition, five terawatt hours of electricity and five million barrels of crude oil. Just as a matter of interest, about 50 percent of Canadian gas and oil production is actually exported through the U.S.,

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so our energy markets are extricably linked, even though we're located in Canada.

With respect to the issues here today, rather than read, I thought I should summarize exactly what I think our positions are. First of all, with respect to significant price discovery contracts, we encourage the CFTC to get the scope right.

We do operate a lot of emerging contracts, and I don't believe that they would necessarily be considered significant. So we may have a few contracts that are deemed significant and meet all the other criteria, but a lot of the emerging contracts were really trying to just gather business from the OTC markets. Putting limits into place for those may not be appropriate.

With respect to position limits, we agree that -- we agree with position limits for spot contracts and crude oil and natural gas, that means up to the prompt month. We also believe that the CFTC is the right authority to set those

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limits, to ensure that they are fair and transparent. The only comment we would make is that the limits may need to be flexible and responsive as market conditions change. With respect to anything forward, beyond the spot month, from an NGX perspective, we have very low market share there. Putting position limits in applicable to our exchange only would perhaps serve to just drive that business away from the exchange. So unless the position limits can be applied to the OTC markets, they don't really make sense for the amount of business we have in our exchange.

As far as the so called hedger exemption, again, with respect to our business, we have seen some non- commercial start to participate in our market. They bring the welcome liquidity that's badly needed in some of our energy contracts. Without liquidity, the business tends to move into the bilateral or the OTC market, so in order for the exchanges and the clearinghouses to be successful, we need

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liquidity.

At present, the hedgers, we've not seen nearly the volume impact that some of the other exchanges have, and our view is that, at this time, there's no real need to change the hedger exemption requirements applicable to our markets.

Again, I think this is in addition to the testimony I filed, okay. I'll close here. And I want to thank you for the opportunity to share our views today, and I'm happy to answer any questions that the exchange may have.

CHAIRMAN GENSLER: Thank you so much. And our last witness, Mr. -- is it ---

MR. FELESKY: Felesky.

CHAIRMAN GENSLER: Felesky.

MR. FELESKY: Thank you, Mr. Chairman and fellow Commissioners. My name is Adam Felesky, Chief Executive Officer of BetaPro Management, Inc., the Trustee and Manager of the Horizon BetaPro ETF's, which are listed on the Toronto Stock Exchange and are the fastest growing family of exchange traded funds in Canada.

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I'd first like to thank the Commission for this opportunity as an international ETF provider to share our views as relates to the Commission's review of the application of position limits and exemptions in the energy marketplace.

Specifically, we support any regulatory action that would improve transparency of all market participants, including ETF's in order to eliminate the potential for excessive speculation and market manipulation. The Horizons BetaPro ETF's currently have assets in excess of $2.5 billion amongst 38 ETF's, 14 of which are commodity based and six of which are specifically linked to natural gas and crude oil. We specialize in offering currency hedged exposure, both long and short, and we're the first managers to offer such products for commodities in North America. All of our ETF's are rebalanced daily, which limits an investor's risk to the capital invested.

Several of our commodity based ETF's have been or are the most actively traded

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securities on the Toronto Stock Exchange, and currently they count for over 37 million shares traded each day. This translates in tremendous and substantial daily liquidity into the underlying futures market.

Our commodity based ETF's are in the aggregate investments of thousands of investors acting independently. And to our knowledge, no one investor has indirectly obtained a significant position in any one of our commodity based EFT's. As an example, as of July 24, 2009, our energy long EFT's, which had on average 35,000 unit holders per ETF, held less than.51 contracts per investor.

In addition, a majority of our commodity investors use our short ETF's to hedge the risk in their long equity portfolios. As a further illustration, I'd like to speak to the role our commodity ETF's had during the 2008 price appreciation of crude oil to the high of $147. We ironically launched the first leverage long and short crude oil ETF's in North America on January

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16, 2008. On that date, the price of oil was roughly $90.

On July 11, 2008, when crude oil peaked at 147, only six months after we had launched these products, our Horizons BetaPro NYMEX crude oil Bull Plus ETF held less than 100 million in notional long exposure or 450 contracts, while our Horizons BetaPro NYMEX crude oil Bear Plus fund had soared to approximately 600 million in notional short exposure, or short 3,850 contracts.

Clearly, our investor saw a significant opportunity to hedge their long equity positions after such a dramatic increase in the price of crude oil. Our data continues to show that our commodity based ETF's attract sellers when commodity prices are rising and buyers when commodity prices are falling.

Instead of being a source of volatility, our commodity based ETF's have proven to be a source of price stability. For example, our designated market maker has seen trading activity levels were on counter to the price of crude oil

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69 percent of the time since the inception of our ETF's. To address the Commission's primary concern regarding transparency and disclosure about the positions held by individual investors, we believe the focus should not be on the holdings of the ETF, but on the holdings of its individual investors.

To void any concerns about excessive speculation or market manipulation, we suggest the CFTC might want to consider the following; one, requiring disclosure to the CFTC by ETF's of any investors who indirectly hold investments with a dollar value that is more than a specified level of the speculative limit on a regular basis; two, mandating any investor in such ETF's to notify the manager if their investment at any time exceeds 100 percent of the current dollar value of the speculative limit; and finally, three, requiring the managers of such ETF's to have the ability to force an investor to redeem all or a portion of their investment so that investors do not exceed any speculative limit adopted by the CFTC.

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We believe that implementing these requirements, which will require the involvement of the applicable regulatory authority such as the SEC, and in our case, the Ontario Securities Commission, can provide a viable solution whereby the CFTC can effectively monitor the users of ETF's without having an adverse impact on the marketplace. In summary, we strongly believe that our commodity based ETF's provide a cost effective, transparent, liquid, limited risk alternative for investors who want to access the commodity markets while playing an integral role in enhancing the underlying liquidity of those markets.

We also believe our commodity based ETF's are one of the most accessible investment tools for the public who want to hedge against potential commodity appreciation. To ensure there are no concerns about excessive speculation, market manipulation regarding ETF's, we fully support any regulatory effort to increase transparency of individual investor positions

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within ETF's. Thank you, and I look forward to your questions.

CHAIRMAN GENSLER: I thank our panelists. I'll try to also live with the five minute rule and we'll see how many rounds we have. Even though the day is going on, we might have a couple of rounds here. I was interested a little bit, Mr. Krenkel, in what you said about operating your exchange. You said that you're supportive of setting position limits in the spot month or near month, but I'm not sure I really followed where you were on sort of a combined month approach, and if you -- because so often where you sit is where you stand. If you had our job, would you be looking at setting position limits on a combined month basis to protect against concentrated economic effects in these markets?

MR. KRENKEL: Right, yeah. We have, just to give you a little perspective on my answer, we have the bulk of our liquidity ---

CHAIRMAN GENSLER: Again, you might pull that a little closer.

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MR. KRENKEL: -- the bulk of our liquidity is really in the spot contracts on natural gas. And we have a very large market share with the OTC market there. It makes sense from our perspective to put position limits into place from a market perspective, also from a clearing perspective. Once we get beyond month two, we have a very small level of liquidity.

CHAIRMAN GENSLER: No, I understood that you all had a small liquidity, so it might not be as relevant on your exchange, so I was looking for if you -- as a market participant and in knowledgeable markets, what do you think is appropriate?

MR. KRENKEL: Right, yeah. I think if you can manage those limits across the OTC market, then they can be effective. If they apply to the exchange business only, you've recreated sort of an unlevel playing field.

CHAIRMAN GENSLER: I think I understand. So, yes, if we could do position limits that include over-the- counter derivatives, as well,

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and find a way to do that ---

MR. KRENKEL: Right.

CHAIRMAN GENSLER: -- but your concern is greater if it was only on the traded markets?

MR. KRENKEL: Yeah, that's correct.

CHAIRMAN GENSLER: Mr. Felesky, in reading your testimony, you talked about a concern of what you said fractionalization, and our earlier panel of witnesses, one member talked about splintering of the market, and I'd like to explore that a little bit more, because I think if you had a diversity of investors, diversity of speculators in a market, that the market might -- that might promote liquidity rather than having one or two or even three large participants who, in a sense, are so concentrated, they might be detracting from markets rather than enhancing markets. So I'd just like to understand your thinking.

MR. FELESKY: Sure, thanks for the question. I think what we're referring to is, if position limits were imposed and they were done at

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the ETF level, for example, the majority of our clients are Canadians, if the limit was imposed on the ETF level, there would be the potential, depending what that limit was, that we would have to take our existing exchange rate fund and create five or ten versions of that same fund to facilitate the demand for those same investors.

So it's a fractionalization of the ETF's themselves. I don't see the end user being a greater amount of individuals just because you've increased the amount of ETF's. I think the end user is still the same people. So the result is a way higher burden of cost to the investors because you don't have the economy scales of that ETF.

CHAIRMAN GENSLER: But our agricultural federal limits originally were set at ten percent of the open interest up to a certain level, 25,000 contracts, and two and a half percent afterwards, so one could think there has to be at least a minimum number of ten or 11 speculators on any side of the market because the inverse of ten percent. Are you suggesting that a market that's

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concentrated that only has three speculators is more liquid than if you have 12, 15, 20?

MR. FELESKY: Absolutely not, I completely agree with your comments. My point is, we have -- let's just take an example. For our natural gas products, we have 40,000 unit holders. If we have -- if we create ten more of those same ETF's, those 40,000 unit holders will just be divided amongst those products, because they'll have all the same investment objectives. So if the 40,000 went to 50,000, which is more unit holders, more speculators, that's a good thing, that's no different if it -- the effect into the market is no different if it's one ETF or across ten.

CHAIRMAN GENSLER: I'm going to switch over to Commissioner Dunn, but I may follow up after at my next chance.

COMMISSIONER DUNN: Thank you very much, Mr. Chairman. Peter, you are -- your home regulator is from Alberta, Canada, is that ---

MR. KRENKEL: Yeah, the Alberta

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Securities Commission, yes.

COMMISSIONER DUNN: Alberta Securities Commission; but you are also an ECM and recognized as a DCO?

MR. KRENKEL: That's correct, yes.

COMMISSIONER DUNN: Okay. I'm interested to know how that works.

MR. KRENKEL: Yeah; it's pretty manageable for us as an organization. We, you know, we're domiciled in Canada, we're in the province of Alberta, hence, our lead regulator is the Alberta Securities Commission. Their rules and principals are actually quite closely aligned with those of the CFTC. We have clients, you know, both sides of the border, do business across the border, and so we chose the path of seeking recognition with the CFTC, as well.

COMMISSIONER DUNN: When we promulgate new regulations or change things, how does that work with you and your lead regulator?

MR. KRENKEL: Well, I think, you know, we'd have to understand exactly what direction you

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were going, but it would apply to all our market participants. We'd have to make, you know, the necessary rule book changes and get our regulator to cooperate with you.

COMMISSIONER DUNN: So you are saying in this age of globalization, it is really important for us to have a good relationship with our sister regulators in other countries; is that ---

MR. KRENKEL: Yeah, and vice versa.

COMMISSIONER DUNN: And vice versa. We often hear that, when we do something here in the United States on our regulation, that that is going to result in flight, that someone is going to go to another country, and you've got a home base, or you've got an operation in Houston; is that ---

MR. KRENKEL: Yes, we have an office there, yes.

COMMISSIONER DUNN: -- as well; do you see that as a viable threat, that if we make things too onerous in the area of position limits or other things, that folks may run to Canada to

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other countries?

MR. KRENKEL: No, I don't think that's likely to happen. Certainly, I don't think they can run to Canada. There may be other places in the world that they can go to. My concern is more that they'll run away from the structured markets into the OTC market either in Canada or the U.S.

COMMISSIONER DUNN: Adam, do you have some thoughts on that?

MR. FELESKY: That's really outside of our expertise as an ETF provider.

COMMISSIONER DUNN: John, I appreciated your paper, and we've been referring to spec limits as kind of a stop sign. You're calling it just a speed bump. Could you kind of amplify on that a little bit?

MR. LOTHIAN: Well, if I can't --- if there's a limit here, you know, say there's a limit in wheat, I'm going to go find another wheat market where I can lay off some of the positions to get that same exposure. Wheat, on a global trade, for example, is a very fungible product.

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Every country grows it and uses it.

Back when --- referring to the grain embargo of '79, there was a USDA study that found that basically it's a fungible product world-wide, and so us not selling to the Russians actually didn't deprive them of any wheat, it just meant that a bunch of other trading partners traded here or there. So if that's what's happening on a commercial basis, that's what's going to happen on an investment hedger basis, as well.

The, you know, if I'm a fund manager and I'm up against position limits, I'm either going to go to the OTC market to lay it off or I'm going to go find another venue in a regulated market in another location in order to do it. I'm not going to send the money home, okay, I'm going to find some place to invest it.

MR. FELESKY: Commissioner Dunn, I would just add to that as -- John referred to the fund manager. At the end of the day, the fund manager of the ETF, the speculator is going to go where there's liquidity. So the question is, if any

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regulation was imposed that was so dire that the liquidity moved somewhere else, and then I think it becomes more of a risk that the flows move elsewhere, but until the liquidity moves elsewhere, no one is going to move their business elsewhere. So it's a chicken in the egg, and I think it's going to be more of a function of the policy and how aggressive it is.

CHAIRMAN GENSLER: Commissioner Sommers.

COMMISSIONER SOMMERS: Thank you, Mr. Chairman. I think I want to follow up on the same line, but a concept that Mr. Lothian had in his testimony with regard to exposure through cash settled contracts rather than the physically settled contracts, and to talk a little bit about whether or not that is appropriate for people that are just looking for passive exposure. If they're out of the physically delivered contract, does that help?

MR. LOTHIAN: Well, I think it does. I mean the issue is that we've seen some of these physically deliverable contracts have tremendous

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exposure to this investment money. I think that that has changed the behavioral aspects of some of those commodities, because such a large dominant player is not acting by the rules of the market that I grew up with, okay. When the market goes up, you take profits, okay.

So basically, to use the wheat example again, you have an index investor coming in investing across a broad index, price of wheat goes up, some other things might go down, some other things might go up, we're not responding like a traditional speculator and selling out the wheat and taking profits, they're looking at the entire index as a whole and saying, oh, things are going up, we're going to invest more money.

And so you've got this aggregate demand type of approach to commodities as an asset class, which I believe has changed some of the dynamics of some of the markets. The markets are adapting to that, but it becomes critical when you get into the delivery period. And so I think cash settled contracts as proxies for that investment money is

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a good thing so as not to interfere with the delivery process.

COMMISSIONER SOMMERS: Thank you. Can the other panelists address that and what you think about -- especially Mr. Felesky, the passive investment in cash settled contracts rather than physically settled?

MR. FELESKY: I think a lot of the panels yesterday and this morning spoke to the fact that, in particular our business, in commodity exchanged traded ETF's, our funds, for the most part, are positioned in the nearby futures contract on the long side. And the effect, if any, is to, when we roll, is to sell the nearby and buy the next one. So the net effect to the end consumer in the physical market, if anything, is a downward pressure on the nearby contract.

MR. KRENKEL: I've got nothing further to add.

MR. LOTHIAN: I'd just like to add to that, though, that in some instances, the index

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players have become such large, dominant players that they are the fundamental in the marketplace, and so the traders are playing the role, as it were, for the index players because that's the dominant theme in the marketplace, that's the dominant flow in the marketplace, as opposed to perhaps the cash futures convergence, and so that element of it can get overwhelmed. In fact, you know, several years ago, when we saw wheat prices spike, part of the problem was that the pit traders were all situated one way in the market to take advantage of the role, and when Australia said, hey, we have some problems with our crop and some other problems cropped up around the world, and all of a sudden the nearby prices shot up and these wheat traders lost not only what they made this year, but what they made last year, as well, thus decreasing the available capital to, you know, absorb, you know, fluctuations in the market.

MR. FELESKY: If I could just add, because I think this is a discussion that's had a

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lot of commentary from the perspective of index players and commodity ETF's and their impact and roles; the one thing that I think everyone has to remember is that specifically contango, which is the term referred to, futures prices being higher than the nearby, it's something that's existed in the marketplace forever. In fact, crude oil is in contango 60 percent of the time, and natural gas is in contango over 80 percent of the time. And then in particular, when you see huge price appreciations, you'll tend to see larger backwardation than the historic norms. Conversely, when you have huge price depreciations, you're going to see larger contangos than the norm, and that's just factually --

CHAIRMAN GENSLER: Commissioner Chilton.

COMMISSIONER CHILTON: Thanks, Mr. Chairman. Mr. Felesky, you've talked about individual investors being monitored by the agency, but is there some level at all that you think ETF's should be monitored? I mean at what

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point --- do you think there should be some additional regulation or do you think there shouldn't be any at all?

MR. FELESKY: I mean I really don't see us any different in some ways as the swap dealer or the exchange that's effectively processing trades. We, as an entity, are not making any investment decisions, we're just an aggregate of these thousands of investors. And if you impose the limit specifically on the ETF itself instead of the individual, I think you discriminate against that tool versus the futures market, for example.

COMMISSIONER CHILTON: Eighty percent of open interest is okay?

MR. FELESKY: Our view is that it's all about the end user, and that if the end user is using the instruments to achieve a position that exceeds the speculate limit that you set, absolutely, they should be forced down to reduce their position.

COMMISSIONER CHILTON: Do you believe

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that accountability levels have any deterrent effect on ETF's trading currently?

MR. FELESKY: I think they do. I think everyone looks at different marketplaces to ensure that their exposure isn't concentrated in one exchange.

COMMISSIONER CHILTON: How about the other panelists on that sort of line of questioning? Mr. Lothian Mr. Krenkel.

MR. LOTHIAN: Well, the question that I ask is, can I, as an investor, accomplish what I want to accomplish in a different way? Can I substitute an individual account with a broker buying gold as opposed to buying gold ETF, and the answer to that is yes, okay. So what we have done is, we have created products which have made it easier for people to be able to accomplish specific investment goals.

If we prevent them from making it easier, are they going to stop doing that? No, they're just going to have to pay a little bit higher price or do it in a different way. Now,

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futures trading is not for everyone, okay, that's one of the reasons why we have products like ETF's that take some of the risk out of that and manage it in a better way. Index funds do the same type of a thing, particularly where they're having investors put up 100 percent of each and every contract trading. So they're doing it in a slightly different way that perhaps is a better risk profile for those particular customers.

But are those customers, are those investors going to say, well, you know what, China is accumulating large amounts of commodities, and I think that this is going to go up for a while, and I think the price of the dollar is going to go down, and I want to own commodities. Now, am I going to be stopped from doing that because I can't buy an ETF? No, I'm just going to go into something else.

COMMISSIONER CHILTON: Mr. Krenkel.

MR. KRENKEL: Yeah; I mean we haven't seen the impact of the ETF's on our market that perhaps some of the other market participants have

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seen, so we don't really ---

COMMISSIONER CHILTON: And you're mainly spot month anyway.

MR. KRENKEL: Exactly; and spot month and in sight, so it's not a big concern for our market. But, yeah, my concern would be if they are faced with position limits, does that just result with them moving their business somewhere else?

COMMISSIONER CHILTON: I mean just something for you to think about. I mean, to me, 80 percent of anything is too much, so ---

MR. KRENKEL: Yeah.

COMMISSIONER CHILTON: But if you have a large percentage, and whatever number it is, and people understand that you have this large percentage, in part because with an ETF, you're reporting, it's more transparent, which I think is good, and everybody knows when you're going to do your role, you have to be crazy not to be thinking about that if you're in the market. So I think it's having -- it can have at least a theoretical

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possibility of having an impact. Anyway, my time is about to expire, I won't let it beep on me.

MR. FELESKY: I don't think any of us would deny that there's a theoretical impact; in fact, there is an impact. But I think the beauty of the marketplace, particularly our marketplace in the commodity exchange rate fund is, it's completely arbitragible between the physical market, and this whole role phenomenon I think is being dramatically overplayed as the physical market can quickly take advantage of that, and we saw that this spring with people putting an immense amount of commodity, particularly crude oil, into storage.

CHAIRMAN GENSLER: If I could ask Mr. Lothian; did I get it?

MR. LOTHIAN: You can't say it, can you?

CHAIRMAN GENSLER: John.

MR. LOTHIAN: John.

CHAIRMAN GENSLER: How do you pronounce your name?

MR. LOTHIAN: Lothian.

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CHAIRMAN GENSLER: Lothian; Mr. Lothian, do you think that, as I'm hearing this back and forth and reading your testimony, did I hear that you feel that index investment has had an influence on the marketplace?

MR. LOTHIAN: Yes.

CHAIRMAN GENSLER: And as it relates to the wheat market, if I can just get your expert advice there, do you think that it's been a contributing factor to the lack of wheat convergence at times, you know, in this past couple of years as wheat convergence problems have existed?

MR. LOTHIAN: I think that there's a number of factors that are involved with the wheat convergence problems. I think that the large passive long in the market is a factor. You know, one of the things that I believe has happened because of the billions of dollars that have flowed into index funds is that, you have an algebra problem, okay, you have a lot of X and not enough Y, okay, and in particular, because you've

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had all of this money flow in, you kind of have a natural balance of long hedgers and short hedgers, okay.

So here you have a natural long, passive, non- manipulative that's in the marketplace, and there's a natural short hedge that's going to participate in the market that's going to match up with that long hedge, okay. So as you get more and more money flowing into this market, the quality of the short hedger capitalization, you know, whatever, decreases, okay. And that, I believe, leads to increased volatility, okay.

There's other things that, you know, is there a concentration in, you know, in the grain elevator business and all of that, are there enough locations that are actively participating in this, are those locations making more money pumping out corn, you know, through them, or soybeans, or other products as opposed to wheat? It's great that, you know, you can make a nickel, you know, storing wheat, but can I make a dime

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three times over doing something else? And if you don't have enough capacity to be able to switch and manage that, then you're going to have some problems.

You know, there's a lot of participants in the market. I mean we talk about high frequency traders and all this kind of stuff that are participating in the market that are just looking for certain algorithms and patterns and all of this kind of thing as opposed to people that had more of an opinion about the market.

CHAIRMAN GENSLER: Let me, because I might only get one more question, so I thank you, but I heard a yes, you think that ---

MR. LOTHIAN: It's a factor.

CHAIRMAN GENSLER: -- it's a factor. Could I turn back to Mr. Felesky and follow up on Commissioner Chilton's question about whether there's any size that could be too large, and ask you again to think about clearinghouses and markets, exchanges, both clearinghouses and exchanges, not when the skies are clear and the

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sun is out, but when we get to stormy times, or when we get to hurricane season like we've seen in financial markets in the last nine months. Isn't it the case that a large concentrated position, whether it's 80 percent, 50 percent, or even 20 percent is harder to liquidate and distorts the market more in stormy times than if it's a two percent position, or an eight percent position?

MR. FELESKY: I think a couple things; one, I think you're assuming that if the end unit holder who is our end client, if he's not in our fund, he's not participating in any other manner.

CHAIRMAN GENSLER: I wasn't assuming anything except for I was wondering whether a 50 or 80 percent market participant, whether it's an ETF, whether it's a swap dealer, whether it's a hedge fund, anybody, needs to liquidate in a difficult market environment, whether you think the CFTC should take that into consideration when we're thinking about position limits.

MR. FELESKY: I have no problem with that as a consideration in your discussions.

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CHAIRMAN GENSLER: Thank you. Commissioner Dunn.

COMMISSIONER DUNN: Thank you. Mr. Felesky, in your written testimony, you indicated that if there is any direct impact emanating from your long commodity based ETF activities, that it would exert a downward effect on price and a moderate upward price pressure. If true, does this downward pressure tend to distort -- to be a distortion of price discovery process?

MR. FELESKY: A couple things; one is how the mechanic of our product actually works, I think is what I was referring to in our long ETF's ruling from the current nearby to the next, which would impact the nearby contract by pushing that price down. How that converged to spot I guess is the question, and I'll leave it to experts in the industry to talk specifically about that.

However, I think the other question or the other data points you can look at is just our history of our asset flows, which, you know, through the whole dramatic increase in commodity

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prices, saw huge net inflows in our short ETF's resulting in downward pressure of selling as the commodity appreciated, and conversely you're seeing a support in commodity prices today as our flows come in from the buy side. That said, natural gas as an example, both in Canada and our competitor here in the United States, we've seen substantial inflows of assets, but natural gas has still managed to fall approximately 40 percent in that time.

COMMISSIONER DUNN: Mr. Lothian, you say in your testimony here that position limits should be set dramatically by the Commission.

MR. LOTHIAN: Dynamically.

COMMISSIONER DUNN: Dynamically, excuse me, by the Commission, not dramatically. It may be some dramatically. 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

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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; the position limits for speculators should be a fixed number of contracts for that particular interval; and limits should be applied to all months with different intervals set separately for delivery months, spreads should be counted on gross basis against the limit, meaning a long and short is two contracts, and that's something I'd like to explore, but how onerous would it be for the Commission to do that? How many people are we going to need? You and I have talked in the past about the resources we have here.

MR. LOTHIAN: Right; I think that that is something that an advisory committee made up of industry participants across the spectrum could make a recommendation to the Commission on. I think that's where the expertise would be and could be utilized for setting the dynamic limits,

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that is.

COMMISSIONER DUNN: Could you amplify a little bit on counting the spread?

MR. LOTHIAN: Well, you can put on a very large position when you have a spread on as opposed to an outright position. And a spread is not necessarily a -- is not necessarily less risky. In fact, if you look at the disclosure document you have to sign when you open an account, it'll tell you just that as much, okay.

There's a lot of people that have the idea that just because they're spread, that they're somehow protected. I have some nasty stories to tell about spreads that -- for a non-public hearing. But the -- I think that people tend to put on larger positions on spreads because they feel like they have less risk, and that's not always the case, so I think that it needs to be -- it needs to be measured in a way that represents that risk that they're taking.

COMMISSIONER DUNN: (off mike)

CHAIRMAN GENSLER: Commissioner Sommers.

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COMMISSIONER SOMMERS: I'm going to continue actually down that same path, because I had questions from yesterday with regard to how we set limits, making it fair for the marketplaces. Do you set the limits based on open interest on each market so that each market has different position limits, or you know, so your dynamic rate is interesting to me, if you could talk a little bit ---

MR. LOTHIAN: Well, I think that you need to take a look at the entire marketplace, both the regulated futures markets and the OTC. You know, we talk about the CME having 95 percent of the U.S. futures market, but when you look at the greater market in which they are trading, both from a, you know, OTC market, cash market, and global market, it's a much broader playing field.

And likewise, you have to look at the cash market, you have to look at the OTC market, as well. It's very easy to do an exchange for a physical type of transaction, offsetting your futures position by interacting with somebody in

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the cash market. So the pool that you're looking at, if you say you have 80 percent of the futures market, you know, it might be just that your denominator is wrong.

COMMISSIONER SOMMERS: Thank you. My next question is for Mr. Krenkel, and it's with regard to your comment and your testimony on the significant price discovery contracts and how that -- how that impacts you as an ECM and the unintended consequences of an ECM that have participation from emerging markets; if you could talk a little bit about that.

MR. KRENKEL: Yeah; as I said earlier, our contracts are really all designed to be fully fungible with the OTC activity. In fact, they're interchangeable in a lot of client's books. So what we're simply looking for is a situation where there are some limits over here that do not apply to the dark part of the market, hence, the unintended consequences that it drives business away unintentionally, so that was my concern.

We do --- with respect to the emerging

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markets, we list a number of contracts where they're new, we're trying to standardize some things at different market centers, we're trying to shepherd the business onto the exchange and into the structured clearinghouse. I don't think it's appropriate to reach down to those and start applying limits. It'll potentially harm the development of the markets in terms of bringing that business to the exchanges and the clearinghouse, so that was really at the root of my comments.

COMMISSIONER SOMMERS: So just to clarify, until they become fungible, the limits aren't appropriate?

MR. KRENKEL: Yeah; I feel until they become more liquid, the limits may not be appropriate, may actually be detrimental to development of the market. Liquidity is really the key for us, and for any exchange, for that matter, but it really makes the exchange function and allows the clearinghouse to operate, so we don't want to see anything that drives liquidity

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away from -- particularly in an emerging market, a new product for us.

CHAIRMAN GENSLER: Commissioner Chilton.

COMMISSIONER CHILTON: Thank you, Mr. Chairman. Mr. Lothian, let me go back to this 80 percent, and forget that it's 80, say it's just a large percentage of an ETF, and I don't want to pick on our panelists, let's just say you know that it's coming up, you know that there's a role coming up, what do other traders in the market do with that information, if anything, or what could they potentially do?

MR. LOTHIAN: Well, it's kind of like an annuity to them because they know that it's there, it's contractually within the agreement of the ETF or the fund or whatever. In fact -- I mean, you know, if I were more involved in that, I would say -- what I would do is, go and invest in those ETF's and go and invest in those index funds and make sure that I knew exactly what the rules were for how they were going to do it and then make sure that I took that in consideration for my

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trading.

It's kind of like selling premium, though, with options, it works until it doesn't work, and as the experience -- the wheat traders back in, I don't know, 2006 found out, that, you know, you can collect a lot of premium, but then something can happen that changes the rules and you can lose it all and more. So, you know, it's not a riskless trade by any means.

COMMISSIONER CHILTON: And to pick up on what Commissioner Dunn and Commissioner Sommers were asking you about with regard to, you know, predefined intervals of setting the position limit, I'm curious whether or not you think there's any sense in a hard cap position limit that might be in tandem with a percentage, as Commissioner Sommers is talking about, of open interest. Maybe this level, except, you know, in this circumstance, because in some of these small, you know, fairly liquid markets, you might have a high percentage of open interest. I'm just curious as to your thoughts.

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MR. LOTHIAN: You know, again, I think that it's difficult to even talk about real effective hard limits when you don't have a view of the entire market. So if the CFTC doesn't have a real good view of what the OTC market size is, and a good feel on the cash, then it's very easy to set the wrong parameters or the wrong limit for that. So I think that you guys need, you know, additional authority over those parts of the market.

Greater transparency is a great thing, it brings more people into the price discovery process, but it's -- there's a broader market out there than just the future, so it's very -- it's difficult. That's why I think it just needs to be a little bit more dynamic. And as I said in my comments here, when the markets go up, they're advertising for selling, and so we need to perhaps be a little bit more responsive in terms of limits like that to allow a greater speculative of interest even to participate in the market, to help, you know, stabilize things.

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COMMISSIONER CHILTON: So sort of like some of the other panelists have suggested, whatever we do or potentially do needs to be done sort of in tandem with additional legislative authority from Congress, otherwise, it could have some unintended consequences, at least holds the possibility of that.

MR. LOTHIAN: Right, absolutely. I mean, for example, the Commitment of Traders Report, you know, it's tremendous information, but I think it only tells part of the story, and it could tell an exact opposite story if I could see the rest of the market and what was going on, so it can be very misleading.

COMMISSIONER CHILTON: Okay, thank you.

MR. FELESKY: If I could just add to John's comment about the role of speculators and how we define that, that our investors, I should say, played again in 2008, if you look at our flows, you look at our major competitor here in the United States, who I think is testifying next week, it's the same experience. They were a

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source of price stability. We were all selling into the dramatic commodity price appreciation in 2008. It's just that's what the data is.

CHAIRMAN GENSLER: Can I just check whether my Commissioners want another -- do you have a question? Well, I'm going to thank all of our witnesses. It's just been fabulous to hear from you, to get your perspective. I think we might want to follow up, John, you said you wanted to say something to us in private about spreads, because I don't want to leave that out there, if there is something that this Commission needs to hear, we'd like to hear that.

But thank all of you and thank our earlier panelists, as well. We're going to, as a Commission, come back together in public hearing on August 5th at 9:00 a.m. That's probably going to be a full day, because, as it turns out, on the last day, some people, you know, want to get in, and we might have to have three panels on that day.

I think, again, it's just been very

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helpful. There seems to be a diverse -- within this diversity of opinion, still support from the exchanges yesterday and even support from some of the major market participants today, and another exchange for us to consider -- seriously consider position limits. There's a lot of debate around who said it, what are the numbers, and whether there are appropriate exemptions. But this has been very helpful for all of us here today, so I think this Commission stands adjourned.

(Whereupon, at 12:34 p.m., the PROCEEDINGS were adjourned.)

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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

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