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Statement

Opening Statement by Commissioner Jill Sommers, Hearings on Position Limits and Hedge Exemptions

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The U.S. futures markets have been continually examined over the past eighteen months as prices for crude oil and many agricultural products reached record highs. The question on everyone's mind is whether speculative trading is responsible, especially through the influx of new traders into the markets such as pension and endowment funds seeking exposure to commodities through passive long-term investment in commodity indexes, and swap dealers who seek to hedge price risk resulting from their over-the-counter (OTC) activity. Those participating in the debate have acknowledged that speculation is a necessary component of healthy markets. It is speculators who take on the risk that hedgers seek to shed and provide the liquidity that is the lifeblood of futures trading. There is a sense by some, though, that "excessive" speculation has pushed prices beyond levels warranted by supply and demand and that something must be done to rein it in.

One of the primary tasks of market regulators is to foster the high level of market integrity necessary to preserve the important risk management and price discovery functions the futures markets perform. So, we must ask ourselves, how do we ensure that the markets are working as they should?

Congress recognized in the Commodity Exchange Act (Act) that market functions can be compromised when excessive speculation causes "sudden or unreasonable fluctuations or unwarranted changes" in the prices of commodities, and therefore authorized the Commission to set limits on the amount of trading that can be done by market participants. Congress also recognized the need for certain market participants to exceed such limits for the purpose of "bona fide" hedging. Determining what constitutes "excessive speculation," however, is not straightforward and there are differing views on the types of risk that should be eligible for hedging.

Historically, the Commission has set speculative limits in only a narrow category of agricultural contracts and granted hedge exemptions to participants with price risk related to the physical commodity, such as farmers, grain merchants and food manufacturers. In 1986, however, the Commission's House and Senate oversight committees urged the agency to consider expanding the concept of hedging to include other trading strategies such as the use of futures for asset allocation and portfolio management by pension funds and others. As a result of this reassessment the Commission reinterpreted its hedge exemption rules to permit entities such as swap dealers to offset in the futures markets financial risk related to OTC transactions involving individual commodities and commodity indexes.

For contracts not subject to Federal speculative limits the Act permits exchanges to establish position limits or accountability levels, as appropriate, and to administer exemptions. The energy complex falls into this category. As the Commission has done, exchanges have permitted entities with financial risk related to OTC exposure to exceed position limits for hedging purposes.

The issues surrounding position limits and hedge exemptions are enormously complex. Every market has its own characteristics so what works for the soybean markets, for example, may not be appropriate for natural gas markets. Trading linked to commodity indexes, exchange traded funds and exchange traded notes presents a different set of questions. Should positions related to such trading be governed by their own set of rules given the passive nature of the activity? How do we determine the appropriate level of passive investment in the markets—should it be based on percentages, numerical limits, or some other methodology? Should hard position limits be imposed in all physical commodities and if so, should they be imposed on exchange trading without similar limits in place for OTC markets? I am especially concerned that doing so will have the perverse effect of driving large portions of the market away from centralized trading and clearing at the very same time we are urging all standardized OTC activity to be traded on-exchange or cleared. Likewise, I am concerned that, without global standards, trading will move to other financial centers around the world.

The Commission has undertaken various initiatives to inform the debate, including collecting detailed information from swaps dealers and index traders, which we plan to publish on an ongoing basis. I believe these hearings are another important step in developing the record. It is critical for us to have input from all sides of the marketplace to inform the debate as the Commission struggles to answer many of these complicated questions. This is a very challenging time but we must do everything we can to fulfill our mission and preserve the critical price discovery and hedging functions of the US futures markets.

I would like to thank Chairman Gensler for organizing these hearings and all of the panelists testifying over the next week for their contributions.