1290

S. HRG. 98-1096

IMPROVING THE EFFICIENCY OF COMMODITY FUTURES MARKETS

HEARING

BEFORE THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

NINETY-EIGHTH CONGRESS

SECOND SESSION

APRIL 25, 1984

Printed for the use of the Joint Economic Committee

U.S. GOVERNMENT PRINTING OFFICE

37-522 O WASHINGTON : 1984

JOINT ECONOMIC COMMITTEE

(Created pursuant to sec. 5(a) of Public Law 304, 79th Congress)

SENATE

ROGER W. JEPSEN, Iowa, *Chairman*
WILLIAM V. ROTH, Jr., Delaware
JAMES ABDNOR, South Dakota
STEVEN D. SYMMS, Idaho
MACK MATTINGLY, Georgia
ALFONSE M. D'AMATO, New York
LLOYD BENTSEN, Texas
WILLIAM PROXMIRE, Wisconsin
EDWARD M. KENNEDY, Massachusetts
PAUL S. SARBANES, Maryland

HOUSE OF REPRESENTATIVES

LEE H. HAMILTON, Indiana, *Vice Chairman*
GILLIS W. LONG, Louisiana
PARREN J. MITCHELL, Maryland
AUGUSTUS F. HAWKINS, California
DAVID R. OBEY, Wisconsin
JAMES H. SCHEUER, New York
CHALMERS P. WYLIE, Ohio
MARJORIE S. HOLT, Maryland
DANIEL E. LUNGREN, California
OLYMPIA J. SNOWE, Maine

CHARLES H. BRADFORD, *Acting Executive Director*
JAMES K. GALBRAITH, *Deputy Director*

CONTENTS

WITNESSES AND STATEMENTS

Wednesday, April 25, 1984

SUBMISSIONS FOR THE RECORD

Wednesday, April 25, 1984

IMPROVING THE EFFICIENCY OF COMMODITY FUTURES MARKETS

WEDNESDAY, APRIL 25, 1984

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, DC.

The committee met, pursuant to notice, at 9:05 a.m., in room SD-538, Dirksen Senate Office Building, Hon. Roger W. Jepsen (chairman of the committee) presiding.

Present: Senators Jepsen, Abdnor, and Symms; and Representative Wylie.

Also present: James K. Galbraith, deputy director; Charles H. Bradford, acting executive director; and Dale Jahr, David A. Smith, and Robert J. Tosterud, professional staff members.

OPENING STATEMENT OF SENATOR JEPSEN, CHAIRMAN

Senator JEPSEN. Good morning. I want to first thank all of today's witnesses. They are extremely busy individuals and their appearance here today is not without considerable personal sacrifice.

Their willingness to devote the necessary time and talents to prepare and present their testimony in itself lends a great deal of credence to the subject of this hearing.

By design we sought out, and were successful in getting, the best in the business.

I want to state at the outset that this initiative is neither to indict nor promote commodity futures markets. This is not an investigation. That is not the role of the Joint Economic Committee. Our purpose is information gathering and educational.

We want more light to be shed on this very complex area which affects so much of agriculture.

The topic of this hearing, "Improving the efficiency of commodity futures markets," is highly complex and controversial and follows this committee's earlier hearing in Chicago 3 months ago. The Chicago hearing specifically dealt with extreme price swings and the unexpected depressed prices for soybeans and corn.

I would be remiss if I failed to mention the concerns recently expressed by the American Soybean Association to President Reagan, Secretary Block, Thomas Donavan—president of the Chicago Board of Trade—and to this committee. The association relayed the distrust among soybean farmers in futures trading regarding unusual price action in soybean futures.

In his letter, Ralph Weems, president of the American Soybean Association, states that the "lack of appropriate action on this matter could easily lead to the demise of the Chicago Board of Trade as the world's price discovery mechanism for many agricultural products, including soybeans."

And this is not the first threat of this kind to come from agricultural commodity representatives.

Several State cattlemen's associations have expressed similar sentiments and objectives.

The concerns of soybean growers are understandable in that a 30-cent drop in soybean prices in 1 day reduces the value of their crop by almost $500 million. The reverse, of course, is equally true: a 30-cent price increase enhances the value of the soybean crop by $500 million.

The central, nagging question, however, is whether these or any price changes are in response to fundamental supply and demand market forces or other influences.

There is no question, however, as to the value of futures markets as a financial planning tool for agriculture. Elevators, bankers, and many farmers consider the opportunity to forward price a key element in obtaining financial security and stability. In fact, in my State today more than ever before, banking, and loaning institutions are requesting farmers and producers to do so.

If this hearing accomplishes nothing else, it is my sincere hope that we will all gain, if not a complete understanding, an appreciation of the extensive role and influence of futures markets in our and the world's economic system.

In 1983, the underlying value of contracts bought and sold in just U.S. futures markets surpassed $3 trillion—a figure challenging this country's gross national product—is twice as large as our national debt, and exceeds the dollar value of all trade between nations by one-third.

But the economic importance of futures markets goes well beyond the value of sales and purchases of contracts. Futures prices are the most widely used pricing reference in domestic and international trade, and there is no more important function of an economic system than price determination.

Futures markets, in fact, may be quite figuratively and literally Adam Smith's "invisible hand"—a force which surpassed and perhaps defies complete understanding. Yet a force with immeasurable effects and consequences. A force which decides what, when, and where commodities are going to be produced and exchanged—whether people are going to eat or go hungry—whether an industry or an entire nation for that matter is going to prosper or fail—and which influences how we live with ourselves and how we live with each other.

Futures markets are commonly perceived as inconsequential, independent business activities occurring on the fringes of our economic system. A more accurate assessment perhaps is that futures markets are our economic system.

This being the case, or even near the case, we are obligated to ask some very basic questions: Questions about the price discovery efficiency of these markets, the concentration of power and influence, motivation of participants, their impact on the development and effectiveness of public policies, and their contribution toward the attainment of our national goals of economic stability, economic growth, economic freedom, and economic justice.

Power is necessary, but it is a tradition in a democratic society to examine it. And in this tradition I have convened this hearing.

Do you have an opening statement, Congressman Wylie?

Representative WYLIE. Thank you, Mr. Chairman.

Mr. Chairman, you summed it up very well and we do have a heavy agenda. I have no statement at this time and look forward to hearing from our witnesses. Thank you.

Senator JEPSEN. At this time I'd like to welcome our first panel of witnesses. I will introduce first of all Mr. Mergell, International Association of Seed Crushers; Mr. Frazier, of Frazier-Parrott; Richard Dennis, C&D Commodities; and Mr. Hieronymus—a very famous name in Grundy County, IA. I don't know whether you realize that or not. Mr. Hieronymus is an agricultural economist.

We have Senator Abdnor joining us. Do you have an opening statement, Senator?

OPENING STATEMENT OF SENATOR ABDNOR

Senator ABDNOR. I'm sorry I'm late. I'm going to be brief and maybe show a lack of familiarity with how the commodity futures work. The Joint Economic Committee had an initial hearing in Chicago which Senator Jepsen chaired in late January. At that time I referred to the commodity exchanges as mysterious black boxes and Bermuda Triangles. I also made the comment that never have so few done so little to extract so much from so many. I'm a farmer, fellows, and you've got to understand that I, like a lot of other people, do not have a full understanding of the operations of the commodities futures markets. From the correspondence I've received in my office from South Dakota, since the Chicago hearing, my previous assessment seems to rather accurately express the sentiments of the agricultural community.

I represent South Dakota, the most agricultural State in the Union. I'm sure we could have filled this room with witnesses more than anxious to share their views on today's topic. I know a lot of my people would have loved to have come here. People have lost rather large sums of money because of low prices and the change in prices. Some people have lost their farms and their businesses and you would have a hard time convincing these people that there wasn't some market manipulation. I'm not saying there is, but in their minds, a lot of them feel that there was.

Farmers and ranchers in South Dakota and elsewhere who have contacted me have expressed total disgust at the futures markets because they view them as being antifarmer and antilivestock producer. Not surprisingly, they also think they're pro-big-trader and speculator. Many of these individuals witnessed the inclusion of certain commodities in the futures markets such as feeder cattle, being subject to great price volatility.

The saddest part of the story is that when the futures markets were established, they were intended to stabilize commodity prices and offer farmers and livestock producers a tool with which they could utilize to protect themselves against unforeseen market declines. Of course, the bitter irony is that the speculators and traders who feed on the futures markets profit when prices fluctuate dramatically. There are some big bucks being made on these fluctuations which gives the industry and traders a motive to create volatile markets, not reduce volatility.

They say for every dollar gained, a dollar is lost in the futures markets. I'm concerned about the dispersion of losses and the concentration of benefits in the futures markets. P.T. Barnum once said that there's a sucker born every minute and I'm not so sure that does not describe the attitude of traders. I'm getting comments from people back home saying large commodity speculators' attitudes toward small, unsuspecting traders, particularly farmers and ranchers, is not good.

Perhaps even more distressing is when an artificial so-called technical adjustment of price of just a nickel during the last 15 minutes of a trading day can reduce the value of farmer-held futures commodity supplies by hundreds of millions of dollars throughout the country and the huge losses just don't affect the small percentage of the farmers and ranchers who have the courage, or perhaps the foolhardiness, to play the futures game. The losses from possible price manipulation affects all farmers and ranchers since futures prices affect the prices farmers receive at their local grain elevators and in the livestock market.

So please understand me, gentlemen. My job is to reflect the opinion and the feeling of my constituents and, believe me, there's not a lot of love in South Dakota for the speculators whom farmers and ranchers believe are working against them and who reap a bonanza harvest from their losses.

Obviously, I do have my own doubts and suspicions or I wouldn't be talking this way. With that, I'm here to learn something. I'm looking forward to hearing from you and maybe I can ask some questions that will relieve some of my fears and doubts. Thank you.

Senator JEPSEN. If we were to give an award for the person coming the longest distance, I'm sure, Mr. Mergell, you would receive it today. Mr. Mergell came over here from West Germany to be with us today. Welcome, and thank you for coming. You may proceed. Your prepared statement will be entered into the record and you may proceed in any way you so desire.

STATEMENT OF ARNOLD F. MERGELL, CHAIRMAN, INTERNATIONAL ASSOCIATION OF SEED CRUSHERS [IASC]

Mr. MERGELL. Thank you, Mr. Chairman. Good morning to all of you.

Mr. Chairman and members of the committee, thank you very much for having invited me and therefore IASC to this meeting. We welcome the opportunity.

Let me just explain to you in a very few words what the IASC is. IASC is the International Association of Seed Crushers and IASC represents the oilseed and refining industry of the world with national associations and individual companies of 33 countries being members. I have had the honor of presiding over this body for the last 3 years and got reelected for a further term in Rio de Janeiro earlier this month.

Without wishing to—I said this in my prepared statement—I have to go into a few statistical things because it will show you, as members of the committee, the impact of the discussion we are having this morning.

The three major soybean producing areas—United States, Brazil, and Argentina—important to the Western supply and demand situation, had in 1983-84 a crop exceeding 60 million tons, which was in total figures, little because we had the disastrous drought last year in the United States, so in normal years this figure could easily be by 20 million tons higher.

Europe—and here the Common Market as well as Spain and Portugal—imports around 13 million tons of soybeans, mainly of U.S. origin. Further, Canada, plus Europe, grow rapeseed crops of about 5 million tons.

All these crops and their marketing operations, plus industrial selling of oil and meal, take largely their basic market dues and price directions from the daily events of the Chicago Board of Trade.

Even other oilseed or oil-producing areas of the world, such as Malaysia and Indonesia, with their annual output of more than 4 million tons of palm oil, and the Philippines with around 1 million tons of coconut oil, cannot ignore or withdraw their eyes from events in Chicago. Such has become the position of the Chicago Board of Trade as an institution of pricing, hedging, and generally as a liquid market serving everybody. Its activities have increased tremendously year after year. Flat pricing for substantial quantities is hardly any longer in evidence with the oilseed exporting crushing and refining industry inside and outside—and I stress outside—of the United States.

The creation of commodity funds, computer pools, and similar organizations having an even more important influence on this market with a tendency to move the market away from fundamentals made me, as president of the IASC, decide to have comments included in my speech at the annual review on the occasion of the Rio de Janeiro Congress, and I think it was those comments which made you, Mr. Chairman, invite me to this meeting today. But as they were read and spelled out in Reuters, I don't think I have to repeat them today again.

It is funny, though, if one sort of tackles this issue as I talk to international associations, individual companies came up to me after the Rio Congress and said, "Arnold Mergell, your comments concerning the futures markets are really much appreciated," and when it comes to associations, they have pointed out to me that in the past they have developed a philosophy of noninterference with Chicago and with the operations of the Chicago Board of Trade, but now they say:

> You have said something and you have started discussing this issue and we gave it second thoughts and we follow you that something is there which is perhaps so-called off-balance, and whatever suggestions you have as a leader of the international industry we're willing to think about this and follow you in that respect.

You, Mr. Chairman, mentioned yourself the other comments which we have all read recently. So even others are concerned about the events that are happening there.

What surprises me as an outsider, a foreigner, is the fact actually that the Chicago Board of Trade seems to me at least not to be that much concerned. I have been myself a member of that body and I always respected this body very, very much, but if so many people start feeling uneasy, I wonder, why don't they do these things you do today? Why don't they start sort of looking at these kinds of questions themselves to have them solved?

Anyhow, Mr. Chairman, you have asked questions which I would like to answer very quickly and as shortly as I can.

The first one of your questions was, has the market moved away from fundamentals and has the quality of trading behavior changed? If so, how and why?

Yes, in my opinion, the market has lately definitely moved away from fundamentals because the general situation prevailing in the grain and oilseeds trading and processing business leaves the field to the portfolio traders who look more to technical possibilities than to fundamentals as a guideline. Their intention is the quick move rather than the industrial behavior or the long-term move.

What role or influence does system-type trading have in today's futures markets? With the portfolio trader managing a huge amount of money is hitting the market at the time of his choice with such a big volume order that the individual market participant, like, for instance, the farmer or individual, has hardly any chance to compete even if he uses organizational background of some kind. I could cite many examples and in my prepared statement which you have, I cited the Continental Grain market report from New York, April 11, 1984. In that respect, it's funny if you live in Europe or outside of the United States, you always receive a report on the happening of last afternoon or evening in Chicago, and there's hardly any comment in these daily comments where these computer pools and money-managed funds and so forth aren't included what they have done in the last day's events on the Chicago Board of Trade. Sometimes the influence has been small, but many, many times you read in these reports that the influence has been very heavy. And as the other Senator has explained himself this morning, sometimes within the last 5 or 10 minutes of the trading session, you see the most peculiar things happening, and one wonders how it could happen. And I, having been a witness to these kind of things for quite some years, I don't think we've had similar events in earlier years.

You asked, is there a need to improve the accessibility, quality, and timeliness of market information? I do not believe so. The Chicago Board of Trade price reporting system appears adequate to me. However, at this moment, I could say that there is critical news to be heard in the industry when it comes to USDA reporting, and I think USDA has sort of accepted that challenge themselves and there have been comments from that ministry saying that they would try to improve their reporting systems and make them more accurate, and I think that would be very much appreciated.

How can the liquidity of the market be improved? The volume, in my opinion, is big enough, but on some occasions, it is in the hands of too few participants.

Are the self-policing methods and commodities futures trading rules and regulations adequate to promote market activity, yet insure the protection of the public interest?

In my opinion, definitely not, as the board rules permit the accumulation of clients who do not give specific orders regarding purchase or sale, but leave it to a representative to put accumulated orders into the market with only one target: To make a profit. I believe the often lamented silver corner investigated against another market participant is a vivid example.

To what extent and how has speculative trading affected trading for hedging purposes?

As nobody likes to, as I quote a little bluntly, stand in front of a freight train, as the market says, the activity on one side almost always produces a thin market or a vacuum on the other side, which naturally makes hedging impossible or at least very difficult at times.

Your views on future prospects and potential benefits of computerized trading versus pit trading. Supply and demand can only play its wonted role, when commission houses or traders handle their own decision and volume, thus giving the market a large number of participants rather than having, as stated by me before, a few powerful hands put out big volumes aided in their decision by computers, charts, and so forth.

Why has the futures markets failed to attract greater farmer participation? I'm really not qualified to give an answer to this point as I'm too distant to that to judge the reasons. I also believe that there are better experts available to you to answer the question regarding options trading for instance.

Mr. Chairman, I'm sorry, I would like to finish my statement there because when it comes to more detailed questions I think Mr. Kohlmeyer from Chicago or specifically my good old friend, Mr. Robert Raclin, from Merrill Lynch, who will give his report later to you, I think he is much more qualified to answer the detailed questions you have on your mind.

I would just like to conclude by saying that your initiative is very much appreciated and I sincerely hope that because of the international importance of the orderly market operation this hearing will become conclusive and you will take appropriate action. Thank you very much.

[The prepared statement of Mr. Mergell, together with an enclosure, follows:]

PREPARED STATEMENT OF ARNOLD F. MERGELL

The I.A.S.C. represents the oilseed and refining industry of the world with national associations and individual companies of 33 countries being members. I have had the honour of presiding over this body for the last three years and got re-elected for a further term in Rio de Janeiro earlier this month.

Without wishing to avoid the subject of this Hearing, please allow me to enter some statistical facts.

The three major soyabean producing areas - USA, Brazil and Argentine -, important to the Western supply and demand situation, had in 83/84 a crop exceeding 60 million tons. Europe - and here the Common Market as well as Spain and Portugal - imports around 13 million tons of soyabeans, mainly of US origin. Further Canada plus Europe grow rapeseed crops of about 5 million tons. All these crops and their marketing operations plus industrial selling of oil and meal take largely their basic market dues and price directions from the daily events of the Chicago Board of Trade.
Even other oilseed or oil producing areas of the world such as Malaysia and Indonesia with their annual output of more than 4 million tons of palmoil and the Philippines with around 1 million tons of coconutoil cannot ignore or withdraw their eyes from events in Chicago. Such has become the position of the Chicago Board of Trade as an institution of pricing, hedging and generally as a liquid market serving everybody. Its activities have increased tremendously year after year. Flat pricing for substantial quantities is hardly any longer in evidence with the oilseed exporting crushing and refining industry inside and outside of the USA.

The creation of commodity funds, computer pools and similar organisations having an even more important influence on this market with a tendency to move the market away from "fundamentals" made me as President of the I.A.S.C. decide to have the following comments included in my '84 annual review.

Quote

One such question has been raised since our last Congress. It is whether the Chicago futures market generates excessive price volatility beyond that justified by the development of fundamental supply and demand factors. The existence of an efficient effective and smoothly operating future market is, of course, crucial for our operations. However, the comments increasingly heard have been that the ability of the Chicago market to fulfill its vital functions for commercial operations is distorted by the activities of computer pools, managed money accounts and particularly large individual speculators. The expansion in these groups and in the amount of money available for trading is certainly now enormous. The possibility is raised that this relatively recent development now produces the power of such participants in future markets to swing the market excessively in first one direction and then the other.

I would not myself make any judgement on this matter at this time being aware that volatile markets for fundamental supply/demand reasons invariably generate additional volatility in futures markets and there is no conclusive way of assessing how futures markets would behave without such funds. Nevertheless, what

one should probably recognise is that as the volume of these funds increases further so does the risk that they will move prices more and for longer periods and introduce a new dimension of uncertainty for ordinary commercial operations. It is important that the market is always two-sided, it is important that the market remains a reliable reflection of the sum total of supply/demand fundamentals and expectations and important that there is not a domination in the market of participants with an interest only in volatility. However, a watchful eye on these operations by the Authorities of the Chicago Board of Trade is undoubtedly being maintained.
Unquote

You have requested comments on specific questions, set down in your telegram to me dated April 12, 1984. I would like to reply as follows.

1) Yes, the market has lately definitely moved away from fundamentals because the general (uneconomic) situation prevailing in the grain and oilseeds trading and processing business leaves the field to the portfolio traders, who look more to technical possibilities than to fundamentals as a guide-line. Their intention is the quick move rather than the industrial behaviour or the long-term move.

2) Answer number one answers this point adequately, I believe.

3) A portfolio trader managing a huge amount of money is hitting the market at a time of his choice with such a big volume order that the individual market participant, like for instance the farmer or individual, has hardly any chance to compete, even if he uses organisational background of some kind. I could cite many examples, however, please take the Continental Grain market report from New York April 11, 1984.

4) I believe not. The CBT price reporting system appears adequate to me.

5) The volume is big enough, but on some occasions it is in the hand of too few participants.

6) In my opinion definitely not, as the board rules permit the accumulation of clients, who do not give specific orders regarding purchase or sale, but leave it to a representative to put accumulated orders into the market with only one target: To make a profit. I believe the often lamented "silver corner" investigated against another market participant is a vivid example.

7) As nobody likes to stand in front of a "freight train", as the market says, the activity on one side almost always produces a thin market or a vacuum on the other side, which naturally makes hedging impossible or at least very difficult.

8) Supply and demand can only play its wanted role, when commission houses or traders handle their own decision and volume, thus giving the market a large number of participants rather than having - as stated before - a few powerful hands put out big volumes aided in their decision by computers, charts etc.

9) I am really not qualified to give an answer to this point, as I am too distant to that clientele to judge the reasons. I also believe there are better experts available to you to answer the question regarding options trading.

On closing let me apologize for not being a specialist on regulations and trade by laws of American commodity exchanges and specifically of the BoT. There are experts and more knowledgable personalities present at this Hearing to counsel you on the matter as how to improve techniques and remedy the situation.
I would like to end by saying that your initiative is very much appreciated and I sincerely hope that because of the international importance of the orderly market operation this Hearing will become conclusive and you will take appropriate action.

Encl.

217681a obum d
211271b dehh d

17,2 Eingang Nr. 5933

12.04.84 09.17 uhr
ak

continental grain berichtet schluss:

str

fm nyk 04/11/84 hp 20:45 est .559.

futures:

technically speaking the walls of jericho have fallen with up-trends in beans meal oil and corn all broken and major support points violated.

refco and cargill were prime culprits in the collapse with refco selling 8-10 mill beans net, and cargill at least 3 mill. both were also pounding the meal, which was the first to break the critical support at 200, that had held for almost 2 months. buying was limited to bottom picking by cmse hses and locals with virtually no pricing coming on the crash.

next objectives should be old lows on meal of 189 basis the may, and 756 and 738 on the may beans. oil continues to look the most positive of the complex, but there too the momentum is downward, with next support at 29.20.

fundamentally, tdy was not that different from yday or the day before except for the absence of pricing from consumers. braz farmer is beginning to move beans, with domestic prices losing their premium to export mkts. the onslaught of so amer movement has always been the driving force behind the bear argument, and altho fob mkts there are only toppy, origin selling may be enuf to fuel the bear case.

u.s. farmer will of course shut off any selling, for the moment at least, but pipeline seems well supplied and dont see any panic shorts willing to pay up for cash.

spreads:

[illegible] [illegible]
july/nov [illegible]
nov/jan 10-1/2-11

just to illustrate the magnitude of professional trading in this mkt, the following is a recap of reported activity of three major professional trading hses during this week alone:

	c and d	chicago	refco
soybeans	sld 1500	sld 7500	sld 9000
oil	sld 700	sld 300	sld 900
meal	sld 1350	sld 400	sld 3300

total sales in three sessions: 490,000 mt soybeans
52,000 mt oil
476,000 mt meal

in addition refco bear spread 2 mln beans and 2500 contracts meal. soybeans in 000,s bushels and meal/oil in contracts.

cash:

flat px erosion has put lid on farmer selling.

barge mkt gained penny in may/june positions responding to selloff in cgo and subsequent drop in interior origination.

fob mkt continues in doldrums gaining maybe 1/2 cent following changes in barge mkt but tradeless.

new crop postions unch/neglected.

fob river lineup going home:

may 1-20 36/39
may 12-31 38-1/2 / 40
jun 1-20 32/34
jun 10-30 32-33/36
jly 1-20 33-4/37
jly 12-31 35/39
gut stot 14/16 1/2
nov 1-20 15/18
nov 10-30 19/22

Senator JEPSEN. Thank you very much.
Mr. Frazier.

STATEMENT OF JOHN H. FRAZIER, JR., CHAIRMAN, FRAZIER-PARROTT COMMODITIES, INC.

Mr. FRAZIER. Thank you, Mr. Chairman. I'm glad to be here. You asked some questions and I can see already that we are going to get some different views, but I hope we can come up with some conclusions.

You asked, has the market moved away from fundamentals? The answer is no. There is a saying in the trade that "fundamentals will prevail." I believe that is true. Fundamentals continue over the long term to be the main inputs into market prices. Futures prices are made by a buyer and a seller agreeing upon a price at that time. Fundamentals may or may not be in their minds at the time when they set that price, but fundamentals are looked at by the entire world, as has already been pointed out. Government agencies from various continents continue to use our U.S. futures markets. Fundamentals, when translated into action which causes price movements, are really what the market trader believes they are. And I've written here that as beauty is in the eyes of the beholder, a fundamental is what is in the mind of the trader. He may be making a mistake. He may have the wrong figures. He may have the wrong fundamentals. But the fundamentals are what he thinks they are. But fundamentals still count.

In the last couple of weeks we have had an example of how fundamentals affect the wheat market. The free supply of Soft Red Winter wheat, which is the kind which is almost always the basis for Chicago Board of Trade futures prices, is very tight and may only be 19 million bushels at the end of the crop year.

Morocco had asked for offers of only 100,000 tons of wheat to be shipped in the old crop year. That's not very much. Then they canceled or they postponed that tender. The market dropped the next morning 4¾ cents or 1¼ percent which, based on the price of soybeans, would be over 10 cents just like that. That was a fundamental change, fundamentals as looked at by the trade change, and the market immediately reacted. So fundamentals still count.

Your question, has the quality of trading behavior changed? It certainly has. A larger proportion of the total speculative trade appears to be coming from pools or combinations of accounts utilizing systems which, while endeavoring to be unique, tend to give buying and selling signals at approximately the same time. The large volume of concentrated buying or selling taxes the capacity of the local professional traders who are expected to provide liquidity by taking the other side of orders coming into the pit. The locals who are trying to take the other side have suffered unprecedented losses and most local traders have been forced to adopt very defensive positions, bidding lower and buying less than they usually would, or offering higher and selling less, making it more difficult to execute large orders except at large price concessions. This problem is accentuated by the tendency of many systems traders to rely on signals flashed during the last few minutes of trading each day, at a time when many pit traders are reluctant to take on large new positions which must be carried overnight or over a weekend which many traders may not care to do or may not be able to do.

Systems-type trading has a greater and greater short-term influence on today's futures markets. This type of trading has grown in popularity. Every week I receive offers of different types of materials to be used in systems trading or full systems themselves. Dozens of methods are available.

Some free-thinking, independent, small traders have decided to put their money in managed accounts, many of which are traded technically. Personally, these small traders provided a flow of small orders into the pits which helped to give a smoother liquidity to the pits in that the orders were more constant and less concentrated than when the orders are coming from a large managed account.

Since most systems attempt to follow trends and to concentrate on those markets that are showing the best or strongest trends, markets from time to time are being subjected to unprecedented waves of one-way buying or selling followed by sharp reversals when participants try to either take profits or limit their losses following various indications which tend to give the same signals at the same time.

While some ancient Chinese or Egyptian trader probably had a system, technical trading or systems trading has exploded in recent years. Therefore, systems-type trading has more short-term influence than ever before.

Is there a need to improve the accessibility, quality, and timeliness of market information?

There is a need for improvement, but considerable progress is being made. In fact, there is more and better information available now than ever before from various news services, some of which have already been mentioned this morning. The need is for analysts able to interpret the information. Considering the number, complexity, and the interaction of factors affecting futures prices, information may vary and even conflict. Futures markets are a place where differences of opinion amongst various competitive participants can work themselves out to provide the best possible approximation of appropriate prices for current and future delivery of commodities.

Recently there's another problem. There has been a loss of credibility by some of the USDA reports. There seem to be figures that don't add up if we take crop reports, stock reports, animal numbers and carryover estimates. There is definitely a need for improvement in that area. I understand some changes are being made. I hope so. There is a need for increased accuracy.

The more widespread information is that's accurate, the more likely the futures markets will reflect the appropriate price in the futures.

A very disturbing element enters the information picture from time to time. This element is false rumors. It doesn't happen frequently, but in recent years there have been several which have caused violent swings in the futures markets. The worst was a rumor that the President of the United States was dead. In the most recent case, the truth was the President was in his office in a meeting with a foreign dignitary and nothing unusual was going on at all. By the time the truth was known, the price swings had been very dramatic. Drastic action needs to be taken to solve this problem.

How can the liquidity of the market be improved?

In preparation for this testimony, Mr. Chairman, I asked advice from economic analysts, traders of different types, consultants to the industry, and others.

In almost all cases, the 1981 tax law was cited as one culprit in hampering liquidity with its market-to-market provision. The act has reduced the incentive for long-term position trading and spreading in futures contracts. Prior to the change, if large orders came into the nearby futures months, spreaders could take the opposite side of those orders and by moving to the deferred months spread out their positions and thus add liquidity to the market in the nearby and reduce the volatility of the price swings.

Without participation of the traders in the so-called back months, the market loses some liquidity in the front months.

Liquidity could be improved with the return of the small trader to individual trading. Many small orders, rather than a few large orders, would smooth out prices.

The return to credibility of Government reports would help also, in that traders would feel that they had solid figures to work with.

Are the self-policing methods and CFTC rules and regulations adequate to promote market activity, yet insure the protection of the public interest?

The self-policing methods and the CFTC rules and regulations are greatly improved. Last week, as you mentioned, there was a call for an investigation or investigations into possible manipulation of the soybean market. I'm sure that call either has been some time ago or it will be now listened to very, very closely.

But if there were any indications of manipulation, the Chicago Board of Trade would investigate out of self-interest. It is to the best interest of the members to have the fairest, best enforced rules that can be written.

I don't think new rules and regulations are as important as other things which have been or will be mentioned in this testimony to get additional liquidity through promoting market activity.

To what extent and how has speculative trading affected trading for hedging purposes?

Normally, hedgers need speculators to take the other side of their trades. The speculator gives the hedger the opportunity to hedge.

The more speculators there are to accept the risk that hedgers wish to avoid, the better the market is for hedging purposes. The more liquidity the market has, the better for hedgers.

Recently, there have been very large volumes on some days which it is surmised are caused by the market hitting certain prices which some systems view as a buy or a sell signal. We may call them trigger prices.

So much attention is now being paid to systems trading that it probably can be assumed that the hedgers in some cases will be able to anticipate the trigger prices and use them to their advantage.

It has seemed that systems trading has, because of large volume, at times created pockets of illiquidity. These pockets may have caused problems to hedgers who had to buy or sell a hedge at the particular time these pockets were hit. They also could have been an advantage to the hedger. It would be preferable, sir, if there were no pockets.

My views on computerized trading and future prospects and potential benefits are quite similar to most persons involved in the industry.

I am not aware of any comprehensive study which purports to show how computerized trading would improve liquidity or produce more valid pricing than has resulted from face-to-face competition among large numbers of individual traders in the pits of exchanges during the past century. I believe for several years an unsuccessful attempt has been made to start an exchange using computerized trading.

I am not sure that the technology exists to handle large volume markets such as corn or soybeans.

Another thing, there may be a security problem such as we have heard of in the use of computers even in our Defense Department.

At this time, I know of nothing in the way of future prospects or potential benefits of computerized trading versus pit trading that would improve the efficiency of the commodity futures markets. One of my colleagues, after reading my statement, said I forgot one thing. He said:

> Under the present methods of trading, there is a lot of public information that comes out carried by the news services that says who is doing what more or less. Commission houses are doing this. The systems traders are doing that. If we went to computerized trading, we might lose a lot of that public information. We might lose the benefit of it.

Why has the futures markets failed to attract greater farmer participation and how useful will options trading be for farmers?

The futures market has failed to attract greater farmer participation because of lack of understanding, fear, and margin calls.

Although the Chicago Board of Trade has carried on an intensive education program for years and other exchanges have participated in the educational process, education is a constant and massive task. The resources to do a complete job are not available and it would be almost impossible to do a complete job.

The old story of having 5,000 bushels of corn dumped on one's front yard as part of the delivery process is an example of tales that have created fear.

A third problem is that of margins. If a farmer legitimately hedged 50 percent of his soybean crop right now by selling November futures at 7.25 or 7.30 and the market goes up $2 a bushel, he has a substantial margin call to meet. If he does not have an understanding banker, he may have a cash bind. He may have to get out and probably at the wrong time.

As producers of corn or soybeans, farmers normally have few legitimate reasons for being on the long side of the futures. Many mistakes have been made by selling the crop and buying the futures without the realization that to the extent the selling of the crop satisfied the consumer's need for the actual commodity there would be less demand for that commodity in the future.

Options may have a use for farmers. The farmer will be able to gain the protection of a short hedge without the concern of margin calls. This is going to be a prime example of an advantage for some farmers.

I'd like to conclude by saying that the following are some of the actions which should be taken to improve the efficiency of the futures markets.

First, revamp the tax laws in some manner to aid traders, to supply liquidity as they did before the 1981 tax change.

Second, take strong action to discourage the starting of false rumors which affect futures markets.

Third, improve USDA reports.

Fourth, expand the education of farmers in the use of futures markets.

Fifth, increase the effort to have a method of fair treatment of brokers and traders worked out so that increased involvement in the markets of the independent traders large and small may be accomplished.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Frazier follows:]

PREPARED STATEMENT OF JOHN H. FRAZIER, JR.

Mr. Chairman and Members of the Committee. You have asked excellent questions with respect to inquiries into improving the efficiency of the commodity futures market. I will answer those questions in the order that you presented them.

1. Has the market moved away from fundamentals?

The answer is no. There is a saying in the trade that is: "fundamentals will prevail". I believe that is true. A dictionary states, "A fundamental serves as an origin or generating soure". Fundamentals continue over the long term to be the main inputs into market prices. Futures prices are made by a buyer and a seller agreeing upon a price. Fundamentals may or may not be in their minds at the time that price is fixed. Fundamentals, however, are looked at by the entire world. Futures markets have become increasingly international in recent years. Government agencies from various continents use our United States futures markets. Fundamentals, when translated into action which causes price movements, are really what the market trader believes they are. At any time the trader may have a mistaken idea of the supply factor or the demand factor. Just as beauty is in the eye of the beholder, fundamentals are in the mind of the trader. The price discovery mechanism which is based on fundamentals must have the correct information to make a correct judgement. If the fundamentals are different from what the trader believes they are or will be, he has the wrong idea of what will happen to prices and may make a mistake.

Fundamentals remain important even though they may be overridden in the short run.

In the past couple of weeks we have had an example of how fundamentals effect the wheat market.

The free supply of soft red winter wheat, the kind which is almost always the basis for Chicago Board of Trade futures prices, is very tight and may only be nineteen million bushels at the end of the 1983-1984 crop year, which is this coming May 31st.

Morrocco had asked for offers of only 100,000 tons of wheat to be shipped in the old crop year. Morrocco cancelled or postponed the tender. The market dropped 4 3/4 cents the next day based almost entirely on the cancellation of the tender. Because the supply of the commodity is tight, the cancellation moved the price down 1 1/4% even though the tender was only of moderate if not small size. This is a purely fundamental market action.

Fundamentals continue to count.

2. Has the quality of trading behavior changed?

The types of trading, or trading behavior, have changed. A larger proportion of the total speculative trade appears to be coming from pools or combinations of accounts utilizing systems which, while endeavoring to be "unique", tend to give buying and selling signals at approximately the same time. The large volume of concentrated buying or selling taxes the capacity of the local professional traders who are expected to provide liquidity by taking the other side of orders coming into the pit. Those who have tried have suffered unprecedented losses, and most local traders have been forced to adopt very defensive postures, bidding lower and buying less or offering higher and selling less, making it more difficult to execute large orders except at large price concessions. This problem is accentuated by the tendency of many systems traders to rely on signals flashed during the last few minutes of trading each day, at a time when many pit traders are reluctant to take on large new positions which must be carried overnight or over a weekend which many traders may not care to do or may not be able to do.

"Systems type trading has a greater and greater short term influence on today's futures markets. This type of trading has grown in popularity. Every week I receive offers of different types of material to be used in systems trading or systems themselves. Dozens of methods are available.

Some free thinking, independent small traders have decided to put their money in managed accounts many of which are traded technically. Personally, these small traders provided a flow of small orders into the pits which helped to give a smoother liquidity to the pits in that the orders were more constant and less concentrated than when the orders are coming from a large managed account.

Since most systems attempt to follow trends and to concentrate on those markets that are showing the best or strongest trends, markets from time to time are being subjected to unprecedented waves of one way buying or selling followed by sharp reversals when participants try to take profits or limit losses following various indications which tend to give the same signals at the same time.

While some ancient Chinese or Egyptian trader probably had a system, technical trading or systems trading has exploded in recent years. Therefore, "sytsems type trading" has more short term influence than ever before.

4. Is there a need to improve the accessibility, quality and timeliness of market information?

There is a need for improvement, but considerable progress is being made. In fact, there is more and better information available now than ever before from various news services. The need is for analysts able to interpret the information. Considering the number complexity and interaction of factors affecting futures prices, information may vary and even conflict. Futures markets are a place where differences of opinion amongst various competitive participants can work themselves out to provide the best possible approximation of appropriate prices for current and future delivery of commodities.

Recently there has been a loss of credibility by some of the USDA reports. There seem to be figures that don't add up if we take crop reports, stock reports, animal numbers and carryover estimates. There is definitely a need for improvement in that area. I understand some changes are being made. There is a need for increased accuracy.

The more widespread accurate information is, the more likely the futures market will reflect the appropriate price in the futures.

A very disturbing element enters the information picture from time to time. This element is false rumors. It doesn't happen frequently, but in recent years there have been several which have caused violent swings in the futures markets. The worst was a rumor that the President of the United States was dead. In the most recent case the truth was the President was in his office in a meeting with a foreign dignitary and nothing unusual was going on at all.
By the time the truth was known, the price swings had been dramatic. Drastic action needs to be taken to solve this problem.

5. How can the liquidity of the market be improved?

In prepartation for this testimony, I asked advice from economic analysts, traders of different types, consultants to the industry, and others.

In almost all cases the 1981 tax law was cited as one culprit in hampering liquidity with its mark-to-market provision. The act has reduced the incentive for long term position trading and spreading in futures contracts. Prior to the change, if large orders came into the nearby futures months, spreaders could take the opposite side of those orders and by moving to the defferred months spread their positions, and thus add liquidity to the market in the nearby and reduce the volatility of the price swings.

Without participation of traders in the so called "back" months, the market loses some liquidity in the "front" months.

Lilquidity could be improved with the return of the small trader to individual trading. Many small orders would smooth out prices.

Return to credibility of government reports would help also in that traders would feel they had solid figures to work with.

6. Are the self policing methods and CFTC rules and regulations adequate to promote market activity, yet insure the protection of the public interest?

The self policing methods and CFTC rules and regulations are greatly improved.

Last week there was a call for an investigation or investigations into possible manipulation of the soybean market.

If there were any indication of manipulation the Chicago Board of Trade would investigate out of self interest. It is to the best interest of the members to have the fairest, best enforced rules that can be written.

I don't think new rules and regulations are as important as other things which have been or will be mentioned in this testimony to get additional liquidity through promoting market activity.

7. To what extent and how has speculative trading affected trading for hedging purposes?

Normally hedgers need speculators to take the other side of their trades. The speculator gives the hedger the opportunity to hedge.

The more speculators there are to accept the risk that hedgers wish to avoid the better the market is for hedging purposes.

The more liquidity the market has the better for hedgers.

Recently there have been very large volumes on some days which it is surmised are caused by the market hitting certain prices which some systems view as a buy or sell signal. We may call them "trigger" prices.

So much attention is now being paid to systems trading that it probably can be assumed that the hedgers in some cases will be able to anticipate the "trigger" prices and use them to their advantage.

It has seemed that systems trading has, because of large volume, at times created "pockets" of illiquidity. These pockets may have caused problems to hedgers who had to buy or sell a hedge at the particular time these pockets were hit. They also could have been an advantage to the hedger.

It would be preferable if there were no "pockets".

My views on future prospects and potential benefits of computerized trading versus pit trading are quite similar to those of most persons involved in the futures industry.

I am not aware of any comprehensive study which purports to show how computerized trading would improve liquidity or produce more valid pricing than has resulted from face to face competition among large numbers of individual traders in the pits of exchanges during the past century. I believe for several years an unsuccessful attempt has been made to start an exchange using computerized trading.

I am not sure the technology exists to handle large volume markets such as corn or soybeans.

There may even be a security problem such as we have heard of in the use of computers even in our defense department.

At this time, I know of nothing in the way of future prospects or potential benefits of computerized trading versus pit trading that would improve the efficiency of the commodity futures markets.

9. Why has the futures markets failed to attract greater farmer participation? How useful will options trading be for farmers?

The futures market has failed to attract greater farmer participation because of lack of understanding, fear, and margin calls.

Although the Chicago Board of Trade has carried on an intensive education program for years and other exchanges have participated in the educational process education is a constant massive task. It has not had the resources to do the complete job and it would be almost impossible to do the complete job.

The old story of having 5,000 bushels of corn dumped on one's front yard as part of the delivery process is an example of tales that have created fear.

A third problem is that of margins. If a farmer legitimately hedged 50% of his soybean crop by selling november futures and the market goes up two dollars a bushel he has a substantial margin call. If he does not have an understanding banker he may have a cash bind.

As producers of corn or soybeans, farmers normally have few legitimate reasons for being on the long side of futures. Many mistakes have been made by selling the crop and buying the futures without the realization that to the extent the selling of the crop satisfied the consumer's need for the actual commodity there would be less demand for that commodity in the future.

Options may have a use for farmers. The farmer will be able to gain the protection of a short hedge without the concern of margin calls. This is a prime advantage for some farmers.

The following are some of the actions which should be taken to improve the efficiency of the futures markets:

1. Revamp tax laws in some manner to aid traders to supply liquidity as they did before the 1981 tax change.

2. Take strong action to discourage the starting of false rumors which affect futures markets.

3. Improve USDA reports.

4. Expand education of farmers in the use of futures markets.

5. Increase the effort to have a method of fair treatment of brokers and traders worked out so that increased involvement in the markets of the independent traders large and small may be accomplished.

Senator JEPSEN. Thank you, Mr. Frazier.

Mr. Richard Dennis, C&D. You may proceed in any way you so desire.

STATEMENT OF RICHARD J. DENNIS, PARTNER, C&D COMMODITIES

Mr. DENNIS. Thank you, Mr. Chairman.

Mr. Chairman, I want to thank you for the opportunity to present my views on improving the efficiency of commodity futures markets to the Joint Economic Committee.

I want to congratulate you on having such a wide diversity of views here and while I fear my views may be the most diverse of all, I'm glad to be here nonetheless.

The relationship between farmers, the pricing of their products, and the regulation of commodity exchanges where that pricing takes place is a topic that needs exploration. What makes markets tick, what problems may arise for farmers in the market and problems of the wider public interest are easily misunderstood. My views are a distillation of 15 years experience as a professional trader and are, I believe, both logically and rigorous and validated by my record in this industry. They are not, however, the conventional wisdom.

I hope to shed some light on a subject that so far has been remarkably murky. Although I have no illusions about the relationship between farmers and commodity traders, I am convinced from my discussions with farmers from throughout Illinois that they, too, are skeptical of simplistic analysis. My remarks should demonstrate that I value straight talk. It helps neither farmers nor traders to engage in a euphemistic battle. The two best examples of people not saying what they mean are volatility and losing confidence in the market. Whenever I hear someone say the market is "too volatile," it usually means they are thinking, "I expected the market to go the other way;" when I hear someone say, "I'm losing confidence in the market," what they are often not saying is, "I lost money in the market."

Market prices, in my opinion, are not predictable by known fundamentals—either bullish ones like last summers drought or bearish ones like the rise of the U.S. dollar—and never have been. Otherwise, anyone smart enough to read could amass huge wealth by consulting the many top-quality fundamental analyses that exist. All the fundamentals, both known and unknown, do cause all persistent trends and determine prices, but no known fundamentals predict price trends since the whole idea of a market is to digest news and discover the news-adjusted new price. Unknown fundamentals—like the true size of a crop before it is known—cause price trends that are one, absolutely inexplicable by known fundamentals, and two, discernible by technical analyses. Technical analysis attempts to predict future prices and price trends from previous prices and price trends.

Since my entry into this business in 1970, the ability of the average trader has zoomed. These better quality traders have moved toward trying to predict price better by ignoring fundamentals and following discernible price trends. Their job is to predict price change, not cause it.

System trading is a natural outgrowth of the increased intelligence of the trading community—a rational response to the above facts. Systems tend to exaggerate trends a little to the prime benefit of farmer-hedgers and the detriment of speculators. Exaggerated uptrends give farmers a chance to market their crops at higher prices than otherwise. Exaggerated downtrends generally find Government price supports coming into play, enabling farmers to hold their crops off the market. Net, this felicitous asymmetry means money in the pockets of farmers when markets overdo it. Possibly exaggerated trends lure extra trend-following traders in and cause them to lose on balance.

If it's of any interest, my opinion is that systems trading is not the way of the future. It won't work with so many people doing it. They will lose their money and they will stop doing it and it will go away.

Although the market always prices itself according to the fundamentals, the fundamentals we all have access to are not useful in predicting price. Hence, there is no use worrying about the accessibility, quality, and timeliness of market information. A hedger must either become a trend-following technical analyst or maintain a program of hedging at regular, predetermined intervals not even trying to outguess the market.

Hedgers would benefit from increased liquidity. Increasing liquidity means increased volume. Increased volume would be caused by: First, more outside customers, including hedgers; second, more member traders; third, larger trading by either customers or members. Currently volume in grain futures is restricted by antiquated and unintegrated position limits. Regulations are illogical when they conclude that, because a 3 million bushel position limit can allegedly service a 2 billion bushel bean crop, the same position limit can somehow service a 7 billion bushel corn crop. I would propose the CFTC expand position limits to 10 million bushels in all but delivery options in soybean futures and making position limits comparable in wheat and corn based on relative crop sizes. Even at these levels the effect of a trader's volume on prices that farmers receive would be almost nil.

I would observe the futures market has failed to attract greater farmer participation because: First, agricultural departments of universities have not done well in explaining futures to students; second, the CBOT has not done enough to reach out to its farmer constituency. Many farmers tell me they are excited about agricultural options trading and its limits risk aspects. The beginning of options trading—which could be exceedingly useful for farmers—would be a good place for both aforementioned institutions to redress poor historical performance. I would also observe the CBOT and futures industry have increased liquidity by dramtically reducing the minimum entry cost to trade on exchange floors through the leasing of membership.

Position limits even an order of magnitude larger than now will effectively guard against manipulation by large traders. Given no restrictions, manipulation attempts are not impossible to imagine; it is, however, impossible for manipulation to work. The markets are too big and the attempt too nonsensical to make manipulation an issue. Speculators pretending to be hedgers can get hurt and did in last year's market. Real farmer-hedgers can't get hurt by speculators—who merely add liquidity and some magnitude to trends.

I believe the public interest has not and cannot be significantly increased by further CFTC regulation. The trading and hedging public can use better consumer information comparing brokers, brokerage firms, trading advisers, and market analysts and their competency. The wider public interest is well served by the BOT and other exchanges who provide centralized price discovery at minimal cost. I believe it would be helpful if there were more traders on the CFTC. Their perspective is sorely missed.

To summarize, the market is absolutely unpredictable by traditional methods. Many farmers probably should hedge at regular intervals and not try to outguess the market. Trading systems in general and speculators in particular do not hurt farmers. Farmers are hurt by lack of understanding of hedging and how it works. The public needs more information to know how to evaluate the abilities of institutions involved in commodity futures. Manipulation is not a problem and CFTC regulation is not an answer to the real needs for progress in the futures industry. More regulation, like outmoded position limit restrictions, are counterproductive.

As expert testimony before this committee in Chicago demonstrated, supply and demand—specifically the strong value of the U.S. dollar, were the fundamentals responsible for price decline. Continued loose talk about speculators causing dramatic price trends or manipulating prices neither helps nor fools anyone. Larger traders play a trivial role in determining prices. The market would be more efficient if they could trade larger.

Again, Mr. Chairman, I appreciate this opportunity to present my views on improving the efficiency of commodity futures markets to the Joint Economic Committee. I welcome your questions. Thank you very much.

Senator JEPSEN. Thank you, Mr. Dennis.

Mr. Hieronymus, from the University of Illinois, you may proceed in any manner you so desire.

STATEMENT OF T.A. HIERONYMUS, PROFESSOR EMERITUS, DEPARTMENT OF AGRICULTURAL ECONOMICS, UNIVERSITY OF ILLINOIS AT URBANA-CHAMPAIGN

Mr. HIERONYMUS. Grain and soybean prices have been unusually volatile during the past year. This has led to criticism of and questions about the pricing performance of futures markets. The central question should go to the quality of speculation in futures markets because these are indeed speculative markets. Has the quality of speculation measured up to the standard of performance that we have come to expect? How can speculative performance be improved? These are the questions on which we should focus.

The past year has been an unusually difficult challenge to the market because of the combined effects of Government programs and adverse weather on the supply of grain and soybeans. Evaluating the quality of the job that markets have done is very difficult because these are not established standards of excellence, such as par on a golf course, by which we can measure performance. We can establish an ideal and then observe that it was not met, but how close we should reasonably expect the market to come to the ideal has not been established. Ideally, the markets should have quickly appraised the impact of programs on acreage and adjusted prices. Then, as the adverse growing season developed, they should have moved up to a level that would have pulled carryovers down to minimum pipeline levels and held stable until the next harvest. Some modification of the ideal is necessary. In actuality, it is necessary to put prices above the equilibrium levels to get users' attention and get them to make adjustments. Thus, historically, we have had price patterns of early seasonal peaks during short crop years. And such peaks have been essential to effective market performance. Lacking performance standards, we can only look at what has happened and make some qualitative judgments.

First, I would look very briefly at corn. May 1984 corn futures decreased from $3.20 in May 1983 to $2.90 in late June. The decrease was the result of overestimating the effect of Government programs on production. Beginning in early July, the price rose to more than $3.80 in late August as the drought continued and its effects became apparent. The price stayed in a $3.65 to $3.85 range for several weeks before falling to $3.40 by the third week of October, and a subsequent decrease to about $3.22 in February and a rise to $3.60 in early April, prior to yesterday's sharp decrease.

Now, how good was the performance in corn? First, it is too early to tell because I don't know where this thing is going to wind up. Is the current price just right to make the existing supply last until a new crop is available or is it so high as to result in an excessive carryover or is it so low that an increase will be necessary to make supplies last until harvest? I don't know. One reason is that I don't know how large existing supplies are. We have not had enough experience with an adjustment of this magnitude to make a reliable estimate.

When the crop year has ended we can look back and form some judgments about the market's performance. At this time, the rapid rise from $2.90 to $3.80 does not appear excessive because of the magnitude of the shortfall in supply. The volatility of prices during the August–September period with limit up days followed by limit down days does appear large. The length of time that the price stayed high does appear to be briefer than we should think necessary to get users of corn to make adjustments. The rally in late October and early November was the result of an unexpectedly small carryover from last crop year. It was not evidence of poor maket performance. At this time the decline from November to February appears to have been excessive and a speculative error. But I can only say that since the price has gone back up to its November level. The market may have to go back up to a level that will pull CCC corn out of inventory. It may not. Again, I don't know.

May soybean futures decreased from $7.25 in April 1983 to $6.35 at the end of June. The impending shortage took over and put the price above $9.50 by the end of August. There was a quick, vigorous, and fully justified response to supply conditions. The market traded in $9 to $9.70 range for 6 weeks. Prices were quite volatile during that period. Much of the criticism of market performance during the past year is focused on this volatility and it did seem at the time excessive. However, I would point this out: the range was only 7.5 percent of the median for the period. Now this is not large when we recall that estimates of the equilibrium ranged from $8 to $12 and higher. It is quite small when compared to volatility in securities markets thus far in 1984. USDA had a range of $8.50 to $9.50 for an equilibrium for the year at that time. I should also point out it is quite small when compared to the volatility of the securities markets thus far in 1984.

The May futures price decreased from $9 in late September to $7.10 in mid-February and has since recovered to the $8 area. The future is uncertain. At this time and with the benefit of hindsight, it appears that the decrease from September to February was greater than justified by the supply-demand conditions, but we cannot evaluate the pricing performance of the soybean market until the season has ended and we see where it finally ends up.

Now, more generally, how good has the pricing performance of grain and soybean futures markets been since last summer? Compared to what? Compared to optimum, it has moved excessive amounts and been too volatile. But these markets have operated in situations of unprecedented uncertainty. The supply/demand price situation is much less uncertain today than it was last fall, but great uncertainty remains.

What will be the average price of corn and soybeans between now and harvest? I have some thoughts about it but I would not be so pretentious as to think that I could come within 10 percent. What I am saying is that we may expect and demand too much from speculative markets. It has been a frustrating year for us fundamental type market analysts. We have had a lot of surprises.

There may be an awful lot of "sour grapes" in some of the current criticism of markets.

I would now turn my attention to the specific questions that you posed.

Has the market moved away from fundamentals? No. First, there is no way that a market can move away from fundamental forces. There is one inevitable equilibrium: Market clearing price. The market makes errors in anticipating the equilibrium price and moving to it, but the errors are always corrected. Some of the lines of causation run from speculation in futures markets to their influence on cash prices. To the extent that speculators control inventory, they influence interim prices. However, the primary lines of causation in interim price behavior are between producers and consumers. Producers almost always hold a high proportion of the existing inventory and the rate at which they feed it on the market is the dominant factor in interim prices. Processors and end users take a lot or a little forward cover and thereby influence interim prices. The decisions that these people make are speculative. They form judgments on the basis of their perception of market fundamentals.

Second, has the quality of trading behavior changed? I don't know. I have the general impression that is held by many people—and you have heard from some of them this morning—that much position taking is based on past price patterns and technical considerations. If this impression is correct, the quality of trading has deteriorated.

These are speculative markets and the essence of speculation is foresight: The anticipation and discounting of futures events into current prices. However, to the best of my knowledge, no one knows who takes and holds positions or the basis on which judgments are made. There need to be studies made of market composition similar to the old Commodity Exchange Authority cross-section surveys.

Third, what role and influence does system-type trading have in today's futures markets? Again I don't know. Judging from the proliferation of commodity funds and the amount of money involved, I should judge that it is a growing role and influence. It is my impression that a high proportion of these funds use system-type trading. The funds are a significant source of new speculative capital, but I doubt that they are of major influence on price behavior. I think that in the aggregate the funds gross break even and net lose by the cost of commission and management fees. But again, the answers are not known. There needs to be more information developed and studies made.

Fourth, is there a need to improve the accessibility, quality, and timeliness of market information?

The amount of supply, use, and price information has increased rapidly and is instantly available. The communication revolution is alive and well. Volume of trading and open interest is available. However, information about the composition of open interest is collected by the CFTC but only a little is made available and that which is made available is often quite late. More and timely information would be useful.

Fifth, how can the liquidity of the market be improved?

Major markets are adequately liquid. Volume of trading is quite large in relation to changes in open interest. In some markets in some contract months, a reasonable amount of prudence is required in placing orders. The patience required is not an undue burden on out-of-pit traders. It should be kept in mind that there is a cost of liquidity.

Sixth, are self-policing methods and CFTC rules and regulations adequate to promote market activity yet insure the protection of the public interest?

There are three levels of futures markets regulation: CFTC, exchanges, and markets. The self-policing by exchanges is of greater importance than regulation by the CFTC. But the great regulator is the competition of the market itself. Futures markets are the closest approximation to pure competition in existence. Competition regulates itself into efficiency and equity.

We should look for places to deregulate rather than regulate. One first point of deregulation should be daily trading limits. Position limits may be desirable, but trading limits are not. I think that regulation of position limits should be removed from the CFTC and made a responsibility of exchanges. Problems of balance have arisen because of control of managed accounts. One person's thinking may influence a good deal more than the position limits. The exchanges are in a more flexible and thus better position to maintain competitive balance than is the CFTC. I think this was fairly well established by the position limits in markets that the Government regulated and in markets where they are regulated by the exchanges.

Seventh, to what extent has speculative trading affected trading for hedging purposes?

It has enabled it. On the other side of a hedged position is a speculative position. Speculators have accommodated hedgers very well during the past year. Open interest in wheat, corn, grain, soybeans, soybean oil, and soybean meal has been much larger than during the preceding 2 years. The same is true of both long and short reported hedges. The markets have fulfilled their risk-shifting function very well.

Eighth, what are your views on the future prospects and potential benefits of computerized trading versus pit trading?

As everybody knows, electronic communication and data processing is increasing rapidly. Potential is limitless, thus some system may be devised that will supplant direct person-to-person trading. But the state of the art is not so advanced at this time. I think such a system will gradually evolve in bits and pieces and it is underway at the present time and will gradually be accomplished over time.

Ninth, why have the futures markets failed to attract greater farmer participation?

It's a troublesome question. I first started teaching farmers how to use the futures markets more than 30 years ago. I have written extensively on the subject. I have watched this evolve over time.

I think my answer is they do not fail to attract farmer participation and the amount of farmer participation has been increasing, especially during the past decade. Surveys indicate that farmers make relatively little direct use of futures markets in marketing their crops and livestock. I think that the primary reason is that they prefer to use forward contracts and delayed pricing arrangements. Thus, the use of futures markets by farmers is indirect. They make forward contracts with elevators and then the elevators hedge in futures. Thus, behind the hedging in the markets is farmer participation.

Now over time farmers have shown a great deal of interest in improving their marketing skills. This interest expanded rapidly during the price turbulence of the 1970's. I have worked closely with farmers in this connection. It is my observation that farmers are increasingly knowledgeable about factors affecting prices, increasingly skilled in price forecasting, and are doing an improved job of distributing sales over time so that they balance risks and aim toward high average prices.

I think that when this year is over we will find that farmers have done a respectable job of marketing their 1983 crops. I note that the number of gains on farms in 1984 versus off farms was the smallest percentage on farms in the last decade and they held a smaller than usual percentage of the existing inventory.

Now reported short hedges in soybeans last September 30 were 399 million bushels compared to 211 the year before. Short hedges in corn were 532 million, up from 380 million the year before. Farmers sold more than a usual amount into what turned out to be high prices. Farmers are pretty respectable speculators and are improving.

Tenth, how useful will options trading be for farmers? It remains to be seen. Buying puts is a conceptually useful insurance system. It will be actually useful if it is cheap enough. Usefulness of options will depend on options prices and that remains to be seen until trading has started.

Now I would make a summary comment. The past year has been one of unusually great speculative stress in grains and soybeans. The futures markets have performed well in their basic risk-shifting functions. Their speculative pricing performance has been less than optimum, but given the extreme uncertainty of the supply-demand situation, it is difficult to fault them, at least until we know at the end of the year what they should have done. My first point is that markets work well and that a basic principle should be observed: If it ain't broke, don't fix it.

We need to recognize, however, that improvement in the quality of speculation that would lead to greater price stability is desirable. How to achieve it? In my foregoing comments I have alluded to three things. First, some of the volatility of prices may have been the result of one set of thinking directing managed accounts that aggregate more than speculative limits. You kept hearing all year, "So and so has sold 25 million bushels and so and so has bought 30 million bushels, et cetera," and these may reflect one person's thinking who controls several managed accounts. Now the resulting imbalance of power and countervailing power may have been responsible for some of the large and erratic price variations. If so, a first step is to remove CFTC speculative limits and add the maintenance of power balance to the responsibility of the exchanges.

Second, we do not know the relative importance of commodity fund trading or its influence on price behavior. The basic data is available to the CFTC and I think that the CFTC should be responsible for making and encouraging others to make studies appraising the importance of the growth in fund trading.

Third, more and timely information about the composition of open interest in markets would be useful to market analysts as would cross-section surveys of market composition. The CFTC has unique access to information and more use should be made of it.

Finally, the central lesson to me from my own observations and deliberation is that we need to have faith in competitive markets. Exchanges succeed or fail—and more have failed than succeeded—on the basis of their ability to maintain competitive markets that serve the public interest. Futures trading is a zero-sum game. The better speculators gain and grow in importance and the poorer speculators lose and go away. Markets are a continuous spelldown. They are very hard to beat which is convincing evidence that they are quite good. Thank you.

[The prepared statement of Mr. Hieronymus follows:]

PREPARED STATEMENT OF T.A. HIERONYMUS [1]

Grain and soybean prices have been unusually volatile during the past year. This has led to criticism of and questions about the pricing performance of futures markets. The central question should go to the quality of speculation in futures markets because these are indeed, speculative markets. Has the quality of speculation measured up to the standard of performance that we have come to expect? How can speculative performance be improved? These are the questions on which we should focus.

The past year has been an unusually difficult challenge to the market because of the combined effects of government programs and adverse weather on the supply of grain and soybeans. Evaluating the quality of the job that markets have done is very difficult because these are not established standards of excellence, such as par on a golf course, by which we can measure performance. We can establish an ideal and then observe that it was not met but how close we should reasonably expect the market to come to the ideal has not been established. Ideally, the markets should have quickly appraised the impact of programs on acreage and adjusted prices. Then, as the adverse growing season developed, they should have moved up to a level that would have pulled carryovers down to minimum pipeline levels and held stable until the next harvest. Some modification of the ideal is necessary. In actuality, it is necessary to put prices above the equilibrium levels to

---

1/ Professor Emeritus, Department of Agricultural Economics, University of Illinois at Urbana-Champaign. Testimony before the Joint Economic Committee of Congress, April 25, 1984.

get users attention and get them to make adjustments. Thus, historically, we have had price patterns of early seasonal peaks during short crop years. And such peaks have been essential to effective market performance. Lacking performance standards we can only look at what has happened and make some qualitative judgements. We can take a cursory look at wheat, corn, and soybean price performance.

May 1984 wheat futures started trading at about $4.15 in April, 1983 and decreased to $3.75 in July. Early on, the market overestimated the impact of government programs on production and corrected its mistake. The mistake was not large. With the drought, the price rose rapidly from $3.75 in July to a $4.20 to $4.30 range in late August through early September. These then followed a decline to $3.30 in February and a recovery to $3.75 in early April. I should judge this as a poor price performance. The market should have recognized that there would be a large carryover and gone no higher than necessary to pull wheat out of the reserve and then gone no lower than necessary to hold substantial quantities in the reserve. The basic mistake that the wheat market made was to follow the lead of corn and soybeans which were in real shortage.

May, 1984 corn futures decreased from $3.20 in May, 1983 to $2.90 in late June. The decrease was the result of over estimating the effect of government programs on production. The planted acreage was larger than expected. Beginning in early July the price rose to more than $3.80 in late August as the drought continued and its effects became apparent. The price stayed in a $3.65 to $3.85 range for several weeks before falling to $3.40 by the third week of October. There followed an increase to $3.60 by the third week of November, a subsequent decrease to about $3.22 in February and a rise to $3.60 in early April.

How good was this performance? First, it is too early to tell because I don't know where this thing is going to wind up. Is the current price just right to make the existing supply last until new crop is available or is it so high as to result in an excessive carryover or is it so low that an increase will be necessary to make supplies last until harvest? I don't know. One reason is that I don't know how large existing supplies are. This comment is necessarily written before April 23 and on the afternoon of April 23 the USDA estimate of stocks of corn on April 1 will be released. At that time I will have a more accurate measure of the rationing problem. I do know that there will have to be a major reduction, on the order of 32 percent, in feed use from the average of the past three years. Even when I know the size of the estimate of existing stocks I will not have the price that will be required to just run out at the end of the year. We have not had enough experience with an adjustment of this magnitude to make a reliable estimate.

When the crop year has ended we can look back and form some judgements about the market's performance. At this time, the rapid rise from $2.90 to $3.80 does not appear excessive because of the magnitude of the short fall in supply. The volatility of prices during the August-September period with limit up days followed by limit down days does appear large. The length of time that the price stayed high does appear to be briefer than we should think necessary to get users of corn to make adjustments. The rally in late October and early November was the result of an unexpectedly small carryover from last crop year. It was not evidence of poor market performance. At this time the decline from November to February appears to have been excessive and a speculative error. But I can only say that since the price has gone back up to its November level. The market may have to go back up to a level that will pull CCC corn out of inventory. It may not. I don't know.

May soybean futures decreased from $7.25 in April 1983 to $6.35 at the end of June. The impending shortage took over and put the price above $9.50 by the end of August. There was a quick, vigorous, and fully justified response to supply conditions. The market traded in a $9.00 to $9.70 range for six weeks. Prices were quite volatile during the period. Much of the criticism of market performance during the past year is focused on this volatility and it did seem excessive. However, the range was only 7.5 percent of the median for the period. This is not large when we recall that estimates of the equilibrium ranged from $8.00 to $12.00 and higher. It is quite small when compared to volatility in securities markets thus far in 1984.

The May futures price decreased from $9.00 in late September to $7.10 in mid February and has since recovered to the $8.00 area. The future is uncertain. The April 1 stock report is uncertain and of critical importance. At this time and with the benefit of hindsight it appears that the decrease from September to February was greater than justified by the supply-demand conditions. But we cannot evaluate the pricing performance of the soybean market until the season has ended.

How good has the pricing performance of grain and soybean futures markets been since last summer? Compared to what? Compared to optimum, it has moved excessive amounts and been too volatile. But these markets have operated in situations of unprecedented uncertainty. The supply-demand-price situation is much less uncertain today than it was last fall but great uncertainty remains. What will be the average price of corn and soybeans between now and harvest? I have some thoughts about it but I would not be so pretentious as to think that I could come within ten percent. What I am saying is that we may expect and demand too much from speculative markets. It has been a frustrating year for us fundamental type market analysts. We have had a lot of surprises. There may be a lot of "sour grapes" in some of the current criticism of markets.

I would now turn my attention to the specific questions that Senator Jepsen posed.

1. Has the market moved away from "fundamentals"? No. First, there is no way that a market can move away from fundamental forces. There is one inevitable equilibrium, market clearing price. The market makes errors in anticipating the equilibrium price and moving to it but the errors are always corrected. Some of the lines of causation run from speculation in futures markets to their influence on cash prices. To the extent that speculators control inventory they influence interim prices. However, the primary lines of causation in interim price behavior are between producers and consumers. Producers almost always hold a high proportion of the existing inventory and the rate at which they feed it on the market is the dominant factor in interim prices. Processors and end users take a lot or a little forward cover and thereby influence interim prices. The decisions that these people make are speculative. They form judgements on the basis of their perception of market fundamentals. Second, the USDA supply-demand releases get widespread attention and reaction and, I sometimes think, too much credence. Commission Houses spend a lot of money on fundamental

analysis and most of their releases treat with fundamentals. The statistical releases of the USDA are anticipated and responded to. It is my impression that there has been an ever increasing amount of information about supplies, rates of use, and prices during the past 35 years.

2. Has the quality of trading behavior changed? I don't know. I have the general impression that is held by many people that much position taking is based on past price patterns and "technical" considerations. If this impression is correct, the quality of trading has deteriorated. These are speculative markets and the essence of speculation is foresight; the anticipation and discounting of futures events into current prices. However, to the best of my knowledge no one knows who takes and holds positions or the basis on which judgments are made. These need to be studies made of market composition similar to the old Commodity Exchange Authority cross section surveys.

3. What role and influence does "system-type" trading have in today's futures markets? Again, I don't know. Judging from the proliferation of commodity funds and the amount of money involved I should judge that it is a growing role and influence. It is my impression that a high proportion of these use "system-type" trading. The funds are a significant source of new speculative capital but I doubt that they are of major influence on price behavior. I think that in the aggregate the funds gross break even and net lose by the cost of commission and management fees. I suspect that they largely offset each other in a given market. But again, the answers are not known. There needs to be more information developed and studies made.

4. Is there a need to improve the accessibility, quality, and timeliness of market information? The amount of supply, use and price

information has increased rapidly and is instantly available. The communication revolution is alive and well. Volume of trading and open interest is available. However, information about the composition of open interest is collected by the CFTC but only a little is made available and it is quite late. More and timely information would be useful.

5. How can the liquidity of the market be improved? Major markets are adequately liquid. Volume of trading is quite large in relation to changes in open interest. In some markets in some contract months a reasonable amount of prudence is required in placing orders. The patience required is not an undue burden on out-of-pit traders. It should be kept in mind that there is a cost of liquidity.

6. Are self-policing methods and CFTC rules and regulations adequate to promote market activity yet insure the protection of the public interest? There are three levels of futures market regulation: CFTC, Exchanges, and Markets. The self policing by exchanges is of greater importance than regulation by the CFTC. But the great regulator is the competition of the market itself. Futures markets are the closest approximation to pure competition in existance. Competition regulates itself into efficiency and equity.

We should lok for places to deregulate rather than regulate. One first point of deregulation should be daily trading limits. Position limits may be desirable but trading limits are not. I think that regulation of position limits should be removed from the CFTC and made a responsibility of exchanges. Problems of balance have arisen because of control of managed accounts. The exchanges are in a more flexible and thus better position to maintain competitive balance than is the CFTC.

7. To what extent has speculative trading affected trading for hedging purposes? It has enabled it. On the other side of a hedged position is a speculative position. Speculators have accmodated hedgers very well during the past year. Open interest in wheat, corn, soybeans, soybean oil, and soybean meal has been much larger than during the preceeding two years. The same is true of both long and short reported hedges. The markets have fulfilled their risk shifting function very well.

We should note in passing that the unusually large short hedges in corn and soybeans last fall had a lot of forward selling by farmers behind them. Open interest increased rapidly during July and August. Farmers were taking advantage of rising prices.

8. What are your views on the future prospects and potential benefits of computerized trading versus pit-trading? As everyone known, electronic communication and data processing is increasing rapidly. Potential is limitless, thus some system may be devised that will supplant direct person to person trading. But the state of the art is not so advanced at this time. I think such a system will gradually evolve in bits and pieces.

9. Why have the futures markets failed to attract greater farmer participation? They do not fail to attract farmer participation and the amount of farmer participation has been increasing, especially during the past decade. Surveys indicate that farmers make relatively little direct use of futures markets in marketing their crops and livestock. I think that the primary reason is that they prefer to use forward contracts and delayed pricing arrangements. Thus, the use of futures markets by farmes is indirect. They make forward contracts with elevators and the elevators hedge in futures.

37-522 O—84——4

Over time farmers have shown a great deal of interest in improving their marketing skills. This interest expanded rapidly during the price turblence of the 1970s. I have worked closely with farmers in this connection. It is my observation that farmers are increasingly knowledgeable about factors affecting prices, increasingly skilled in price forecasting, and are doing an improved job of distributing sales over time so that they balance risks and aim toward high average prices.

I think that when the year is over we will find that farmers have done a respectable job of marketing their 1983 crops. Reported short hedges in soybeans last September 30 were 399 million bushels compared to 211 the year before. Short hedges in corn were 532 million, up from 380 million the year before. Farmers sold more than a usual amount into what turned out to be high prices. Farmers are pretty respectable speculators and are improving.

10. How useful will options trading be for farmers? It remains to be seen. Buying puts is a conceptually useful insurance system. It will be actually useful if it is cheap enough. Usefulness of options will depend on options prices and that remains to be seen.

I would make a summary comment. The past year has been one of unusually great speculative stress in grains and soybeans. The futures markets have performed well in their basic risk shifting functions. Their speculative pricing performance has been less than optimum but given the extreme uncertainty of the supply-demand situation it is difficult to fault them, at least until we know at the end of the year what they should have done. My first point is that markets work well and that a basic principle should be observed: If it ain't broke, don't fix it.

We need to recognize, however, that improvement in the quality of speculation that would lead to greater price stability is desirable. How to achieve it? In my foregoing comments I have alluded to three things. First, some of the volatility of prices may have been the result of one set of thinking directing managed accounts that aggregate more than speculative limits. Resulting inbalance of power and countervailing power may have been responsible for some of the large and erratic price variations. If so, a first step is to remove CFTC speculative limits and add the maintenance of power balance to the responsibility of the exchanges.

Second, we do not know the relative importance of commodity fund trading or its influence on price behavior. The basic data is available to the CFTC and I think that the CFTC should be responsible for making and encouraging others to make studies appraising the importance of the growth in fund trading.

Third, more and timely information about the composition of open interest in markets would be useful to market analysts as would cross section surveys of market composition. The CFTC has unique access to information and more use should be made of it.

Finally, the central lesson to me from my own observations and deliberation is that we need to have faith in competitive markets. Exchanges succeed or fail (and more have failed than succeeded) on the basis of their ability to maintain competitive markets that serve the public interest. Futures trading is a zero sum game. The better speculators gain and grow in importance and the poorer speculators lose and go away. Markets are a continuous spelldown. They are very hard to beat which is convincing evidence that they are quite good.

Senator JEPSEN. I thank all of you. I have some general as well as specific questions. I would like to start with the general questions first and have the entire panel respond to them.

Do current rules and regulations and/or their enforcement provide the opportunity for price manipulation, Mr. Dennis?

Mr. DENNIS. In my view, there is no opportunity for price manipulation. There's a certain amount of definition involved. I assume you mean moving the price more than a trivial amount by some conspiratorial means, and so far as I know, that hasn't occurred. Also, the rules are more than adequate to prevent it.

Senator JEPSEN. Is it possible for any individual, through whatever means or associations, to cause price changes?

Mr. DENNIS. Well, we have to understand that any order can change the price a little and define what kind of price change we're talking about here. A big enough order might change the price a couple of cents.

Senator JEPSEN. Mr. Frazier, is it possible for an individual, through whatever means or associations, to cause any price changes in the commodity market?

Mr. FRAZIER. Yes. I believe that orders can be big enough at certain times to make a considerable move, if by considerable move you may mean 3 or 4 cents. That's possible without a doubt.

Senator JEPSEN. Let me ask, do current rules and regulations and/or their enforcement provide an opportunity for price manipulation? Is it possible?

Mr. FRAZIER. Well, Mr. Chairman, the move in the market of a soybean price of 3 or 4 cents on an $8 item is a relatively small percentage and I really don't think that that comes under the definition of manipulation.

In my prepared statement I was pointing out that if we had many more small, independently thought-out orders, which would be called resting orders in the pit, then you wouldn't—a 2-million- or a 3-million-bushel order might not move the market that much.

Senator JEPSEN. Do you agree with that, Mr. Dennis? You indicated you wanted larger amounts to be able to trade.

Mr. DENNIS. Well, I think what Mr. Frazier is saying is correct, but on the other hand, if I were allowed to trade larger I might be there and cause whatever price moves there are also. So it seems to me there's more than one way to get at that, larger position limits and more individual traders trading smaller quantities.

Senator JEPSEN. Would you recommend both be made available?

Mr. DENNIS. Absolutely.

Senator JEPSEN. Would you, Mr. Frazier?

Mr. FRAZIER. No, sir.

Senator JEPSEN. You recommend the smaller but not the larger?

Mr. FRAZIER. If we're going to have limits at all, I don't know that the 3-million-bushel limit which is the CFTC limit is out of line on soybeans. I would agree with Mr. Dennis' earlier testimony that when you're trading corn where we will probably have close to an 8-billion-bushel corn crop this year, the limit could probably be higher because orders of larger magnitude would not move the market and they don't move the market that much in a corn market.

Senator JEPSEN. Well, what is your fear of raising the limits as Mr. Dennis suggested? Why do you hesitate with any commodities?

Mr. FRAZIER. I don't want a 10-million-bushel order shoved into any pit at any time. I think it can create what I referred to as a pocket and I don't like pockets. I like a smooth, liquid market. I think that's better for everyone and concentrated orders cause larger price moves than smaller orders naturally.

Senator JEPSEN. Do you have any comment on that or anything so far, Mr. Mergell?

Mr. MERGELL. No. I find it very correct what the gentleman on my left, Mr. Frazier, has been saying.

Senator JEPSEN. Mr. Hieronymus?

Mr. HIERONYMUS. I have participated as a technical expert in four legal processes having to do with manipulation and I don't think markets can be manipulated in any realistic sense at all. I think that placing the very big orders can on occasion move markets until we get these gaps in them and things of that sort. I should not expect this to happen. I think the market will prevent it because it's just not a smart thing to do it. Somebody who forces a market—any time you force a market, that market will eventually turn around and bite, and as soon as the other participants learn it, somebody who goes in and hammers the bean market 20 cents one day with no justification is going to get creamed the next day. This is what I mean by market regulation.

Senator JEPSEN. When you're talking about people forcing the market and the market turns around and bites. Who, in your opinion, are the primary beneficiaries of the futures markets?

Mr. HIERONYMUS. The largest beneficiaries in the futures markets—I think I would probably say the public broadly and generally. Now in a more direct sense—we're talking about agricultural futures markets, now I think it's the farmer. I recall in 1966 testifying before a House subcommittee revising the Commodity Exchange Act in which the thrust of my comments was in defense of the speculators and speculation and I said, for whatever else you want to say about speculators, they are a farmer's best friend because he's putting stuff into the market that eventually gets picked up, the inventory is carried and it makes selling opportunities for farmers and the biggest single beneficiaries are farmers.

Senator JEPSEN. Who, in your opinion, are the primary and large beneficiaries of the futures markets, Mr. Frazier?

Mr. FRAZIER. I believe that the consumer winds up being the main beneficiary of the futures market because I think that if we did not have futures markets margins would have to be much larger than now in the case of exporters, soybean processors, flour millers, elevators. Now an elevator knows just about what he can get for something because he knows what the futures price is. He knows the historical basis of his own place and this reduces the cost of the movement of the farm product into the kitchen of the housewife and I think the consumer is the main beneficiary of the futures markets.

Senator JEPSEN. Producers, Mr. Hieronymus; consumers, Mr. Frazier. Mr. Dennis, who is the beneficiary?

Mr. DENNIS. I think the farmers are, not the consumers necessarily. The difference is that without the board of trade, prices wouldn't be made in the light of day and wouldn't be flashed instantaneously from Chicago overseas and to the farming country, and I think that's a tremendous help.

Senator JEPSEN. Mr. Mergell?

Mr. MERGELL. Well, I think when one talks about on the one side about the farmer and on the other side the consumer, I think that in essence is correct, because it's the demand created by the consumer; it is the production created by the farmer. So indirectly, these two bodies have the most advantages—indirectly I say—because the technical people like the farmers, like the exporters, like the crushing industry—we are the users of the futures markets, not so much the consumer. But if this instrument would not be available to the industry—exporters and producers—then I think in the long run the consumer would lose.

Senator JEPSEN. Now various rules of the Chicago Board of Trade relate to members' activities with reference to "the demoralization of the markets, the conduct and acts of a member detrimental to the exchange, and reckless dealings." These are all quotes taken from the various rules of the Chicago Board of Trade.

In your opinion, were any of these or other rules violated, thereby contributing to the so-called collapse of the soybean market on April 11, 1984, which is the date that has been referred to most recently by the American Soybean Association? I'd like your comments on that. We'll start with Mr. Frazier.

Mr. FRAZIER. Mr. Chairman, I know of none, but I can assure you, I believe, on the years I've been there, that if there is any suspicion that such is the case, that it is under investigation at the present time. If there is that suspicion, I assure you that some of those 50 employees of the Office of Investigation and Audits are working on it right now.

Senator JEPSEN. Mr. Dennis.

Mr. DENNIS. I'd like to point out how much of the information that people get about the commodity markets from newspapers is inaccurate and as an example I'd like to talk about April 11, 1984. I've got here the Wall Street Journal summary of what happened in soybeans that day and it says, "Soybeans were slightly higher on the opening but heavy selling by Revco, Inc., and C&D Commodities"—that's my firm—"both trading and broker firms based in Chicago, soon depressed prices." OK.

That was news to me. Later on in the article they said they called our office and we declined to comment. It sounds like that's what happened.

I went back and looked. Our firm for that whole day sold in soybeans 121 contracts, 605,000 bushels. I think everybody here would admit that that's not enough to move the market more that a half a cent or a cent, and I just want to point out that a lot of what's been said of what goes on does not match with the facts and that's what I think the investigators find. And to the extent that I was supposed to be involved in it that day, it just didn't happen.

Senator JEPSEN. Why would the Wall Street Journal reporter do that to you?

Mr. DENNIS. Well, they talk to people on the floor and it makes a better story I think if my name is involved. Everybody likes a story with a little more pizzazz and I think sometimes 600,000 bushels becomes 6 million and sometimes 3 million becomes 30 million in these stories.

Senator JEPSEN. Any other comments?

Mr. HIERONYMUS. I would make two observations. First, in answer to a couple of the questions where I don't know because I don't know who does what, C&D and all the Revcos and so forth things for months and months now, and I don't know the facts and I think these should be examined. I think the material is in the hands of the CFTC and we really should get in a dispassionate sort of way some studies made of what direct shortrun influence this has. I would point out secondly that prior to April 11 the soybean meal price was about $10 under the nearby futures on the board and this is the widest base I have ever seen in soybean meal and maybe the reason that market collapsed that day was that it was too darn high and had been too darn high for some time. The only thing you can fault is the speed with which it came down and that was probably much more the absence of resting order, particularly of our commericals, than it was by C&D. But if C&D hammers that market on a given day and had they hammered, sure, they would have knocked it down by a huge amount and had the meal base been $2 over the board the next day they would have tried like everything trying to get out of this position.

Mr. DENNIS. That's the major point. I try to predict prices. I don't try to cause trends. The trends I'm trying to profit from when I trade either exist in the real world based on the fundamentals or they don't. I can't create them out of nothing.

Senator JEPSEN. Mr. Frazier, Mr. Hieronymus has given a possible reason for the change in the market that day, April 11, 1984. Mr. Dennis indicated reasons that had been published and had been given the public were not accurate. Is that correct?

Mr. DENNIS. That's correct.

Senator JEPSEN. Now, Mr. Hieronymus gave us a possible reason for it. Do you have anything to add about why on April 11, 1984, there was this sudden collapse of the soybean market and why that might have happened?

Mr. FRAZIER. Well, I think, going back to what Mr. Hieronymus said, we had a terrible basis in the meal market and those of us who have come out of the cash business watch the basis on all things very carefully and when the basis gets way out of line it usually does indicate that we are either going up or we are going down and the futures markets usually moves to whatever the right appropriate price is.

Apparently, at that particular time, the fundamentals did not justify the price being up where it was.

Finally, as people began to realize that there was something here, we had the drop. It was over what we call overpriced.

Senator JEPSEN. Mr. Mergell, any comment?

Mr. MERGELL. The only thing I can add was although I was in Europe at that time, we got individual market reports every day and from your point of view, you're behind us—all day in Europe there was quite active trading going on and people—the market participants in Europe were actually expecting the market to move up and everybody was a little bit flabbergasted about the events of April 11 when the market first of all maintained itself and then after half the session went really down drastically as it has been described here. That was commented on that the market has gone away from fundamentals. But concerning your question about the CFTC regulations, I'm sorry. I am too far away. I wouldn't dare recommend any.

Senator JEPSEN. I understand there's a 3-million-bushel open position; is that correct?

Mr. DENNIS. Yes.

Senator JEPSEN. I further understand that traders can circumvent this constraint by having separate 3-million-bushel overnight positions on two or more exchanges; is that correct?

Mr. DENNIS. There are two exchanges, yes.

Senator JEPSEN. That is correct, you can have positions with each?

Mr. DENNIS. Correct.

Senator JEPSEN. 3 million bushels of soybeans on the American Exchange and on the Chicago Board of Trade?

Mr. DENNIS. That's correct.

Senator JEPSEN. Is this a breach of the law, in your judgment?

Mr. DENNIS. No, it's absolutely legal. Those limits are for contracts and those are separate markets.

Senator JEPSEN. If a person had that position and it is possible to do it and it is legal, is the 6-million-bushel position limit one that could lead to dramatic effects on the market?

Mr. DENNIS. Well, no, I don't believe so. If somebody just decided to sell 6 million bushels, they might move the price down the 3 or 4 cents we talked about, but probably one or two things would happen. Either their judgment would have been correct in which case the price would have stuck at 3 or 4 cents lower, or they would have been incorrect in which case the price would have gone right back up to where they started.

A dramatic trend caused by an order of that nature was a trend that was going to happen anyway based on the fundamentals. That's my opinion.

Senator JEPSEN. Mr. Frazier.

Mr. FRAZIER. Mr. Chairman, market forces are going to prevail. Market prices are going to be what they should be and the problem is, of course, that we do get these temporary times when because of concentrated selling or concentrated buying we move these prices perhaps—I don't like to use the word more than they should move because that is what happens. But in the long run, the market comes back to where it should be and, as Mr. Dennis said, if somebody sold 6 million, 3 million in each place, in all probability, depending on what day it is and what the other events in the world are that are going on and how the other markets are moving, that can move the market 3 or 4 cents. It's not going to move the market 30 cents and the market will eventually come back to the appropriate price.

Senator JEPSEN. I'm not being the devil's advocate here, but I understand the feedback of what I've just heard said here is what will be will be, that the law of supply and demand ought to prevail and the market is going to work itself out, but that really isn't what a lot of folks are asking.

They are asking about these rather dramatic swings and if you hold onto the swing ultimately you're going to stop swinging and come back where you're supposed to. But some of these folks when it swings out this way, they're going to have a problem; it might not be the right time, and they are wiped out. I think this is getting more specifically to what drives down the credibility and whereas, Mr. Dennis, as you indicated earlier, you felt somebody just wants money or made a bad decision and that's human nature, I guess; but is there such a thing as, again, using the word "manipulation"—I don't know of a different, better word—maybe if somebody would present one we would use it. Mr. Dennis, you said that if you had 6-million-bushel open position, that's possible the way things are now, 6 million bushels?

Mr. DENNIS. Right.

Senator JEPSEN. You could do something that would provide a 4 cent difference. Now 4 cents a bushel isn't much, but 4 cents times 6 million is quite a bit, no matter how you count it.

Mr. DENNIS. Right.

Senator JEPSEN. So who would benefit from that, having that position? Would the producers, the farmers, the consumers? Or would the person who had the contracts benefit from it?

Mr. DENNIS. Well, depending on if the trader was buying or selling, if the prices were going up the farmers would benefit; if the prices were going down, the consumers would benefit. I think it's important to understand that in no case would the speculator benefit. Any speculator who understands anything about what they're doing understands that if they've got 6 million bushels to sell or 600,000 bushels to sell or 5,000 bushels to sell, they want to execute that order with the minimal possible price difference. It's never to their advantage to create more price difference when their order is being executed. If I had a broker who came back to me and said: "I could have filled this and the market would have gone up 2 cents but I decided to knock it down 4 instead," I say: "You're fired."

The inference is that you could start selling at $8 and buy at $7.95 and then you'd have a profit because you've sold at somewhat higher levels, but it doesn't work that way because there would be no way to repurchase those contracts immediately at the $7.95 price. You would have to start the reverse process and you would wind up losing.

Senator JEPSEN. Congressman Wylie, and Senator Abdnor, and Senator Symms, you may proceed here. I have taken a little more time than we allow for each individual, but you may proceed now.

Representative WYLIE. Thank you very much, Mr. Chairman. I have a feeling that this is an area in which you're more knowledgeable than I and I was fascinated by the questions and the responses thereto, but I do feel the need to enhance my own education and knowledge on this subject and so I will ask some questions here.

You mentioned the article in the Wall Street Journal which I also found very fascinating, and I'm not sure that I heard the answer as to why there was a sort of avalanche or a plunge in the market prices for soybeans on that particular day. You mentioned in your testimony, Mr. Frazier, that sometimes these actions take place because of strong rumors that affect the market.

Would you expand on that a little bit? Was that a factor on this particular day?

Mr. FRAZIER. I don't believe it was a factor on that particular day. What happens is that markets are interrelated. Years ago this wasn't so important as it is today, but now when the grain trader walks on the Chicago Board of Trade, the first thing he does is he looks up and sees what the gold price is and the silver price is, the yen, the mark, the franc, and the bonds and the Ginnie Maes. If they're all down, he figures that the grain market is going to be down. If they're all up, he figures the grain market is going to open up.

We have so many factors that are interrelated so that if you have a rumor which is going to upset the balance in the world, such as the President being dead, the gold market goes wild; the silver market goes wild; and this affects the grain market on the up side. These rumors—there have been several of them in the past few years which have actually caused 30 cent moves. As you pointed out rightly, this is a lot of money when you spread it over the soybean crop. And these are the things that—this is one area where we could take some uncertainty out of the market if we could stop such a thing. It is, of course, a criminal act.

Representative WYLIE. How would you go about stopping it?

Mr. FRAZIER. First of all, you find out who started it and you punish them severely.

Representative WYLIE. You punish them severely?

Mr. FRAZIER. Absolutely, so it won't happen again.

Representative WYLIE. How would you punish them?

Mr. FRAZIER. You put them in jail.

Representative WYLIE. You put them in jail?

Mr. FRAZIER. It's a criminal act.

Representative WYLIE. Do you pass a Federal law to do that?

Mr. FRAZIER. Yes, sir.

Representative WYLIE. Do you pass a Federal law to do that if somebody starts a rumor?

Mr. FRAZIER. Yes, sir.

Representative WYLIE. False or otherwise?

Mr. FRAZIER. Any false rumor that is put out with the intention of affecting the markets is a criminal act.

Representative WYLIE. Well, what if it turns out to be true?

Mr. FRAZIER. Then it's not a false rumor.

Representative WYLIE. But you wouldn't know that except in hindsight.

Mr. FRAZIER. Well, that's the point. Nobody knows whether it's true or it isn't, but many commodities are traded out of fear, the fear that you're going to lose on your position and you take action to protect yourself.

Representative WYLIE. Mr. Dennis, you might want to comment on that, but I'd also like you to comment on another attribution to you that you have made millions of dollars this year according to a Wall Street Journal article of May 8, 1983, thanks in part to a summer drought and to the Federal budget deficit.

Right now in Ohio we have been having a considerable amount of rain and I think throughout all the Midwest, so farmers are not able to plow and plant. Are you taking a range on a wet season or how do you go about putting that into a formula? While you're doing that, getting into this in terms of the enhancement of my education on this subject, reference has been made here during the course of this discussion this morning about some sort of a statistical model which analyzes successive prices and projects future prices. Do you use some sort of a statistical model? Do you feed in a drought and the budget deficit and rain in the Midwest?

Mr. DENNIS. Let me separate sort of the real causes of price situations, that I believe the members of this committee are somewhat unhappy with, the price decline since September, which I believe was caused mostly by the budget deficit and the high interest rates that ensued and the strong dollar that was caused by both of those, and how I trade, which is based on computers and numbers and statistical models that doesn't factor in things like deficits and drought.

The only thing I'd add, if it's of any interest or relevance to the argument about what speculators did or didn't do in the market, is that I did best when the farmers did best; I did worse when the farmers did worse. You can check my trading records in September, October, November, and December. I was a net loser in soybeans futures. I made money in the summer when the prices were going up.

I guess I'd like people not to have in their mind that this game is so zero sum that if the speculators are making money they're making it from the farmers. That, in fact, is not correct. Almost all the money I have known speculators to make has been made in up markets in markets where the price of agricultural commodities was appreciating.

Representative WYLIE. Do you use a statistical model, though, to project future prices and to hedge your bet?

Mr. DENNIS. No. I don't use what would be a traditional econometric model. It seems to me that those models are basically useless in predicting price. I try to predict future price from past price. That's different than a statistical model.

Representative WYLIE. In your opinion, what would you say are the most important forces which affect the futures markets?

Mr. DENNIS. The pricing of the commodities on the futures markets?

Representative WYLIE. Yes, sir.

Mr. DENNIS. No doubt that the prices are determined by supply and demand, by the fundamentals, by the push and pull of bullish and bearish fundamentals I think we all occasionally look at one fundamental and turn a blind eye to the other one, and I think that's what happened with the drought last summer. Those are the real factors and that's what's important.

Representative WYLIE. Mr. Mergell, is the United States still the price leader in the world market?

Mr. MERGELL. When it comes to the producing side, you have a very, very heavy influence, but one should not quite forget the demand side, and the demand side is, as well, very, very important. And I think in this whole discussion here this morning and certain, not accusations but observations concerning price deceptions by prices going down after the events of last summer's drought, I think indirectly they are somewhat linked to the demand side of it because we now know—as we are members of the famous soybean fraternity—we know that Russia, for instance, has been very, very disappointing in their meal purchases and I think this had a lot to do with the depressing prices earlier this year.

Representative WYLIE. What I had reference to is, you said in your testimony that other countries are affected by what goes on in Chicago—I rephrased it as the United States is still the price leader in the world market. Do these other countries have an opportunity to air their opinions to the Chicago Board, for example? I mean, do you have input into it?

Mr. MERGELL. Well, I don't know whether you recall there was on Reuters and generally in the press, one could read sometime in February, that Brazil stopped giving export licenses for beans, meal, and oil on the pretension that the markets were manipulated downward, not reflecting in their opinion the fundamentals, and some multinational export companies were accused of that. You see, in essence, to me it means that the Brazilian producers, the Brazilian exporters, but as well the Brazilian Government, thought that something was manipulated and that they indirectly depended on the movements of Chicago. I can't give you any better example as giving you this answer to your question.

Representative WYLIE. I will ask one more question of each of the witnesses. Do any traders have control over prices and, if so, how much?

Mr. MERGELL. No, I wouldn't say—perhaps I didn't quite understand your question. I do apologize.

Representative WYLIE. You indicated a little earlier about forces in Brazil had an impact on the futures market and maybe I'm not phrasing it correctly, but I'm trying to say, would there be a force—and you referred to traders in the futures market.

Mr. MERGELL. In my opinion, no. There's fortunately still too much competition going on between traders to be able that anyone can influence a certain price downward or upward.

Representative WYLIE. So in your opinion, it is not possible then to manipulate futures prices through a particular trader or through a particular group of traders?

Mr. MERGELL. Well, if you refer to traders as being what I understood from your question as being for instance the exporters, I would say no. If it comes to other participants in the Chicago Board of Trade, there I'm more reluctant to give such a clear-cut answer.

Representative WYLIE. Mr. Dennis, are you a trader?

Mr. DENNIS. I am a trader.

Representative WYLIE. And you're not an exporter?

Mr. DENNIS. There's a terminological problem here by traders and———

Representative WYLIE. I have a little more knowledge on the subject than I thought.

Mr. DENNIS. "Speculator" is a nasty word, I suppose, for it. I don't know of any speculators who have any control over prices. As I said, my job and all the people that I know who speculate are trying to predict prices. Everything my experience has taught me is that to try to control prices is to put yourself on the road to becoming an ex-trader. It just can't be done.

Representative WYLIE. Mr. Frazier.

Mr. FRAZIER. No, sir; no trader can control the prices of any agricultural commodity. As I pointed out in my testimony, the futures markets now is an international market. Mr. Mergell pointed out that Brazil has its effect on it, but also Mexico and Australia. It is now so big a market that no trader can manipulate the prices to any great extent and in fact, in today's climate, I don't even know anybody who would even think he could.

Representative WYLIE. Mr. Hieronymus, do you agree with that?

Mr. HIERONYMUS. I quite agree. First of all, it would be stupid to try; and second, there is just no one that big. We've got an inventory in the United States so that on April 1, there were 153 million bushels, and to control that is just a gross impossibility. We went over the interest in 5 million bushels at the Chicago Board of Trade and over 1 billion bushels in corn. There is no one who can fly in the face of fundamental supply and demand forces.

Senator JEPSEN. Senator Abdnor.

Senator ABDNOR. Thank you, Mr. Chairman. Gentlemen, as I said in my opening statement, I'm not knowledgeable of the functioning of the board of trade and how it operates in detail, and I doubt if many of my constituents are. They do have a perception, and it's not good. I guess I'm not the only one who's said that. I brought a number of quotes from some of the letters I have received from my farmers and maybe there is a lack of information. But nevertheless, the quotes illustrate what people perceive. When one is a Member of the Senate or House, he may think that he is doing a great job for the people. But if they don't perceive it that way back home, they throw him out. And I don't think our people perceive you people and the board of trade as exactly the greatest people or institutions that's ever come down the pike.

Now how do you change that image, if you are doing so well for the farmer? Do you have any thoughts on this. Do you think we ought to have a campaign going on to say that this is a good thing for the farmers?

Mr. FRAZIER. I'll be happy to answer.

Senator ABDNOR. Let's convince these people.

Mr. FRAZIER. Senator, I really believe, as I said, that this is an educational process that has to be ongoing and it's a massive task. The rules that we trade by are not understood. I believe many farmers think that we go in the back room and fix the prices, where in reality it's illegal to do anything except in the open. It's right out there in the open. I think that we should have and we do have thousands of farmers come and see how the system operates so that they can see right in front of them, and I think that any farmer who visits the board of trade will go away with a much better understanding, and I invite them all to come. And I think that would be a great help. So I think it's an educational process.

Senator ABDNOR. Mr. Frazier, how long have the futures markets been in existence?

Mr. FRAZIER. Since 1848, sir.

Senator ABDNOR. In 1848 and it was really created and designed to stabilize prices and to allow the processors and producers some stability?

Mr. FRAZIER. Yes; it was started so that a farmer didn't have to ship a small craft of wheat into Chicago and not know what he was going to get for that wheat or barley or oats or whatever. It was originally started so that the farmer would know what price he was going to get for his product when it arrived at its point of destination. That's what it was started for.

Senator ABDNOR. And you feel for that purpose it's still as dependable and reliable as it was in the beginning?

Mr. FRAZIER. I think it's reliable today and I think that the board of trade would function greater, as I testified earlier, if the farmers used the board of trade more and we had more of their orders coming in.

Senator ABDNOR. Do you really feel then, as you said earlier, that in no way is the volatility the markets have experienced the fault of the trader; that he doesn't have much of an effect on the ups and downs?

Mr. FRAZIER. It is traders who put the orders in to buy or sell and I supposed we'd have to say that everybody that enters a buy or a sell order is a trader, whether he's a hedger or whether he's a speculator, he's still a trader. And the board of trade itself is only a place. It's only a marketplace.

Senator ABDNOR. But some people are in this who do the work who do the producing, and it's their land and their money yet others play with it to make a buck.

Mr. FRAZIER. But the point of the speculator is to take the other side of the farmer when he wants to hedge his grain.

Senator ABDNOR. Well, this is all very interesting. Do you have any idea how much the board of trade made last year in 1983? I was told it made $9 billion before taxes. Is that crazy or is that right?

Mr. FRAZIER. I forget. Believe me, it's not a real moneymaking proposition.

Senator ABDNOR. They don't make that much money?

Mr. FRAZIER. Well, the board of trade actually——

Senator ABDNOR. Do they have to show what they make?

Mr. FRAZIER. Oh, sure. There's a financial statement. I'd be happy to mail you one.

Senator ABDNOR. You don't think it's possible that they made $9 billion before taxes?

Mr. FRAZIER. It is possible, but that's not really very much money, sir, when you——

Senator ABDNOR. Do you have the answer, Mr. Hieronymus?

Mr. HIERONYMUS. Well, the board of trade is a nonprofit operation. It provides the marketplace and writes the rules and supervises the trading and so forth, but it in no way participates in any trading. It's a clearinghouse that becomes a buyer to all sellers and a seller to all buyers. The clearinghouse breaks even, market-to-market every day, collects and pays out exactly equal amounts. So futures trading is a zero-sum game.

Senator ABDNOR. In other words, they didn't make anything?

Mr. HIERONYMUS. No; I think you probably had assessments, didn't you, in your membership like a country club?

Mr. FRAZIER. Senator, actually it's not really a moneymaking proposition. It may have a profit some years and it may have a loss some years.

Senator ABDNOR. Who makes it? I mean, are they doing it for their health, just for the salaries they get? Is that what it is?

Mr. FRAZIER. The members themselves own the board of trade.

Senator ABDNOR. Who do you mean by the members?

Mr. FRAZIER. There are 1,402 regular members of the Chicago Board of Trade and there are several other categories. I think the total membership is up around 2,400 or 2,500. We are assessed every quarter dues which we pay.

Senator ABDNOR. All right. Are any of those people farmers, to your knowledge?

Mr. FRAZIER. Oh, sure. Oh, yes, we have farmer members.

Senator ABDNOR. You do?

Mr. FRAZIER. Absolutely. Lots of them.

Senator ABDNOR. When I think about farm net income from last year, the whole shibang, what farmers and ranchers lived on—I believe it was nearly $22 billion. When they make that much and then I learn what some traders make, it makes me wonder why we have the futures markets. Maybe the farmers would be better off without it. We have more and more people coming into trading and the volume is getting bigger, is it not? Is that good or bad?

Mr. FRAZIER. I think the bigger the volume, the better it is for all because the bigger the volume in all probability, the smoother the price action will be.

Senator ABDNOR. Didn't you tell us earlier in your statement, Mr. Frazier, that maybe we have too many large traders?

Mr. FRAZIER. What I'm getting at there is that if we had myriads of small orders rather than concentrated large orders, you would have a smoother, liquid market, and you wouldn't have the quick short-term price moves that we get from big orders sometimes.

Senator ABDNOR. A minute ago you said that speculators were needed to take the opposition position from hedgers. Then why are short seller speculators needed? Do we need these short sellers?

Mr. FRAZIER. Do we need short sellers?

Senator ABDNOR. Are they helpful to the farmer?

Mr. FRAZIER. The theory, of course, is that a farmer with a growing crop—if I had some November soybeans or if I had some soybeans that were coming out this fall, I would be hedging part of my crop right now at this $7.20 level and on up. And so the farmer would be selling to fix a price which $7.20 beans will cover his costs and give him a profit so he's got some money locked in. Now when he wants to sell those soybeans, there must be somebody on the other side who's going to buy those soybeans and basically that's where the speculator comes in. He takes the opposite side of the true hedger and in that case the farmer is the true hedger.

Senator ABDNOR. And there's no way he can disrupt the marketplace?

Mr. FRAZIER. No; I said manipulate the marketplace. Disrupt for a few minutes—a big order may "disrupt," if you want to use that word—it may cause a movement of 2, 3, or 4 cents.

Senator ABDNOR. A nickel a bushel is a big sum of money if it drops at the close of the day. Let me ask you this: What are the original margins required for a wheat contract?

Mr. FRAZIER. They usually run about 10 percent of the value of the commodity.

Senator ABDNOR. Does it vary from corn to wheat to cattle?

Mr. FRAZIER. Yes; it varies. It's about 10 percent in the grains.

Senator ABDNOR. There's no set figure on it?

Mr. FRAZIER. No; margins are set by the board of trade and, as I said, normally they will run about 10 percent of the value of the commodity. Now if an unusual situation exists in the market where it is believed that one force or another is out of line, then it is incumbent upon the margin committee to raise those margins and they have done that.

Senator ABDNOR. Well, that surprises me. I thought there would be a flat rate. Is that the way it is all around the world? Does the margin change from time to time or from day to day?

Mr. FRAZIER. It doesn't change from day to day. It changes quite infrequently.

Senator ABDNOR. How much fluctuation will we see; 1 or 2 percent?

Mr. FRAZIER. Rarely over 5 percent.

Senator ABDNOR. I remember back when I was younger and Mr. Kennedy was President. Wasn't that about the time they made a much stiffer requirement on the margins for the stock market? Why did they do it? It must have been for a purpose. Can't a speculator play around a lot more by putting up such a small percent and can't he affect the market more? Maybe we ought to make him a true investor and make him put up some money so he will be a little less likely to have huge amounts to play with. Everybody ought to benefit by it if it's a good time to sell. Why shouldn't we raise the margin?

Mr. FRAZIER. Why shouldn't we raise the margins when, sir?

Senator ABDNOR. On the grain markets, so you had to put up more or your own money when you buy or sell. What's wrong with doing that?

Mr. FRAZIER. The higher the margin requirement, naturally, the fewer players you can have and the fewer people.

Senator ABDNOR. Maybe we'll get some of this wild fluctuation out of it.

Senator SYMMS. It wouldn't work. It would make the market less liquid. Well, I'll let him answer.

Mr. FRAZIER. Exactly. It would make it less liquid. If we raise the margins, we'd drive a lot of people away and therefore you have less liquidity.

Senator ABDNOR. Maybe this thing would level off. You can't tell me people aren't playing the futures like a poker game. People go broke gambling and maybe that means liquidity, but I'm not so sure that it doesn't cause a lot of volatile price changes and helps the guys who are smarter than the farmers, and who have more time to pay attention to what's going on in the market. Why do elevator managers pay so much attention to the market? They don't make a move unless they're watching the market price.

Mr. FRAZIER. The elevator has to sell the product that it buys from the farmer to somebody and that's based on the—in your area, it's probably based on the Minneapolis Exchange more than it's based on the Chicago Exchange, but in the case of your wheat, it's based on the price of wheat futures in Minneapolis.

Senator ABDNOR. Well, to go back to the securities exchange, they have a 50-percent margin now. Why did they do it? Isn't it just as important in the stock market to have this liquidity you're talking about as it is in the grain market?

Mr. FRAZIER. Well, Mr. Hieronymus is an expert.

Senator ABDNOR. All right. Whoever wants to answer.

Mr. HIERONYMUS. There's a definitional problem with the expression "margin." The margin requirements in the futures trading is posted by both sides, both buyer and seller. It's a guaranteed performance. It's earnest money.

Now, the margin in the securities market, I think, is a misnomer because it's a loan to buy stocks and the Securities and Exchange regulation says I may not borrow more than 50 percent of the money, but it regulates the amount of loan.

There is no loan, no indebtedness at all, in the futures market. It's been a very difficult thing to try to explain all of these years.

Senator ABDNOR. That definition is confusing, too.

Mr. HIERONYMUS. It's the wrong nomenclature. A margin in the futures market is simply a guarantee of performance.

Senator ABDNOR. In stocks it's one thing, but it doesn't mean that with commodities?

Mr. HIERONYMUS. That's right.

Senator ABDNOR. Why? I guess you just told me but I don't understand.

Mr. HIERONYMUS. Well, I wish the securities people would find a different term because what we're really talking about in securities is indebtedness, a loan. These are all people who are long. In commodities it's earnest money. It's a guarantee of performance on a contract. It's posted by the seller of the contract. It's posted by the buyer of the contract. So, it has an obsolutely neutral effect on the market itself.

It's kept at levels as low as possible but will still protect the financial integrity of the contracts. By keeping the margin requirement low, we add to the liquidity of the market and increase the access to the market, and I think thus reduce the total cost of transactions.

Representative WYLIE. Would the Senator yield?

Senator ABDNOR. Yes.

Representative WYLIE. You mentioned mark-to-market a little earlier in your testimony, Mr. Frazier, you said: "In almost all cases the 1981 tax law was cited as one culprit in hampering liquidity with its market-to-market provision."

Would you two gentlemen explain this?

Mr. HIERONYMUS. We're talking about different things.

Mr. FRAZIER. My testimony referred to the fact that if a person has an open position at the end of the year, December 31 or whatever it happened to be, if he has a profit in an open position, he must pay a tax on that profit even though that transaction isn't finished. It's just like your house. You have to pay a tax on the value of your house at the end of the year even though you're still living in it and you have profit in it. So, a trader who doesn't know where he's going to be able to get out of this position that he has on the books does not want to carry a profit over the end of the year because he's paying a tax on a transaction that he may lose on.

So the market-to-market provision prevents—this is one thing it does—the trader who used to trade off in what we call the back options, say a year away. He cannot carry those open positions over the end of the year with the profits because he's paying money out that he may never see. So, he avoids them and, therefore, we don't have traders trading in those back months any more.

Before the 1981 tax law, when a 6 million, 10 million, or whatever the particular orders came in to the front end where most people trade, the nearby futures months, when they started to move, the traders would merely go over and take the opposite position in the back months. Now he can't do that because he doesn't want to carry this back month position for a long time. So we've done away with that particular point in the market which gave us liquidity.

I'm not saying go back and do it exactly as it was pre-1981, but do something which enables these traders who took the risks to be able to go back and handle their trades like they did prior to the 1981 tax law. It's made a big difference in our trading.

Senator ABDNOR. Mr. Hieronymus, going back to the margin requirement issue, I guess I don't understand why it's OK to put the 50-percent requirement on stocks but not on commodities. All I can say is that the more grain that somebody can control for a less percent of the dollar, the more he can affect that market by buying and selling. Wouldn't you say that's true? The guy who sells 10 million bushels of wheat at one crack is going to affect the market a lot more than the one who sells 1 million bushels. Wouldn't that take some of the volatility out of the market, by deterring traders from dumping grain near the end of the day? Why not require speculators to pay a greater margin?

Representative WYLIE. But you're going to get a cheaper price.

Senator ABDNOR. Not if you only require speculators to pay the higher margin.

Mr. HIERONYMUS. Let me try to structure a question which is what I think you're asking, which is, what level of equity should traders be forced to have before taking a market position?

Senator ABDNOR. That's right.

Mr. HIERONYMUS. Now this question has come up—I have no idea how many times. The first thing I wrote on the subject was published in the New York Commercial & Financial Chronicle in 1951. It's come into consideration in every kind of legislation that's been reviewed. The answer has always come up the same and, that is, the purpose of the margin is to guarantee contracts and we've never had a default on a contract at the Chicago Board of Trade. So, it serves its purpose and serves it very well.

Now, if we had unduly large margins, we would discourage participation in futures markets, because the great attraction of markets to speculators is leverage. Actually, the price variability in commodities is substantially less than price variability in securities. So, if you boost it to 100-percent margin on futures contracts, the trading would be just like watching paint dry. It would just be too dull and we would not get people into it. And because we do have this breadth of speculation and large numbers of speculators in these markets and they are attractive and they do have to compete directly with each other for zero net profit, we do stabilize markets.

So what I'm trying to say is that by having a smaller guarantee that is consistent with financial integrity, we increase liquidity, we increase participation, and we decrease volatility. Volatility comes out of thin markets, markets with low levels of participation.

Senator ABDNOR. Well, let me ask you this. If that's the logic, then why not eliminate the margin altogether? Let's eliminate the margin.

Mr. HIERONYMUS. In that case, the contracts would lack financial integrity and if they don't have financial integrity, then there's just no point in their existence.

Senator ABDNOR. Well, I think there's a fine line in this entire situation.

Thank you, Mr. Chairman.

Senator JEPSEN. Senator Symms.

Senator SYMMS. Thank you, Mr. Chairman, and I want to thank the witnesses for their patience through this line of questioning this morning.

I was on the House Agriculture Committee when the Commodities Futures Trading Commission was set up and I was the one member of the committee that opposed the setting up of the Commodities Futures Trading Commission and I think you made a comment about—one of you did in your testimony—that they require economic feasibility requirements before the exchanges can set up a market. But isn't this kind of a waste of the regulators' time and effort and money to do that?

Mr. HIERONYMUS. Well, my underlying philosophy about new contracts, new commodities, and so forth, is run it up the flagpole and see who salutes, see who wants to buy.

Senator SYMMS. Absolutely.

Mr. HIERONYMUS. Historically, a very high proportion of all new commodity offerings of commodity stocks have failed and I can make logical economic cases, speculative cases and so forth, for the trading in many more commodities than we have at the present time. At the moment, for the past year or so, I've been working with some people in Oregon and Washington who are trying to get a white wheat futures market contract functional in the Minneapolis Grain Exchange.

Senator SYMMS. We'd like to have one. I'm from Idaho.

Mr. HIERONYMUS. And I guess I can make all of the arguments for it and really think it would work, but I think the odds are against it.

Senator SYMMS. If I recall in the middle 1960's the New York Mercantile Exchange set up an apple contract and they couldn't get the apple growers to hedge because basically in the apple business we're all speculators anyway or we wouldn't be in that business, and they never really had a market, so it failed because the cold-storage houses didn't want to hedge. They just never had the other side of the market and it failed of its own volition and we didn't need the Commodities Futures Exchange to tell us that it wasn't economically viable, that the market would take care of it.

But you brought up an interesting point to Congressman Wylie on the market-to-market tax thing now. I personally think that the market-to-market was a very bad mistake on the part of Congress and I think I was the one vote in the Finance Committee opposing market-to-market taxation, and I'd like to have each of your opinions.

From a farmer-producer standpoint, which is my bias, in favor of silver production, wheat production, meat production, grain production, the things that we produce in my State, timber production, so we're a producer State. The old tax law pre-1981, did it not have somewhat of a bias in favor of the bulls? In other words, there was a reason to get in the market and stay long and hold a long position through the holding period and this put some of the longs in strong hands that way. Now on April 11 when the price collapsed, if I'm a trader today with market-to-market and I've got a profit in my position, why the heck should I stay in? Why not get out? I'm going to be taxed by the IRS or I'd lose it all, so there's no advantage for holding a long position contract. Is that not true, that the bias has been fully removed now from the Tax Code, and you just as well be short as long?

Mr. DENNIS. That's correct. Before 1981 a long-term gain would have been taxed at 40 percent and short-term gain would be taxed at 70 percent and now that's down to 50, but that's essentially correct.

Mr. HIERONYMUS. I think theoretically, it's quite good. It may have been the old tax law certainly had a bias on the long side. I find it almost impossible to resist a facetious sort of comment that says that a long-term capital gains position is designed to increase taxes and it certainly does because most of them turn into longer term losses. I sort of think the other side of that——

Senator SYMMS. But with a 70-percent confiscatory tax rate which we have and a 28-percent long-term position, there would be an incentive for someone to hold soybeans or hold grain or hold silver or whatever from a longer position—timber or whatever it was—and convert that gain into capital gains.

Mr. HIERONYMUS. But the problem is, he takes those positions and he hedges off against them, so his net long position may well terminate and I guess I kind of like the 60–40 compromise.

Senator SYMMS. You like the market to market?

Mr. HIERONYMUS. The 60–40 compromise.

Senator SYMMS. However, from the standpoint of looking at it from a producers' State point of view, Mr. Frazier talked about the fact that you don't have people trading in the far out contracts.

Mr. FRAZIER. That's right.

Senator SYMMS. So say the Hecto Mining Corp., for example, that produces 4 or 5 million ounces of silver a year, they don't have the long-term liquidity and price stability for them to sell into a forward contract as good now as they had before, is that correct?

Mr. FRAZIER. Absolutely true.

Senator SYMMS. Do you disagree with that?

Mr. HIERONYMUS. I would in a way disagree with it because a silver mining company wants to hedge way out, that silver market is not liquid out in those back months. He's got to exercise a good deal of patience in getting out there and if he's got patience in doing that he will find a trader in the pit who will do it for a carrying charge. He doesn't have day-to-day liquidity, of course, if he wants to go in there and trade his position day in and day out and have a big proportion of his production hedged on a given day and increase it sharply. As the market moves around, he's going to lose liquidity, yes. We're talking about liquidity, but as far as ability to really do it in the long far out position, no.

Senator SYMMS. Well, with respect to the IRS and the market-to-market tax policy, is it not true that a great deal of concern now by many of the traders is that the IRS is trying to go back and apply market-to-market rules to trades that have happened since 1978 and 1977?

Mr. FRAZIER. I can't answer that.

Mr. DENNIS. I believe there is and I think there's a general perception that the IRS has got a specific program, although I think they deny it, to do just that. Task force is I think a word they'd like to avoid, but that's, I think, what they're doing.

Senator SYMMS. I think there is a task force out there. They have almost admitted it a few times.

Mr. DENNIS. Yes.

Senator SYMMS. But I do think that Senator Abdnor makes a very good point for the industry that there is a misunderstanding of the futures markets in the general public. The Cattleman's Association in Idaho passed several resolutions to outlaw the trading of cattle futures on the Mercantile Exchange. Now I'm not sure that they all really feel that way because many of them use the futures markets, but one thing they did say was that that was one way they could get Clay Adams to come out and speak to their convention. When they passed that resolution he accepted to speak immediately. So I think that there is a general misunderstanding on the part of the public.

I don't know how you're going to overcome that other than get more people trading so more people understand it.

Mr. HIERONYMUS. I think that over time the National Cattlemen's Association has substantially modified its position. It's appointed a special study committee and every one of them comes in with answers favorable to cattle futures trading and wants to develop educational programs and so forth. So over the last 15 years the attitude of cattle producers has substantially modified and their knowledge has increased. It's a very slow process.

Senator SYMMS. How about with respect to perishable commodities? At one time, even long before the Commodities Futures Trading Commission was set up, the USDA outlawed the trading of onion futures. Would you want to comment on that?

Mr. HIERONYMUS. The Congress did it.

Senator SYMMS. Congress did it.

Mr. HIERONYMUS. Congress did it and I looked in great detail at the operations in the onion futures market. In fact, the first time I ever testified before a congressional subcommittee I was against that particular bit of legislation in 1957. The onion futures market was a very useful market. It tended to get quite volatile at the expiration of the contract in the spring because the last onion was a very valuable onion or it was garbage, depending on whether it was the right one.

You raised the question of perishability. Everything is more or less perishable. It is more difficult to write contracts in perishable commodities but we have long since learned how to do it as in cattle and so forth.

Senator SYMMS. The reason I asked that question is that the onion market is not all that stable. I think my colleague from South Dakota, if he watched what the onion market does today, it is one of the most volatile markets and people bleed and die every day in the onion market because there isn't any liquidity and you never really know what the price is.

Mr. HIERONYMUS. Some of us made before futures and after futures studies and price volatility increased after the cessation of futures trading in onions and there were others of these as well. In commodities that don't have futures markets, the sellers are at a substantial disadvantage.

Senator SYMMS. How about the stock indexes, the futures prices traded on the stock indexes? Is that turning out that that's a very valuable tool for mutual funds or pension funds to use those markets, or who are the big users of the stock price index?

Mr. HIERONYMUS. We don't know. I have not been that close to them. The biggest one is the S&P 500 in the futures market. This is different from the options. The biggest one in the open industry is not very big against the total ownership of the pension funds and public ownership of stock. Again, we don't know the composition of who is long and who is short, how much of this is hedges against pension funds and hedges against individualized portfolios, and so forth. And until studies are made of the composition, we won't be able to answer that question.

Senator SYMMS. Well, just looking at the Chicago Board of Trade yesterday in the Wall Street Journal today, for example—and I've been told the U.S. Government won't go into the market unless the Chicago Board of Trade is open, is that correct, to finance the debt?

Mr. DENNIS. That's correct. They probably wouldn't do it on a day the board of trade was closed.

Senator SYMMS. Because they use that for price discovery. Yesterday there were 131,000 open-interest contracts in June, 19,000 in September, 7,000 in December, 5,000 in March 1985, and it just goes right on down to March 1986; it's down to 1,100 contracts.

Do you think if we had the old tax law that that open interest would be spread out more, Mr. Frazier?

Mr. FRAZIER. I certainly do.

Senator SYMMS. Mr. Hieronymus.

Mr. HIERONYMUS. I would probably agree.

Mr. DENNIS. Absolutely.

Senator SYMMS. Mr. Mergell.

Mr. MERGELL. I'm sorry, but it's too far away from Europe.

Senator SYMMS. OK. Well, this will probably be an issue I know, Mr. Chairman, that the Finance Committee will be interested in our testimony on this and I'm interested in that because of how the tax law affects these things. I suppose that the traders and the industry will learn how to use it, but I can assure them that once everybody learns how to work under the present set of rules, if Congress is consistent with its past record, it will change them. I like Congress and the Finance Committee with the game of roller ball—once the players learn how to play it, the officials change the rules and they just keep changing it and changing it, and anybody that learns how to use the tax law somehow when people think there's an advantage to one group or another—and I think in your industry what you should be careful of is that the 60-40 rule will be changed to raise the 32-percent rate up to a higher level because there's already an attempt to do that in this present tax bill, if you're not aware of that, and if it hadn't been for a couple of us on the committee I think it would have been changed, when it has only been in effect for less than 3 years. So I think there is a movement to limit those risktakers from the opportunities that are out there and also because people think that there's no—they forget about the performance side of the contract that Senator Abdnor is concerned about—and I appreciate his concern, but for every time the price of soybeans goes down if you've got more contracts you're going to have to perform and lose more money.

Mr. HIERONYMUS. Well, I would argue that if you want to change the 60-40 and raise the 32, they should make all capital losses tax deductible as well as capital gains being tax deductible.

Senator SYMMS. I agree.

Mr. HIERONYMUS. There is a heads I win, tails you lose aspect to this.

Senator SYMMS. Absolutely.

Mr. HIERONYMUS. The winner pays the taxes and the loser doesn't get out of paying any taxes, and this is very hard on the participation in the speculative markets.

Senator SYMMS. I quite agree with you. However, the movement in Congress has been to reduce that, not expand it. So there's a disincentive for someone to go out here and take a risk today in a capital instrument of any kind, because if they lose they can't charge it off against ordinary income except up to $3,000 a year. I think it's even changed to one. I think it may be. We'll have to dig into the bill and look, but I think there is a move to reduce it.

Mr. HIERONYMUS. That would be very harmful for the futures markets specifically. In a very broad context, it's very bad for all capital markets, generally.

Senator SYMMS. Thank you, Mr. Chairman.

Senator JEPSEN. Would any one of the panel like to make a closing statement for the record?

Senator SYMMS. I think what we ought to do, Mr. Chairman, is have everybody in Congress trade at least one contract for a year.

Senator JEPSEN. Mr. Hieronymus.

Mr. HIERONYMUS. When Mr. Weems first became executive director of the CFTC and he was recruiting people for it, and I said that one of the requirements should be that they have to escrow 20 percent of their salary and put it into an active speculative account and thus they will learn.

Senator SYMMS. That's right.

Senator JEPSEN. Mr. Dennis.

Mr. DENNIS. I just want to thank the committee for hearing me out and you specifically, Mr. Chairman, for your kind and gracious attitudes and remarks, and I know it's a remarkably arcane subject for you to have to grapple with and I hope that I have just shed a little light on the subject and helped you come to a little better decision.

Senator JEPSEN. Mr. Frazier.

Mr. FRAZIER. Mr. Chairman, thank you and the members of the committee for your courteous treatment of all of us and we sure hope something good comes out of it.

Senator JEPSEN. Along that line, just one yes or no answer again—the CFTC rules and regulations, are they adequately and properly enforced, in your judgment? That's one question. The other one is, Should there be some additions or changes made? You mentioned the rumors. You think there needs to be some severe penalty for the rumors?

Mr. FRAZIER. Yes, sir. I definitely do.

Senator JEPSEN. Generally, what about the rules? Are they adequate and are they enforced?

Mr. DENNIS. I think the rules are enforced and I think they are adequate to prevent behavior that's not desirable. There needs to be some more information, I think, on a consumer level about what goes on in the futures markets, what services firms provide, and I suspect that the private sector can do that.

Senator JEPSEN. Anyone else? I thank you, gentlemen, for coming and I wish you a safe journey in returning to wherever your home may be and I now call the next panel.

Mr. Robert Raclin, Mr. Howard Stotler, Mr. Robert Kohlmeyer, and Mr. Richard Bell. I welcome all of you to the panel. I would advise you that your prepared statements will be entered into the record and you may proceed in any manner you so desire. We will start with Mr. Raclin, managing director of Merrill Lynch. You may proceed.

STATEMENT OF ROBERT L. RACLIN, MANAGING DIRECTOR, MERRILL LYNCH CAPITAL MARKETS GROUP

Mr. RACLIN. Thank you, sir.

I would like to focus, since what we have written has gone into the record, on why this subject has come up, and to do that, it seemed to me that the first thing I ought to do is just briefly run through the structure of the market and tell you how I preceive it's changed.

Basically, a futures market—and you can take any one of them—has two elements in it. You have the speculative element that is interested in vertical price risks and the word "speculation" obviously goes back to the ability to foresee. You take the factors as you receive them and you have a judgment, a vertical price risk, whether the market is going up or down. You base part of it on supply and demand and so-called fundamentals, political action, interest rates, political moves, wars, and so on.

Within this group of speculators you really have two groups. One is the so-called—it's like playing cricket—where you have the amateurs and the gentlemen in England, and the amateurs are the amateurs and the professionals are the people that do it for a living, and we have that in the futures market where you have professionals who generally go right down on the floor—they may be scalpers, or they may be spreaders, or they may be position traders—terms that you're familiar with; and then you have the so-called amateurs. These are the people that don't want any changes and do other things for a living. These are the dentists, the doctors, the lawyers.

Now, against that group that is interested in vertical price risk you have a commercial element in a market and these are people who do not basically care whether the market goes up or down in price but are interested in the relationship between the cash that they own or the cash they wish to buy and the futures price, and they are interested, if you will, in the horizontal difference between cash and futures, and these are the exporters, the farmers, the processors, the flour millers, the vegetable-oil makers that make margarine, and this type of thing.

Now, what we have had happen, in my judgment, with the advent of the computer is that the amateur speculator who traditionally loses money because so many things are against him, because he wishes to speculate, has sought another vehicle for the investment or the speculation of his funds and he has gone to commodity mutual funds; he has gone to money managers; he has gone to powers of attorney, discretionary accounts, and he is having somebody else handle his money. He is no longer willing to do it himself, feeling that the other fellow will do better than he can do for himself.

This has led to a situation where the market, which traditionally has layers of orders—formerly had these layers of orders from all these small speculators—these small orders have disappeared and they have been replaced by pools, whether they be commodity funds, money managers, or whatever.

These funds generally, strangely enough, are not doing better than the speculator did for himself. In the Wall Street Journal on April 24, which was only a couple of days ago, it pointed out in talking about commodity funds: "Something went wrong. Last year 56 out of 61 of the largest funds lost money. For every dollar that an investor put into them, they lost 14.5 cents as an average."

Now, what this has done, by losing the small outside speculator to these funds, we have attracted a highly concentrated pool of money in a very few money managers' hands and this doesn't really bother me. But what does bother me is that these money managers are acting far beyond the capability of individual pools of money, whether it be an individual or a partnership, and the impact of their orders, I must state, as opposed to the testimony here this morning, has had a dramatic impact on the price movement of the market because another thing has happened.

The floor trader, which is a speculative unit interested in vertical price risk, traditionally tries to go with the orders. And what has happened by these large orders hitting the market, these floor speculators are no longer willing to take the positions they used to take because the market has lost that liquidity.

So we have lost in the futures markets, basically due to the computer which we can't change, two important elements in terms of their economic activity—the small speculator, the outside amateur, and we've lost the size that the floor traders are willing to trade.

The net result of that is that you have greater price movements, in my judgment.

Now, what I think within the present laws we can do to correct this situation is this. We have to get back to the strict adherence of following the rules in terms of quantity that are set at the present time by the CFTC. This will cause the exchanges, I think, to look into these partnerships of money managers and say to them, in essence: "If you *x* money manager have 10 funds of 10 individuals or 10 corporations that you're handling, you must act as though it was one and be limited in size as though it is one," because what's happening today is this—instead of being limited—I'll use soybeans as an example—with a limit of 3 million bushels, if you have 10 individual accounts each of 3 million, you have the ability to put into the market 30 million bushels of soybeans at one time, and it may be that the market does not have the offsetting orders.

Now I do not believe that there is collusion or manipulation in any way between these large money managers. Rich Dennis was sitting here. I don't think Rich Dennis consults with Tom Depper of Revco, but they see the same things in the market about the same time. Normally, positions develop like this. If a man wants to buy 1 million bushels of grain, he doesn't buy 1 million bushels of grain. He buys 25,000 and if the market goes with him he adds to it. He keeps adding to it as long as his perception is right and he builds what I call an inverse triangle and he starts out with a small amount and it gets bigger. At some point the news changes. At some point, a chart point is hit—a trigger price. At some point something happens and people that are long see that about the same time and they have a tendency to sell, but the quantities they're selling are much bigger than the quantities as they build up. The net result of it, without this liquidity, you have volatile price movements.

Now I would believe—and I would take the opposite viewpoint from what was said here earlier—I would believe that limits are constructive. I think they should be reasonable in size and I quite agree that limits on corn should be bigger than the ones on soybeans because the crop is bigger on corn then it is on soybeans. But I do believe that this problem can literally disappear if money managers are required, whether they be mutual fund managers, whether they be regular money managers that just handle it, or computer operators—if they are required to act synergistically so that a money manager as an individual cannot exceed this amount, I think you will see these huge orders disappear. I think that the market will then regain the confidence to call the outside speculator in and I think you will get increased activity from the floor traders which will add to liquidity and be self-destructive in terms of volatility of operation.

Now if we go in that direction and the present rules are there, I don't have any problem with seeing that what we are met with today about will go away and I think it should go away because Mr. Mergell and I were down there in Brazil a fortnight ago and we heard from people all over the world that were at this conference that they were disenchanted with the futures market volatility. They want to use the futures market. They have to use the futures market.

You know, the futures market, a place to trade, facilitates the most important aspect which has not been mentioned here this morning in my view—crops or commodities, gold, silver, platinum, tin, copper, cocoa, coffee—all of these crops are financed in the world's financial banking system. The individual original processors, whether they be an elevator or they're a soybean crusher or they're a store, ultimately go to a bank, whether it be a governmental, or commercial bank, or private bank, in a system and borrow the money to finance that.

Now these banks will not loan these original buyers unless these people are hedged. Now if you don't have a futures market and they can't be hedged, these banks will, by necessity, be forced to loan less.

Now, I'm a director of two farm banks. One is about a $100 million bank and one is about an $80 million bank in Indiana, and we are down in the guts of the Indiana farm area and I tell you, when the farmers come to us and want to borrow for seed, want to borrow for tractors, want to borrow, we loan them money if they're hedged and we loan them one hell of a lot less money if they're not hedged.

Now the farmer is caught somewhere between being a speculator and a commercial. He really is commercial but, regrettably, acts like a speculator. The distinguished Senator from South Dakota's constituency complained about the price drop. I doubt that he heard anything from any farmer out there that sold last summer. He hears from the people who did not sell, who speculated on price, and then when it went down they complained. Well, that's like Rich Dennis complaining and saying: "Gee whiz, there's something wrong with this thing because I went short and the damned thing went up."

Now the farmers that I talk to, generally speaking, fall into two categories. There are farmers that are commercials that hedge and these people are speculating on other things than their crops. They're speculating on the price of land. They're speculating on the weather. They're speculating on size of crop. And then there are farmers I talk to that are the worst speculators in the world. These are the guys that believed that when soybeans were $9.75 in Chicago that the darned things were going to $12, and when they went back to $7, they were screaming like the dickens at the speculators who brought the price down. The price wouldn't have gone down had there been a demand.

Now what I'm saying is we lost two elements in this market, we can regain two elements in this market within expressed rules.

Now I would like to address myself just to a couple other things that were said here, if I may rather quickly, which had something to do with the questions.

One is the stock index futures that was asked about. I'm one of those who is very much against stock index futures markets for not a speculative reason or the fact that the mutual funds are using them. I believe that if the speculative money with lower margin is drained off of the capital formation market, because you can take a position of financial risk for a lot less captial, you will cause a situation that will cause less farmers to go into the original offerings in the over-the-counter new issue market and any government should encourage the formation of small new businesses which is done by this financial mechanism of new issues in smaller markets. We have seen a decline in volume and a decline in the ability to come out with new issues of emerging small companies with very good products and very good ideas because there isn't that capital available and it's being drained off to that extent.

I don't really believe it is a hedge. It is a general statement and the only hedge would be if you held the exact stocks that will be in those averages, but otherwise it's just a hedge quasi-speculation. So I am one of those who would disagree with that viewpoint.

I also really believe—and I know this is going to be controversial—that speculators can move price. When I use the word "speculator," I would include governments. I have been a witness before the Grant Commission and the Third World is demanding a fair price for a greater share of what they import and what they export, and fair price gets down to what they import should be low and what they sell should be high. In an effort to stabilize some of these prices, because some of these governments can't finance the holding of commodities when they think the price is too low, you have had definite moves by governments to try to stabilize prices, when by stabilized prices they mean at a high price, and I pointed out the Malaysian Government and what they tried to do on tin, or I can go back to what the Peruvian Government tried to do on fishmeal, or what the U.S. Government tried to do on the price of rubber in the First World War. All these things do is to lead to more competition of a substitute product.

I really think, however, that there can be efforts to move prices in the direction you want them to go.

Now getting down to the individual situation of the floor of the Chicago Board of Trade and these large pool operations—can they move prices? In my viewpoint, gentlemen, they can and do. It depends on your definition. Over the very long run—and by very long run I mean 1 month—they don't have any real influence on it. But in any given day, they have a tremendous influence on it which may be self-correcting the next day like a pendulum, where it gets up here and the next day it swings plumb and the next day it gets back the other way. And you get those. I don't think that is constructive to a market. I don't think that it's done in any other—remembering that they're speculative—other than a profit motive. I think that if their judgment is right, they benefit; and if they're wrong, they don't.

I do think that the day of reckoning will happen when you will see less activity of them if these other rules presently in place are enacted. Thank you.

[The prepared statement of Mr. Raclin follows:]

PREPARED STATEMENT OF ROBERT L. RACLIN

LADIES AND GENTLEMEN:

I AM DELIGHTED TO HAVE BEEN INVITED TODAY IN ORDER TO SHARE WITH YOU MY VIEWS UPON "IMPROVING THE EFFICIENCY OF COMMODITY FUTURES MARKETS".

I COME BEFORE YOU AS AN INDIVIDUAL AND NOT AS A SPOKESMAN FOR MY EMPLOYER--MERRILL LYNCH. I HAVE BEEN A MEMBER OF THE BOARD OF DIRECTORS OF THE CHICAGO BOARD OF TRADE, THE CHICAGO MERCANTILE EXCHANGE, AS WELL AS A MEMBER OF THE BOARD AND CHAIRMAN OF THE MIDWEST STOCK EXCHANGE. I HAVE BEEN A WITNESS BEFORE THE BRANDT COMMISSION IN LONDON, AS WELL AS THE WORLD FOOD COUNCIL IN ROME. I AM PRESENTLY A MANAGING DIRECTOR OF MERRILL LYNCH CAPITAL MARKETS GROUP, A DIRECTOR OF MERRILL LYNCH INTERNATIONAL, A DIRECTOR OF MERRILL LYNCH INTERNATIONAL BANK IN LONDON, AND MERRILL LYNCH BROKERS AND DEALERS IN LONDON, AS WELL AS OUR COMMODITY COMPANY--MERRILL LYNCH FUTURES, INCORPORATED.

I HAVE BEEN INVOLVED IN FUTURES MARKETS AS A PRINCIPAL OR A BROKER SINCE 1950 WHEN I WAS A DIRECTOR OF THE WORLD COMMERCE CORPORATION WHOSE CHAIRMAN WAS SIR WILLIAM STEVENSON--"A MAN CALLED INTREPID". I HAVE GIVEN PAPERS ON COMMODITY FUTURES

AT HARVARD, THE UNIVERSITY OF MINNESOTA, THE UNIVERSITY OF INDIANA, AS WELL AS SEVERAL BEFORE THE INTERNATIONAL ASSOCIATION OF SEED CRUSHERS.

ENOUGH OF MY CREDENTIALS. I WOULD LIKE TO TOUCH ON THE STRUCTURE OF A REPRESENTATIVE EXAMPLE OF A FUTURES MARKET AND THEN PASS ALONG MY COMMENTS AS TO MY VIEWS OF THE QUESTIONS WE WITNESSES WERE ASKED.

ANY FUTURES MARKET HAS TWO IMPORTANT ECONOMIC SEGMENTS.

THE FIRST IS THE SPECULATIVE ELEMENT WHICH IS INTERESTED IN THE REWARDS AND RISKS OF VERTICAL PRICE MOVEMENT. IT TRIES TO BE CORRECT AS TO ITS JUDGMENT AS TO WHETHER THE MARKET IS MOVING UP OR DOWN.

THIS GROUP HAS TWO SUB ELEMENTS:

A) THE PROFESSIONALS WHO MAKE THEIR LIVING IN THE MARKETS. THEY MAY BE 1) SCALPERS WHO BUY AND SELL FOR TINY PROFITS AND NORMALLY OCCUPY A POSITION PHYSICALLY ON THE TRADING FLOORS OR IN THE TRADING "PITS". THEY TRY TO "GO WITH" THE MARKET. THEY ARE GENERALLY MEMBERS OF THE EXCHANGE ON WHICH THEY TRADE AND GIVE THE MARKET TREMENDOUS LIQUIDITY.

2) THEN THERE ARE THE SPREADERS WHO BUY AND SELL EQUAL QUANTITIES OF THE SAME COMMODITY

WHICH WILL VARY IN PRICE DIFFERENCE NORMALLY AS TO INTEREST RATES AS WELL AS THE TOTAL SUM OF SUPPLY AND DEMAND.

3) THERE ARE ALSO POSITION TRADERS WHO TAKE OUTRIGHT LONG OR SHORT POSITIONS BASED ON THEIR OPINION OF SUPPLY, DEMAND, NEWS SUCH AS WORLD, WEATHER, WORLD EVENTS, ACTIONS OF FOREIGN GOVERNMENTS WHO MAY HAVE COMPETING EXPORTABLE SURPLUSES OR IMPORTABLE REQUIREMENTS. THESE GROUPS CLOSELY WATCH INTEREST RATES.

THE SECOND ELEMENT OF THIS SUB GROUP OF SPECULATORS IS THE PUBLIC OR THE AMATEURS. THESE ARE THE DOCTORS, THE DENTISTS, THE BUSINESSMEN, ET CETERA, WHO WISH TO SPECULATE IN COMMODITY MARKETS. THIS GROUP RARELY MAKES MONEY IN SPECULATION, FOR THERE ARE MANY FACTORS AGAINST THEM SUCH AS THE COMMISSIONS THEY PAY, THE PHYSICAL INABILITY THEY HAVE TO REACT AS QUICKLY AS A FLOOR TRADER DOES, NEW INFORMATION COMING INTO THE MARKET WHICH THEY KNOW LITTLE ABOUT WHILE THEY ARE BUSY DOING THEIR DAILY WORK. HOWEVER, THEY DO ADD TO LIQUIDITY. OVER A PERIOD OF TIME, MANY OF THESE NO LONGER ACT FOR THEMSELVES BUT ARE NOW TURNING OVER THEIR MONEY TO POOL OPERATORS OR MONEY MANAGERS OR COMMODITY FUNDS

UNDER POWER OF ATTORNEY OR LEGAL CONTRACT TO SPECULATE ON THEIR BEHALF FOR A FEE OR A FEE PLUS A SHARE OF THE PROFITS. MANY OF THESE MONEY MANAGERS ARE COMPUTER ORIENTED IN THEIR OPERATIONS. THEY HAVE VARIOUS TRADING TECHNIQUES WHICH THEY FOLLOW. THESE OPERATORS HAVE GROWN TO HUGE PROPORTION IN RECENT YEARS.

THE SECOND SEGMENT OF A FUTURES MARKET ARE THE SO CALLED "COMMERCIALS". THESE ARE THE FARMERS, THE ELEVATORS, THE BUYING AND SELLING PROCESSORS, THE EXPORTERS, ET CETERA. THIS GROUP LOOKS TO THE HORIZONTAL RELATIONSHIP BETWEEN A CASH COMMODITY AND THE FUTURES PRICE OF THAT COMMODITY. THESE ARE THE SO CALLED "HEDGERS" WHO MUST BE AS CLOSE AS THEY CAN TO 100 PERCENT HEDGED SINCE THEY RELY ON BORROWED MONEY FROM THE COMMERCIAL BANKING SYSTEM TO FINANCE THEIR CASH INVENTORIES. THESE COMMERCIALS LOOK AT THE SAME FACTORS IN THE MARKET AS THE SPECULATOR BUT FOR OBVIOUSLY DIFFERENT REASONS.

SO MUCH FOR THIS POSSIBLY INADEQUATE AND OVERSIMPLIFIED VIEW OF A FUTURES MARKET.

LET ME SAY RIGHT HERE THAT I HAVE ALWAYS BEEN ONE OF THOSE WHO MIGHT BE DESCRIBED AS A FREE

MARKET EXPONENT AND I HAVE THAT VIEW TODAY THAT THE LESS REGULATION YOU HAVE THE BETTER YOU ARE. WE HAVE, HOWEVER, A WHOLE NEW WORLD IN FUTURES TRADING DUE TO THE COMPUTER.

I HAVE JUST RETURNED A LITTLE MORE THAN A FORTNIGHT AGO, FROM A TRIP TO BRAZIL AND PERU. I VISITED IN BRAZIL AT THE ANNUAL MEETING OF THE INTERNATIONAL ASSOCIATION OF SEED CRUSHERS WITH REPRESENTATIVES FROM SOME 27 COUNTRIES. IT WOULD INCLUDE A RED CHINESE DELEGATION, A RUSSIAN BUYER LOCATED IN BRAZIL, A NUMBER OF OIL SEED CRUSHERS FROM THE ECC, THE UNITED STATES, BRAZIL, AFRICA, AND MALAYSIA. THE MAIN SUBJECT DISCUSSED AT THIS MEETING WAS THE VOLATILITY OF THE FUTURES MARKET. INDEED, THE PRESIDENT OF THAT GROUP IN HIS ANNUAL REVIEW PUT IN HIS STATEMENT THE FOLLOWING:

"OVER TIME, MORE DIFFICULT TRADING CONDITIONS HAVE ALSO STEMMED FROM INCREASING VOLATILITY IN AREAS SUCH AS EXCHANGE RATES, IN OILSEED CROPS AND CERTAINLY OVER THE LAST TWELVE MONTHS IN PRICES. WHILE MUCH OF THE UNCERTAINTY, CHANGE AND VOLATILITY WE FACE MUST OF NECESSITY BE ACCEPTED AS REFLECTING WEATHER CONDITIONS AND THE DYNAMICS OF EVOLVING WORLD MARKETS AND OF WORLD ECONOMIES, THERE IS ALWAYS THE QUESTION OF WHETHER SUCH SITUATIONS ARE BEING EXACERBATED IN ANY WAY.

ONE SUCH QUESTION HAS BEEN RAISED SINCE OUR LAST CONGRESS. IT IS WHETHER THE CHICAGO FUTURES MARKET GENERATES EXCESSIVE PRICE VOLATILITY BEYOND THAT JUSTIFIED BY THE DEVELOPMENT OF FUNDAMENTAL SUPPLY AND DEMAND FACTORS. THE EXISTENCE OF AN EFFICIENT, EFFECTIVE, AND SMOOTHLY OPERATING FUTURE MARKET IS, OF COURSE, CRUCIAL FOR OUR OPERATIONS. HOWEVER, THE COMMENTS INCREASINGLY HEARD HAVE BEEN THAT THE ABILITY OF THE CHICAGO MARKET TO FULFILL ITS VITAL FUNCTIONS FOR COMMERCIAL OPERATIONS IS DISTORTED BY THE ACTIVITIES OF COMPUTER POOLS, MANAGED MONEY ACCOUNTS, AND PARTICULARLY LARGE INDIVIDUAL SPECULATORS. THE EXPANSION IN THESE GROUPS AND IN THE AMOUNT OF MONEY AVAILABLE FOR TRADING IS CERTAINLY NOW ENORMOUS. THE POSSIBILITY IS RAISED THAT THIS RELATIVELY RECENT DEVELOPMENT NOW PRODUCES THE POWER OF SUCH PARTICIPANTS IN FUTURE MARKETS TO SWING THE MARKET EXCESSIVELY IN FIRST ONE DIRECTION AND THEN THE OTHER.

I WOULD NOT MYSELF MAKE ANY JUDGMENT ON THIS MATTER AT THIS TIME BEING AWARE THAT VOLATILE MARKETS FOR FUNDAMENTAL SUPPLY/DEMAND REASONS INVARIABLY GENERATE ADDITIONAL VOLATILITY IN FUTURES MARKETS AND THERE IS NO CONCLUSIVE WAY OF ASSESSING HOW FUTURES MARKETS WOULD BEHAVE WITHOUT SUCH FUNDS. NEVERTHELESS, WHAT ONE SHOULD PROBABLY RECOGNIZE IS THAT AS THE VOLUME

OF THESE FUNDS INCREASES FURTHER SO DOES THE RISK THAT THEY WILL MOVE PRICES MORE AND FOR LONGER PERIODS AND INTRODUCE A NEW DIMENSION OF UNCERTAINTY FOR ORDINARY COMMERCIAL OPERATIONS. IT IS IMPORTANT THAT THE MARKET IS ALWAYS TWO-SIDED. IT IS IMPORTANT THAT THE MARKET REMAINS A RELIABLE REFLECTION OF THE SUM TOTAL OF SUPPLY/DEMAND FUNDAMENTALS AND EXPECTATIONS AND IMPORTANT THAT THERE IS NOT A DOMINATION IN THE MARKET OF PARTICIPANTS WITH AN INTEREST ONLY IN VOLATILITY. HOWEVER, A WATCHFUL EYE ON THESE OPERATIONS BY THE AUTHORITIES OF THE CHICAGO BOARD OF TRADE IS UNDOUBTEDLY BEING MAINTAINED."

IN PERU I VISITED WITH THE FORMER OWNERS OF ONE OF THE BIGGEST SUGAR REFINERIES IN THE WORLD BEFORE LAND REFORM, WITH LAND GROWING SUGAR ON SOME MILLION ACRES. THIS OPERATION HAD ITS OWN RAILROAD, ITS OWN CRUSHING PLANTS, ITS OWN REFINERIES, ITS OWN AIR STRIPS, SCHOOLS, HOSPITALS, AND SHIPS TO CARRY THEIR PRODUCTS TO FOREIGN LANDS. THIS OPERATION IS VIRTUALLY SILENT NOW, SHOWING WHAT CAN HAPPEN WHEN GOVERNMENTS TAKE OVER PROPERTY. THEY NO LONGER USE THE FUTURES MARKET.

BUT I ALSO VISITED WITH THE EX-OWNER OF ONE OF THE WORLD'S LARGEST FISH MEAL PRODUCERS WHICH SUPPLIED VALUABLE PROTEIN TO THE WORLD. UNDER GOVERNMENT OWNERSHIP IT IS NO LONGER A MAJOR FACTOR IN THE

WORLD.

THESE ARE EXAMPLES OF TOO MUCH REGULATION. BOTH OF THESE FIRMS, HOWEVER, DISCUSS THE FACT THAT THEY WOULD LIKE TO USE, (AS THEY HAVE SMALLER OPERATIONS OUTSIDE OF PERU), FUTURES MARKETS BUT THE EXTREME VOLATILITY PREVENTS THEM FROM DOING SO.

THERE ARE SPECULATORS AND COMMERCIALS ALL OVER THE WORLD WHO ARE USING OUR FUTURES MARKETS BUT TODAY TO A LESSER DEGREE. THIS WOULD INCLUDE THE SOY BEAN CRUSHERS, FOR EXAMPLE, IN THE ECC, THE SOVIET IMPORTERS, THE PRC IMPORTERS AND EXPORTERS, THE SOUTH AMERICAN EXPORTERS. IT WOULD INCLUDE IN THE PRECIOUS METALS MARKET SHEIKS FROM THE MIDDLE EAST AND COMMERCIAL BANKS USING FINANCIAL FUTURES MARKETS.

THERE IS REALLY NO ONE WITH AN INTEREST IN THE MOTIVE OF PROFIT THAT DOES NOT HAVE A USE FOR A FUTURES MARKET. THE PARAMETER OF THE INTEREST IN THE FUTURES WORLD EQUALS PROBABLY THE TOTAL MONEY SUPPLY OF THE WORLD. THERE IS HARDLY A CASH COMMODITY TRADED IN INTERNATIONAL TRADE THAT DOES NOT HAVE A LINK WITH THE FUTURES MARKET AND THE PRICES ARE DETERMINED BY FUTURES MARKETS.

BUT WHAT HAS HAPPENED? WITH THE COMPUTER'S AMAZING ABILITY TO CALCULATE MORE RAPIDLY THAN THE

HUMAN MIND, A WHOLE NEW ELEMENT HAS COME INTO THE MARKET ON THE SPECULATIVE SIDE. THE OUTSIDE NONPROFESSIONAL SPECULATORS, IN DROVES, HAVE TURNED OVER THEIR FUND TO MONEY MANAGERS, POOL OPERATORS, COMPUTER CHARTISTS WHO NOW HAVE ENORMOUS FUNDS TO WORK WITH.

FORMERLY THESE MARKETS HAD LAYERS OF ORDERS TO BUY AND SELL AT A PRICE AT ANY GIVEN MOMENT. THE CFTC AND THE EXCHANGES HAVE RULES AS TO HOW MUCH ANY INDIVIDUAL ACCOUNT CAN BE LONG OR SHORT. FOR EXAMPLE, AT THE PRESENT TIME AN ACCOUNT CAN BE LONG APPROXIMATELY 3,000,000 SOYBEANS, 720 SOYBEAN MEAL, 540 CONTRACTS OF SOYBEAN OIL. HOWEVER, THESE POOL OPERATORS, CLAIMING THAT EACH OF THEIR ACCOUNTS HAVE DIFFERENT OBJECTIVES, ET CETERA, LINK ALL OF THEIR ORDERS TOGETHER AND CAUSE HUGE ORDERS TO HIT THE MARKET, CAUSING THIS EXTREME VOLATILITY.

LET ME GIVE YOU AN EXAMPLE, IF I MAY. ON THE 11TH OF APRIL, ONE OF THESE MONEY MANAGERS, WHEN I WAS ABROAD, APPARENTLY SOLD SOME 9,000,000 SOYBEANS, 3300 CONTRACTS OF MEAL, 900 CONTRACTS OF OIL, 15,000,000 BUSHELS OF CORN, AND DID SOME 2500 SPREADS IN SOYBEAN MEAL OF SELLING THE OLD CROP AND BUYING THE NEW. THE WALL STREET JOURNAL CARRIED THE FOLLOWING ARTICLE THE NEXT DAY REPORTING THIS:

"HEAVY SELLING BY PROFESSIONAL TRADING FIRMS AND GRAIN COMPANIES TRIGGERED A COLLAPSE IN GRAIN AND SOYBEAN FUTURES THAT ONE ANALYST CALLED AN AVALANCHE. SOYBEANS FOR MAY DELIVERY FELL ALMOST 21 CENTS A BUSHEL TO $7.75, THE LOWEST PRICE IN ABOUT FIVE WEEKS.

CORN WAS LITTLE CHANGED AS TRADING OPENED, AND SOYBEANS WERE SLIGHTLY HIGHER. BUT HEAVY SELLING BY REFCO, INC. AND C & D COMMODITIES, BOTH TRADING AND BROKERAGE CONCERNS BASED IN CHICAGO, SOON DEPRESSED PRICES. MAJOR GRAIN MERCHANTS HELPED TRIGGER THE SELL-OFF.

AS PRICES FELL, INDEPENDENT TRADERS AND OTHERS SCRAMBLED TO CASH IN CONTRACTS AND CUT THEIR LOSSES, PUSHING PRICES STILL LOWER. PRICES BROKE THROUGH SEVERAL IMPORTANT POINTS FOLLOWED BY TRADERS WHO WATCH PRICE CHARTS, UNLEASHING FURTHER WAVES OF SELLING BY COMPUTER-MANAGED COMMODITY FUNDS AND OTHERS THAT FOLLOW TECHNICAL TRADING PROGRAMS.

THERE WAS <u>LITTLE NEWS TO PROMPT THE SELL-OFF</u>; ANALYSTS AND TRADERS SAID THE PLUNGE WAS MOSTLY TECHNICAL. SOME SAID LACK OF DEMAND FOR SOYBEAN MEAL ENCOURAGED SELLING IN THAT MARKET. IN A REPORT RELEASED LATE TUESDAY, THE AGRICULTURE DEPARTMENT LOWERED ITS ESTIMATE

OF U.S. SOYBEAN MEAL EXPORTS FOR THE YEAR ENDING AUGUST 31 BY 5% TO 5.7 MILLION SHORT TONS FROM SIX MILLION SHORT TONS. THE DEPARTMENT ALSO CUT ITS ESTIMATE OF DOMESTIC MEAL USAGE SLIGHTLY, TO 17.4 MILLION SHORT TONS FROM 17.5 MILLION SHORT TONS. A SHORT TON EQUALS 2,000 POUNDS.

RUMORS CIRCULATED THAT MAJOR GRAIN MERCHANTS SELLING FUTURES TO LOCK IN PRICES FOR BRAZILIAN AND ARGENTINIAN SOYBEANS AND SOYBEAN MEAL. HARVESTS FROM THOSE MAJOR EXPORTING NATIONS ARE COMING ON THE MARKET. SLACK DEMAND FOR CORN ALSO FUELED THE COLLAPSE, ANALYST SAID."

C & D COMMODITIES DECLINED TO COMMENT ON THE DAY'S TRADING AND BROKERS FOR REFCO WEREN'T AVAILABLE. WENDY L. WALL

THESE OPERATORS PRETEND THAT EACH OF THEIR CUSTOMERS HAVE DIFFERENT OBJECTIVES AND DIFFERENT GOALS AND, THEREFORE, THEY ARE ALLOWED TO TRADE THE LIMIT FOR EACH ONE OF THEM. THESE POOL OPERATORS, REGARDLESS OF THEIR MODUS OPERANDI, HAVE DESTROYED THE LAYERS OF ORDERS AND CAUSED A CONDITION IN THE MARKET WHERE THE FLOOR TRADERS WHO NOW TRY TO FOLLOW THESE HUGE OPERATORS RATHER THAN RELY ON THEIR OWN ANALYSIS. WE HAVE SEEN MARKETS DO NOTHING IN PRICE MOVEMENT FOR THREE HOURS DURING A TRADING SESSION, ONLY TO VIOLENTLY

MOVE UP OR DOWN IN THE LAST TEN MINUTES. WE HAVE SEEN ORDERS ENTERED IN SUCH HUGE QUANTITIES THAT THEY ACTUALLY MOVE THE PRICE SHARPLY. YOU CAN IMAGINE THE POSITION OF A FLOOR TRADER WHO TRIES TO FOLLOW ORDERS AND SELLS AS HE SEES SELLING COMING IN THE MARKET, ONLY TO HAVE IT BLOW UP IN HIS FACE AS A HUGH BUYING ORDER COMES IN THE MARKET. THIS HAS CAUSED THE FLOOR TRADERS TO BECOME EXTREMELY GUN SHY AND HAS SHARPLY REDUCED THE LIQUIDITY AND HAS CAUSED INCREASED VOLATILITY BY THE LACK OF FLOOR TRADER PARTICIPATION.

WE HAVE ALSO SEEN A SITUATION HAPPEN ON SEVERAL OCCASIONS ON THE LAST OR THE SECOND TO THE LAST CALENDAR DAY OF A MONTH WHERE WE WILL SEE A HUGE ORDER TO BUY FOR AN INDIVIDUAL ACCOUNT; AND BEFORE THE REPORT OF THAT TRADE IS RECEIVED BACK, IT IS FOLLOWED BY A HUGE ORDER TO SELL. THIS LEADS ONE TO A SUSPICION THAT SOME OF THESE POOL OPERATORS ARE CHURNING ACCOUNTS AND, THEREFORE, INCREASING THEIR OWN COMMISSIONS. BUT THIS IS ALMOST IMPOSSIBLE TO PROVE. FOR EXAMPLE, IF A POOL OPERATOR MADE A CUSTOMER $100,000 IN ONE MONTH AND ON THE LAST DAY BY BUYING AND SELLING VIRTUALLY SIMULTANEOUSLY CREATES A $10,000 LOSS AND A $5,000 COMMISSION FOR THE POOL OPERATOR, THE CUSTOMER WOULD END UP WITH AN $85,000 PROFIT FOR THE MONTH AND

THE POOL OPERATOR WOULD END UP WITH AN ADDITIONAL $5,000 IN COMMISSION. THE DEFENSE, HOWEVER, IS SIMPLE. THE POOL OPERATOR MERELY STATES THAT HE THOUGHT HE SAW ELEMENTS IN THE MARKET THAT MADE HIM WANT TO BUY; AND HAVING DONE SO, SAW A NEW FACTOR COME IN THE MARKET THAT MADE HIM THINK HE WAS WRONG AND HE WANTED TO LIQUIDATE.

BUT THIS TYPE OF THING WITH THESE HUGE ORDERS IS DISRUPTIVE. THE MARKETS NOW HAVE BECOME VIRTUALLY IMPOSSIBLE FOR THE HEDGERS TO USE AND IS SHARPLY CUTTING DOWN THE VOLUME OF INTERNATIONAL TRADE AND DOMESTIC TRADE INSOFAR AS ITS USE IN THE FUTURES MARKET. WE HAVE SEEN ENORMOUS SWINGS IN PRICE WHICH HAVE NOTHING TO DO WITH FUNDAMENTALS OF THE MARKET. THE SYSTEMS TRADERS, BECAUSE OF THEIR SIZE, HAVE CHANGED THE VOLATILITY FACTOR.

<u>THERE IS NOTHING WRONG WITH THE MARKETS TODAY IN TERMS OF THE ACCESSIBILITY, LIQUIDITY, AND MARKET INFORMATION</u>. IT IS PROBABLY BETTER THAN EVER. BUT THESE POOL OPERATORS ARE RAPIDLY DESTROYING FUTURES MARKETS FOR ALL HEDGERS. COMPUTERIZED TRADING VERSUS PIT TRADING IS NOT THE ANSWER BUT WOULD PROBABLY ONLY INTENSIFY THE PROBLEM.

THE ANSWER IN MY VIEW REALLY IS QUITE SIMPLE. IT IS " NO ONE MANAGER ACTING IN A FIDUCIARY RESPONSIBILITY FOR OTHER'S FUNDS, REGARDLESS OF SIZE OF INDIVIDUAL FUNDS USED, SHOULD BE ALLOWED TO TRADE IN ANY GREATER SIZE THAN THE PRESENT RULES ARE FOR A SINGLE OPERATOR." THAT IS TO SAY THAT IF A LIMIT OF SOYBEANS IS 5 MILLION BUSHELS OR WHATEVER THE CFTC DECIDES, THEN NO ONE POOL OPERATOR CAN TRADE MORE THAN 5 MILLION SOYBEANS FOR <u>ALL</u> OF THE ACCOUNTS. ALL CUSTOMERS MUST BE SYNERGISTICALLY TREATED. THERE WILL BE SCREAMS OF PROTEST FROM POOL OPERATORS, COMMODITY FUNDS, AND COMPUTER ORIENTED MONEY MANAGERS, ET CETERA, ON THIS VIEWPOINT. BUT IT IS VERY SIMPLE. THE RULES MUST BE EQUALLY APPLIED TO ALL FACTORS IN THE MARKET, ALLOWING EACH SEGMENT TO OPERATE ON A LEVEL PLAYING FIELD. THE POOL OPERATORS MUST ACT WITHIN THE SAME CONTEXT AS EXPORTERS OR PROCESSORS OR THE DENTIST OR THE DOCTOR. WE CANNOT CONTINUE WHERE WE HAVE A SITUATION WHERE ONE FIRM CAN TRADE IN THESE HUGE QUANTITIES UNDER THE PRETEXT THAT ITS CUSTOMERS HAVE DIFFERENT OBJECTIVES, ET CETERA. THIS HAS RESULTED, AS WE HAVE SEEN, IN THE LOSS OF MARKET LIQUIDITY AND HIGH VOLATILITY, LEADING TO UNPREDICTABLE PRICE MOVEMENTS. POOL OPERATORS MUST NOT BE ALLOWED TO CONTINUE THIS COURSE OF VIOLENT

PRICE MOVEMENTS. IT CAN BE CORRECTED BY THE CFTC WITHIN THE PRESENT STRUCTURE. THIS MEANS, OF COURSE, THAT LEGAL LOOPHOLES MUST BE PLUGGED. YOU CANNOT ALLOW THE PRESENT PARTNERSHIPS WHICH HANDLE THESE ACCOUNTS TO CLAIM THAT EACH OF THEIR PARTNERS ARE HANDLING DIFFERENT CLIENTS SO THAT AN INDIVIDUAL FIRM WILL BE CONSIDERED WITHIN THE LIMITS, NOT THE FIRM'S CUSTOMERS.

THANK YOU. I SHALL BE DELIGHTED TO ATTEMPT TO ANSWER ANY QUESTIONS YOU MIGHT HAVE. I ONLY ASK THAT YOU CONSIDER THAT I SPEAK FOR MYSELF AND NOT FOR MY EMPLOYER.

Senator JEPSEN. Thank you, Mr. Raclin.
Mr. Stotler.

STATEMENT OF HOWARD STOTLER, PARTNER, STOTLER & CO., AND MEMBER, CHICAGO BOARD OF TRADE

Mr. STOTLER. Mr. Chairman and members of the committee, I would like to thank you for the opportunity to appear and address the topic of "Improving the Efficiency of Commodity Markets."

I have been involved in the futures markets and in the cash markets for over 50 years, coming from a family of four generations of farmers, and I began working on farms in the summer and working on a country elevator for 1 year in 1933 when corn prices were 10 cents a bushel, so I do know something about the farmers' attitude about futures markets and I've heard that over many years. On the other hand, I later was vice chairman of the Chicago Board of Trade and chairman of the Futures Industry Association and member of the executive of the NFA, a self-regulatory body, and I'm familiar with the other side of it.

If there's one part of the testimony I would like most to bring forth today, it is a term we used to use—"Cash market is king." It's a term we've often used. But in the end, the truth in supply and demand factors in the cash market will prevail. There has been sort of a running argument over the years on whether futures markets lead to cash markets or whether cash markets lead to futures markets. And it would seem ultimately that cash fundamentals will prevail and cash market basically will lead to futures.

For example, in the fall of 1980, corn futures prices were 50 cents per bushel to the cash market. There was concern that futures were leading the cash market. Ultimately, future prices tumbled and came in line with that cash market. This has been frequently demonstrated.

There's been some concern, I gather, that the sharp break in the markets last year caused concern that it was being manipulated and that it was not in line with fundamentals. I do not think there was that much change in the character of the market or the volatility factors during that period.

I think again, as demonstrated in 1980, the futures markets tumbled during those periods because cash values and the demand factors and other economic factors did not justify that price level.

In chart 1 of my prepared statement you see an illustration of the daily volatility of all four commodities, corn, soybeans, barley, and sunflower. I submit these to show you that the volatility factor on these was practically the same. All four commodities have similar supply and demand characteristics. They're different size crops, but they were all affected by last summer's drought. Trade in the volume of sunflower has not been exposed to large speculators or to system traders. Yet, simply stated, and you will see in the chart, that the volatility of corn and soybeans was greater than barley but much less than sunflowers in the beginning. Over the past month, however, the volatility of barley has surpassed both corn and soybeans.

The study suggests that corn and soybeans are no more volatile than other commodities which have similar supply and demand fundamentals.

The fact that during the summer, while the soybeans reached a volatility of 20 percent, that's not historically abnormal. We had volatility in other years much greater than we had during that period. In 1973, the volatility factor on cash soybeans reached 134 percent, four times the volatility of last year.

It has been stated that a very large speculator or commodity pool or hedger may obviously influence futures prices in the very short run on any given day as a position is being established in the market. Once this is accomplished, however, that position has absolutely no influence on the market. It only has influence when this position is gone from the market. So it's a two-sided issue and the speculator is the hedger.

As to the comments about full information, there's been more and more of a custom now, promoted by information firms, to pass on information out to the trade and to the country about what's going on on the floor and in order to be a little better informed they go out on the floor and they try to find out who is doing what as a news item. However, this has been overstated and often this information is not exactly accurate. It's picked up by the press and I think we heard this morning that one of those figures was inaccurate, and it gets to be greatly exaggerated influence to the public and to the press and perhaps it's not that much of an influence in the marketplace.

I would like to address another point, a topic of concern, the accessibility of the marketplace to the farmer and to the public and going back to the older days. I actually think the dissemination of market information today is greatly improved and has been improving every year because we have highly sophisticated and improved quotation systems, much more reasonable than it used to be, at every elevator, and many farmers even have them. This dissemination of market information and market quotation is a great aid to the producer today because he knows what the market values are and therefore cannot be taken advantage of.

I can go back to the older days and back in those days, in the early 1930's, when there was a great price variation between what the country elevator would pay the farmer in one area and what he would pay in another area, due to the fact that there wasn't that much sophistication and knowledge as to what it was worth. And it was true, I'm sure, that the ability to take advantage of a producer was much greater before we had this dissemination of price quotations.

If nothing else, the services of the Chicago Board of Trade on its quotation price to inform the producer and the other exchanges of what these products are worth, that in itself would justify its existence.

As to computerized trading, I think one question was addressed to that. I think the computer lacks the human element of discretion and that discretion is necessary for those who execute orders or are in the pits. Without that human discretion and an open auction system, a computer would have no cushion, so piles of orders would have to come in one way. Therefore, you would have big gaps of trading. As it is now, there is a discretion used and an open auction system is used. And I can't overstress an auction. It's a benefit to the user of a market.

As to the comments on farmers not using the futures markets, I think Mr. Hieronymus made the point that I would like to emphasize, and I've always emphasized this. I used to give a lot of lectures on hedging to farmers and to country elevators. Actually, the farmer uses the future markets a great deal more than people are aware of. They use them to forward price. If it were not for futures, which are price discovery mechanisms to discover prices in the future which are a valuable protection for both the user and the producer of the commodity, without that deferred pricing of the Board of Trade, for example, and other commodities and other exchanges, the producer would not forward price his crop.

Mr. Raclin pointed out the opportunity did exist last year through forward pricing in the cash markets brought about because the country elevators who used futures markets could have sold the crop very well before then, but he has the opportunity, and forward pricing was made possible by future contracts and is probably one of the best uses the farmer does make of the futures markets and it is in effect the same as a hedge.

About agricultural options, I think they will be extremely beneficial. They do have one advantage. They act more or less like price insurance. The producer will not be subject to margin calls and I think they will improve the relationship between the producer and the banker and will expand the use of the hedging concept to the producer. In my opinion, they are a much needed marketing tool.

In summary, I'd like to say that I do not agree with some statements made that the basic character of the marketplace has changed. I pointed out that the volatility has been greater in other periods than it has been in recent periods. I think the deferred contracts are probably not traded as heavily as they were before, but that would be the only basic change that I can see in the character of the marketplace.

Free markets, of course, by their nature, are imperfect. Whenever you have supply and demand factors tugging, there is an imperfection. Those who produce want it to go up and those who buy want it to go down. The speculator who wants to make money wants it to go his way, and it can't perform in accordance with everyone's wish.

So I would summarize by saying that the events in the marketplace over the past year do not seem to indicate that there need to be any major changes in the regulations and I do not believe that the volatility or the quality of the trading behavior has made any major changes.

[The prepared statement of Mr. Stotler, together with attached charts, follows:]

PREPARED STATEMENT OF HOWARD STOTLER

Mr. Chairman and Members of the Committee,

I would like to thank you and the Committee for the opportunity to appear and address the topic of "Improving the Efficiency of Commodity Markets" and the "price discovery" function of commodity markets. Topics of concern include: the quality and integrity of futures markets to respond to fundamental changes in the marketplace, the effects of system-type trading (funds, commodity pools, and etc.) and large speculators on liquidity, volatility and hedging interests, and gathering industry opinions on market information, computerized trading and agricultural options.

This is not the first time, nor will it be the last, that the price discovery function of futures markets has developed as a major topic of concern. The academic research in the area of economic efficiency and price volatility is very extensive and well documented. The overwhelming consensus of the research leaves little doubt that futures markets both improve the efficiency and decrease the volatility of cash markets while greatly benefiting the producer, processor and consumer alike. Futures markets, like any other free market system are not without falibility since short-term aberrations occur due to the naturally conflicting forces of supply and demand.

If there is one major point which I hope my testimony will leave with this Committee, it is that "the cash market is king". The marketplace is bigger than any one speculator, commercial or organized group of system-type traders. There is a constant argument on whether futures markets lead the cash markets or does the cash market lead futures. Although many cash forward contracts are established with futures contracts, ultimately the cash price fundamentals will prevail and cash markets will lead futures. For example, during the sharp run-up in futures prices in the fall of 1980, corn futures prices were approximately 50 cents per bushel premium to the cash market. There was concern that futures were leading the cash market. Ultimately, futures prices tumbled and came in line with the cash market.

Due to the increased volatility in the grain markets during late 1983, there is some concern that the market has "drifted away" from fundamentals. In my opinion the market has not drifted away from the fundamentals. The perception by some sources that the market has not performed par with fundamentals merely illustrates the fact that varying degrees of opinion is what makes a market. History has shown time and time again that the cash price or cash fundamentals will eventually prevail in the marketplace.

The fundamental factors of a large carryover, a strong U.S. dollar, the poor economic condition of the U.S. livestock sector and expected large 1984/85 planting intentions due to an easing of government programs are all fundamental factors which caused the market to decline late last year. In order to submit that the market has drifted away from the fundamentals, a supply distortion would have to occur. The market allocates a set supply over a period of time through price. If price was held artificially too high by some outside non-fundamental factor, the supply of this commodity would consistently increase. (A good example is the government grain stock piles of the 1960's). If the price was held artificially too low, we would literally run out of this commodity. It is my emphatic opinion that futures markets have, and will continue to allocate commodities over a given period at the most economically ffi-cient price. Once again, "cash is king" and this year was no different.

The impact of large speculators and (or) systems-type traders has recently received considerable attention in the press. The negative influences have been well publicized: 1) they cause increased volatility in the market, and 2) they artificially affect the price. Given their ultimate impact on the marketplace, much of this is exaggerated. I feel the positive influences of these traders far and away outweigh the negative influences.

In order to challenge these accusations, I submit this simple comparison of corn, soybeans, barley and sunflower. Corn and soybeans are traded on the CBOT, while barley and sunflower are not actively traded in any major futures market. All four commodities have similar supply and demand characteristics and were equally affected by last summer's drought. Trade in barley and sunflower has not been exposed to large speculators or systems-type traders.

Chart #1 illustrates the daily volatility of all four commodities from October of 1983 to present. The volatility figures used in this chart were derived from the annualized standard deviation of daily price changes in the underlying cash markets. Volatility of 20% would mean that 66% of the time, the cash price of the commodity will trade within a 20% price range of the prevailing price at any given time. This method of measuring volatility is used throughout the industry, often in connection with

37-522 O—84——7

option pricing models. Simply stated, Chart #1 illustrates that, in general, the volatility of corn and soybeans was greater than barley but much less than sunflower. Over the past month, however, the volatility of barley has surpassed both corn and soybeans. The study suggest that corn and soybeans are no more volatile than other commodities which have similar supply and demand fundamentals. The fact that during the summer rally, soybeans reached a volatility of 42% is not an historical abnormality. In fact, it is surprising that the volatility did not move any higher. This point may suggest that because of the increased volume of trade in futures markets over the past several years, volatility has actually decreased. During 1973, for example, volatility on cash soybeans reached 134%.

Chart #2 is an illustration of cash market prices for the October/March period. The combination of both charts strongly suggests that large speculators or system traders had no effect on either the price or volatility of corn and soybeans. Cash prices for these commodities moved in a very similar pattern to both barley and sunflower.

A very large speculator or commodity pool may obviously influence futures prices in the very short run on any given day as a position in the market is being established. Once this is accomplished, the large position has absolutely no influence on the market until a liquidation order is entered. Only when orders are being executed will any given entity influence the market. The price influence of any one given position will be equal to and directly opposite to the price influence when the initial position was established.

The news media and floor information has advanced to the point that many people spend a tremendous amount of time and energy trying to gather information as to the size and nature of orders from different large speculators or systems-type traders. This information and the influence of these trades are often grossly exaggerated in the news media. When a large speculator or system trader is thought to have moved the market with a profitable trade the news is widespread, whereas the news is thought to be rather mundane if the spec is on the wrong side of the market.

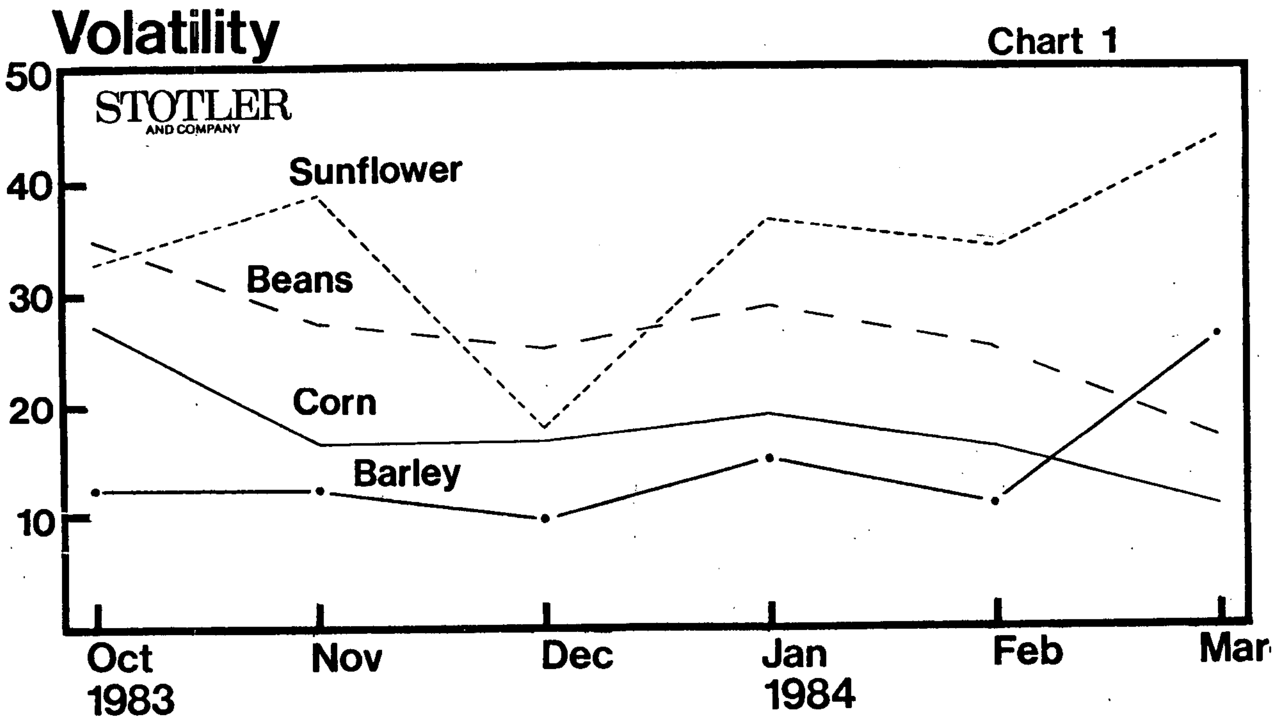
A quick glance at the performance records of the many commodity pools illustrates that different pools perform very differently in any given month. The published performance record of commodity pools since January 1, 1984 states that pools on average are down 9.9% as of April 1, 1984. For every large speculator establishing a position, there will likely be another large speculator establishing the opposite position; the same is true for pools. Once again, the market is much larger than any individual or system, and the underlying fundamentals will prevail. Large speculators and system traders add needed liquidity to the market, and their positive influence for hedgers, users, market efficiency, and "price discovery" should not be underestimated. Large hedgers need the increased liquidity provided by large speculators and trading systems in order to efficiently and economically transfer risk.

To address another topic of concern, the industry is constantly improving the accessibilty, quality and timeliness of information. Dissimination of market information has improved dramatically over the past several decades and will continue to due so. The dissimination of market quotations and information helps to ensure a fair price for producers and prevents local distortions in price. This information adds to the marketing ability of all producers.

The current self-regulation methods by the exchanges and the NFA under CFTC jurisdiction are adequate, if properly enforced, to ensure the protection of the public interest. I cannot conceive of any major changes in this area that will improve the futures markets for the American farmer and consumer alike. It follows that this is in the best interest of members of the industry, to constantly monitor these rules and regulations and see to it that they are strictly enforced. Infractions of these rules only burden the industry and destroy the credibility of the marketplace.

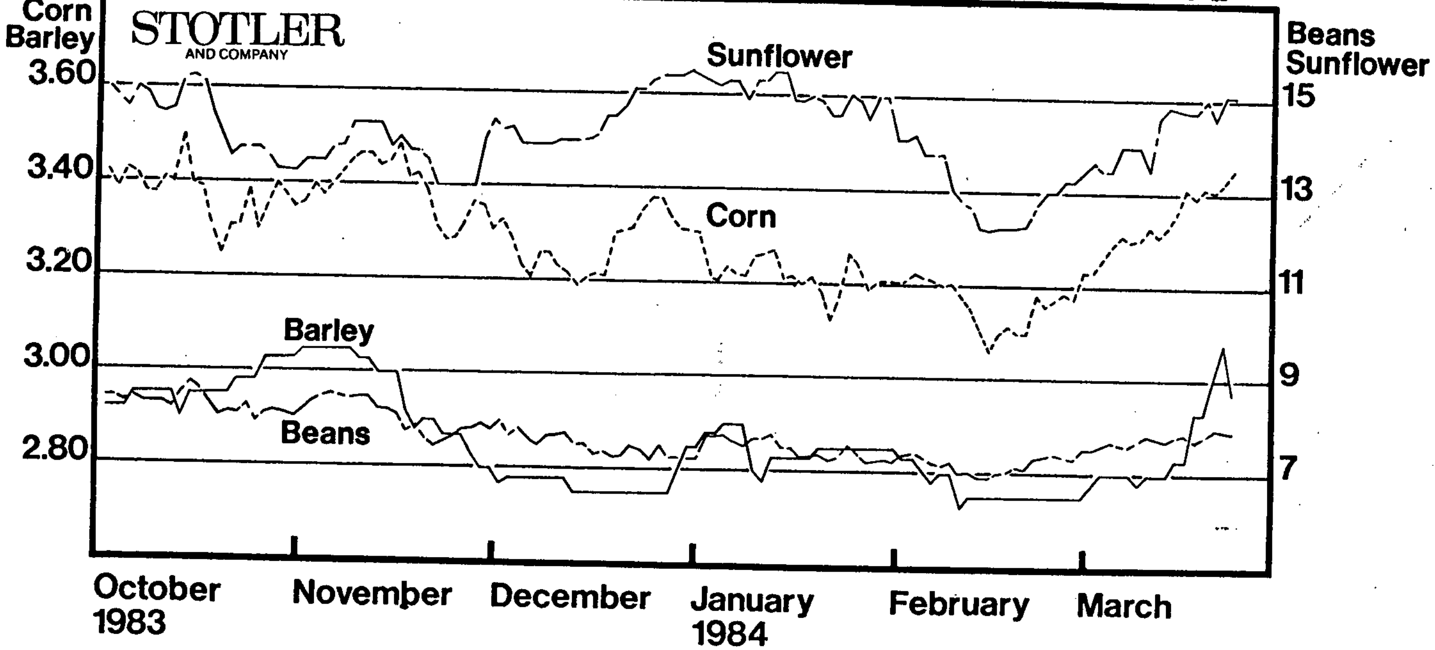
My views on computerized trading versus pit trading are basis. A computer totally lacks the element of human discretion that is exercised in the open markets. A local speculator would have difficulty performing his economic function in a computerized marketplace. The elimination of local speculators would also cause large voids in pricing, the market would become much more volatile, and "at the market" orders would become very unpredictable. The economic function of the local trader is invaluable as he (or she) provides liquidity in what could be very il-liquid contracts (such as deferred futures months). This would make it very difficult for grain handlers or commercial processors to offer forward contracts or deferred pricing contracts to producers.

Without these deferred futures contracts, the ability of the producer to price his product in the future would be limited, which is the most valuable function of today's futures markets.


Volatility
Chart 1
STOTLER
AND COMPANY
Sunflower
Beans
Corn
Barley
50
40
30
20
10
Oct
1983
Nov
Dec
Jan
1984
Feb
Mar

Cash Prices

Chart 2



Senator JEPSEN. Thank you, Mr. Stotler.

Mr. Kohlmeyer, manager of the futures department for the Commodity Marketing Division of Cargill, Inc.

STATEMENT OF ROBERT KOHLMEYER, MANAGER, FUTURES DEPARTMENT, COMMODITY MARKETING DIVISION, CARGILL, INC.

Mr. KOHLMEYER. Thank you, Mr. Chairman. As you have indicated, I do manage the futures department for the Commodity Marketing Division of Cargill, Inc., of Minneapolis, MN. Cargill is an international merchant and processor of agricultural and industrial commodities.

As a participant in the agricultural marketplace, Cargill manages the many risks inherent in doing business by hedging cash or "physical" commodity positions in futures markets. As such, my company is vitally interested in policies and programs that maintain the quality, viability, and integrity of futures markets. I appreciate the opportunity to appear before this committee on the subject of futures markets.

Futures markets provide an irreplaceable risk-management tool for all that use them. At the same time, they serve the public in general through their open, centralized price discovery process. The two functions together provide market participants a continuous flow of information on attitudes toward global market developments and the means by which those participants can adjust their bids and offers in relation to that fluid marketplace.

In recent months, however, questions have been raised regarding the role speculators are playing in the market—specifically, whether they have been able to move the market away from fundamentals. This controversy is no doubt one of the reasons for these hearings.

There is no simple answer to this question. At the most general level, the fundamentals of supply and demand always have been the dominant determinant of price and price relationships, and they continue to be dominant in today's market. The sensitive question is interpreting how fundamentals determine market levels. The first point I would stress is that fundamentals exert their influence over time. That is not to say that in day-to-day trading, other considerations won't intervene, causing erratic, short-term fluctuations. That is the nature of markets. They rest upon uncertainty and they function as an organized public, but unpredictable, search for appropriate price levels.

The second point I would like to stress is that fundamentals are not hard and fast facts. Events are obviously reshaping them all the time. Perhaps more important, the term fundamentals refers to opinions about supply and demand, not known facts. They reflect informed estimates. As such, they can and do change as new information on price, weather, political events, and the like emerges. They also are estimates that are modified as old estimates are replaced with actual production and consumption figures that may confirm or alter past beliefs but become starting points for new estimates.

Commodity futures markets also will reflect macroeconomic factors such as U.S. monetary policy, fiscal policy and interest rates.

Once again, the effects on the marketplace are not entirely predictable because these macroeconomic factors pass through prisms of perception, interpretation and judgment themselves.

Experience has shown that imperfect market perceptions will be corrected in time in viable futures markets. The sheer number of active, informed participants quickly draws the market back to true values, reflecting the consensus of market participants. But at virtually all moments, there will be market participants who believe that market values do not currently reflect fundamentals and, of course, it's that conflict of opinion that give markets their viability.

You have asked if the quality of trading behavior has changed. I believe that, if anything, the quality of trading has improved. Today's market participants represent an ever broadening agricultural marketplace. They are better informed, with access to greater, more varied types of information. They are more sophisticated, reflecting the greater number of market opportunities available to them. Finally, as a result of new technologies in the marketplace, today's participants can be served more quickly and better than ever before.

You're asked about the impact of systems-type trading upon the markets. Systems-type trading is based on the theory that prices can be forecast from historical price movements and current market activities. Of course, it's not a new phenomenon. We've had systems-type trading in futures markets and equity markets as long as there have been such markets. Traders have developed chart and analytical systems and used them for many, many years—alone or sometimes in conjunction with trading methods based on their perception of fundamentals.

However, the change has been that computers have made it possible to develop and maintain more complex trading systems than ever before. Computer-based technologies are also responsible for making these systems accessible to a greater number of people than in the past.

I see the role of systems trading as being no different than any other market activity. It provides volume and breadth to the market. But to the extent that systems trading relies on a common-enough basing point, and when applied on a large enough scale, systems trading can affect futures markets, just as any large transaction can.

The effects of systems trading generally are limited to a very short time—a few minutes, an hour, perhaps a day. At some finite point in time, however, the axiom "never go against the fundamentals" comes back into play. The market will continue to reflect new transactions and new information, and its price discovery process will sort out the extraneous. We have yet to see a system of trade develop that is bigger than the market's ability to digest it and adjust to it. And I might observe, we've yet to see fundamentals overshadowed by technical maneuvers on a longer term basis.

You have asked it there is a need to improve the accessibility, quality and timeliness of market information. I'd like to observe that the accessibility quality and timeliness of market information have never been better. I have no doubts that market information will continue to improve as new technologies are applied to generate and disseminate it. At the same time, however, I believe the Federal Government has a role to play in assuring that objective, accurate and timely information is available to all.

Market participants—from producers to intermediate handlers and processors to domestic and foreign consumers—have come to rely on the outlook and situation work done by the U.S. Department of Agriculture as the bottom line in market information. In the past, USDA estimates and analyses have had an excellent track record for accuracy and timeliness; they are available to all. More recently, questions have been raised, particularly concerning the accuracy of some of the crop estimates, the stocks and all positions reports; but they are often the only such analyses available, underlining the need for their continued public support.

Unfortunately, in recent years funds have been cut from the outlook and situation work done by USDA and as a result, some reports have been discontinued or combined with others, some have been scaled back or based on less detail. The void created by changes in USDA's statistical and economic reports has been felt throughout the marketing system. There is a greater chance for market "misinformation" to develop and less opportunity to correct it in the current environment concerning the USDA and its statistical reporting work. When it is the USDA that is in error, the impacts are even greater.

How can the liquidity of the market be improved? Frankly, I know of no short-term steps to improve market liquidity. It cannot be manufactured. Liquidity will be derived from complex and changing economic forces.

Agricultural futures markets, like the agricultural economy in general, would benefit greatly, however, from a revitalized world economy. Policies that help end the current economic crisis will revitalize futures markets by revitalizing markets for the underlying commodities.

Let me explain briefly. The global recession and the strong dollar constricted demand for agricultural products abroad. With good weather, world supplies remained large. Weak demand and plentiful supplies generally result in users buying on spot markets only to fill their immediate needs. This holds down their interest and holding costs. The effect has been reduced liquidity in futures markets generally and particularly in reduced trading interest in the more deferred positions.

I would also note that Government policies can have unintended side effects on market performance. For example, U.S. tax policies, as has been mentioned several times before, that were aimed at ending what were seen as abusive tax straddles have been formulated in a way that may be reducing liquidity in deferred agricultural contracts. This is the market-to-market concept that others have referred to this morning.

In talking about market regulation, it seems to me that if the public is to retain confidence in commodity futures markets, there must be adequate regulation by the exchanges and by the CFTC.

In our judgment, self-policing by the exchanges with oversight by the new National Futures Association and the CFTC should be enough to assure public protection from market abuses.

How has speculative trading affected trading for hedging purposes? Speculative trading fulfills several vital economic functions in the marketplace. Speculators provide needed capital that augments risk-shifting opportunities for hedgers and the liquidity—that is to say, trading volume—that enables hedgers to buy and sell in large volume with relative ease. And although it generally goes unrecognized, the presence of more speculators in futures markets tends to reduce, rather than increase, market price volatility. More opinions and more frequent reactions to market movements, other things being equal, adds to liquidity and reduces the likelihood of sudden, large price swings.

I can offer little expertise in answering your question about prospects for and potential benefits of computerized trading versus pit trading. However, I believe that the business I am in is a sensitive one, one that is generated by human efforts and human demands, and I find it hard to believe that trading can or should be mechanized to a point that the human element will be removed.

Finally, why has the futures markets failed to attract greater farmer participation?

Well, there are probably several reasons why farmers have not participated in futures markets more than they do. First of all, farmers have been encouraged to rely on U.S. farm programs for price protection. Assured prices, especially when they become the market's price, reduce both the need for risk insurance that can be obtained in futures markets and the uncertainty about future price levels.

Furthermore, the recent stress on production-oriented farm policies has confused marketing education or left it out of the picture entirely. As a result, U.S. farmers often have little knowledge of how futures markets can offer them new opportunities. And I say this despite an ongoing and I believe very expensive effort on the part of the Chicago Board of Trade and other grain exchanges to conduct educational programs on futures markets. I sense, however, that those programs tend to be fragmented and that they do not tend to reach a broad enough geographic area of this country. As we've seen in production areas for particularly corn and soybeans—expand, I don't sense that the educational programs currently in place are reaching the new areas.

Of course, many farmers are already using futures markets indirectly, although they may not realize it. Those who are forward contracting are locking in a price that typically is available only because the buyers are able to hedge in futures markets.

Whether the trading of options on futures contracts will draw the attention of more producers to the importance of marketing remains to be seen. Options will give producers benefits that futures contracts do not, without some of the risks. Speaking as a member of the CFTC advisory committee on agricultural options, I would advise farmers to take a good look at them and consider how options may be useful to them.

Theoretically, options may fill the gap between futures markets and Federal farm programs, which today offer the major form of price insurance available on the major crops. However, as long as crop price and income supports provide generous protection at little direct cost to farmers, those programs will exert strong influence on farmers' production and marketing decisions while leaving less room for the price uncertainty needed to sustain options trading.

In the end, the success of agricultural options will be decided by the frequency and use made of them by market participants, and this I find very difficult to predict. In turn, the market forces of supply and demand for options will determine their cost.

Thank you for the opportunity to appear here, Mr. Chairman. I would be pleased to respond to any questions that you and the committee might have.

Senator JEPSEN. Thank you, Mr. Kohlmeyer.

Mr. Bell, president and chief executive officer, Riceland Foods, you may proceed.

Mr. BELL. Thank you, Mr. Chairman. If I may, I would like to summarize my statement and make some comments about some of the issues that have been raised this morning.

Senator JEPSEN. I appreciate that. Your prepared statement will be entered into the record and you may proceed.

STATEMENT OF RICHARD E. BELL, PRESIDENT AND CHIEF EXECUTIVE OFFICER, RICELAND FOODS, INC.

Mr. BELL. I would like to compliment you, Mr. Chairman, on calling the hearing we're having today. I feel that at today's hearing you are getting at the substance of the issues, whereas the one you held earlier in Chicago was a good overview, but I still felt it was not getting at the fundamental problem that I feel the industry has been facing for some months. So I compliment you for your perseverence and continuing to ask questions about the subject.

I would like to point out that I feel that I bring a different perspective to the hearing than some of the other people participating in it because of my long career in Government service before I entered the business sector in 1977.

Back in the period when I was in the Agriculture Department, although my area of specialty was international trade and price support programs and farm programs, I in fact had the opportunity to have a close working relationship with what at that time was called the Commodity Exchange Authority, which at that time was responsible for supervising the futures markets in the United States and was an agency of the Department of Agriculture, and worked directly under the Secretary of Agriculture.

As time goes on, Mr. Chairman, that was a pretty good system. I know we have made some substantial changes in how the futures markets are supervised in recent years, but as I have studied the cost of that and looked at what we did in those days, I think we did a pretty fair job.

But that aside, I think that it's important to recognize that there is more to the market that we're talking about in American agriculture than just the futures market and I look upon myself as being an entire marketing person. I am interested in the basis as well as the futures markets. I point out in my prepared statement that my principal activity today is to do the marketing job of a lot of farmers in eastern Arkansas and surrounding States.

I probably, perhaps other than the people from Cargill, have the opportunity to do more flat pricing in terms of volume of grain than anyone here today. So I look at it in a broader perspective. To me, it's important, though, that the futures markets in fact be functioning properly. If they're not, you're going to have other elements of the marketing system which in fact will be skewed and I think in the past year we have seen that. I felt that the basis that we've had for beans, and some of the soybean products, have in fact been distorted and they have been distorted because of unusual developments in the futures market.

In the case of a processor of agricultural commodities such as soybean processors, it's the basis that determines whether they have sufficient margins to make a profit and the basis, in turn, is affected by the futures market. So I do think that it needs to be looked at in its very broadest context.

This morning I felt that some of the comments may not have been entirely accurate because there was just too much focus on the futures market always being correct. I have confidence in the system but I know that it's not right every day, every moment, if other things are out of kilter.

I believe that some of the problems we have been having in the futures markets in recent months—I am of the view that there are some problems—come about in large part because of the vast change that has taken place in the American economy and in the farm sector in particular. Part of this is related to the recession, our loss of export markets, the exchange values of foreign currencies, and also new technologies of information systems affecting how quickly the decisions can be made and how quickly those decisions can be transmitted from one place of the world to another.

My view is that although the board of trade has got a nice new building in Chicago, there's more to the institution than just the building and perhaps the rules that worked 15 to 20 years ago are not the same type of rules that you need in today's world which is so fast moving.

I do believe, though, that the fundamental theory that underlies the futures markets is correct and that you must have many participants. You must have lots of trades each day and no one, by themselves, can dominate the market for any extended period of time. If those criteria are met, then I feel that the market basically is functioning in a proper manner.

We have had two features which have come on the scene in recent months and in fact they were with us before but I think they have gained more prominence in the last several months—that have caused this system at times to be out of kilter. These have to do with what I call computer pools and what I call managed accounts.

I find myself agreeing with Mr. Raclin this morning with regard to the conclusions he has drawn from his observations of the market. In my view, the computer pools do accentuate the rise and fall of market prices, but they are fairly predictable. After all, they are almost all using the same machines. Most are using the same software packages. Most are feeding in the same raw data. So the answers that come out are fairly predictable, except they're all getting about the same answers in sequence, so they will start the market moving up and down more than it would without their being there.

Because of their being fairly predictable, I do not see computer pools as much as a problem as I see the managed accounts. I would have to say, Mr. Chairman, I'm not sure of the function of computer pools. Some people would say that it's to provide liquidity. I'm not sure. I think every participant in the market needs to have a function.

I think the managed accounts have caused problems in terms of erratic or extreme fluctuations in prices during market sessions in very short periods of time. That was one of the quarrels I had with the testimony that was provided by most of the people at the Chicago hearing. There seemed to be great emphasis on why prices had come down since the harvest period began and I think anyone who's studied markets over time knows the old trade adage that a short crop has a long tail. But I think our real quarrel with the marketplace today is on these very extreme, short-term erratic price movements, where you have soybean prices, for example, moving 10 to 15 cents within a few minutes, and they may not only move 10 to 15 cents, they may move that amount both ways within a very few minutes. And it also seems that these fluctuations almost always begin at the first few minutes of the session, and the market really begins at 1 p.m. The last 15 minutes is when most of the participation seems to take place. Why that occurs, I don't know.

We have had discussion here this morning of what happened on April 11. There's probably been too much discussion on the Wall Street Journal article being wrong. There were some things in the article that were correct. In my view, the prices did drop that day because of very large selling in a very short period of time by a managed account. It just happened not to be Mr. Dennis' firm, but the price decline that day occurred because of the very large sales that occurred at that time.

As Mr. Raclin has said, I believe that it's very important that the speculative limit be maintained and be honored, and it is my feeling that intentionally or unintentionally, that the actions of the managed accounts have in fact transgressed the 3 million bushel limit and this is the major factor causing the violent price fluctuations in very short periods of time.

I do feel that it is important that we try to find a remedy to the problem, and move as quickly as we can to restore confidence in the institution of futures trading.

I would have several suggestions to make on how that might be done. One of those, I believe, is that we very badly need to broaden the leadership of the Chicago Board of Trade. I have not gone back and looked at the bylaws in terms of who the leadership of the board of trade is to be, but I did go back and look at the annual report of last year and I was a bit taken aback that of the 20 some people that are listed that I only knew three of them, and I feel that I'm one of those people in American agribusiness that knows almost everyone that is active in the business. Upon closer examination, I discovered about 80 percent of the people were what I call independent traders or people directly involved with trading on the floor.

Again, I think the Chicago Board of Trade futures trading is much bigger than Chicago and the floor traders. I think that there ought to be almost equal representation between the producers and the grain elevators on one side, the consumers, the processors, and exporters on the other end, and then the middle people which include the floor traders and the commission houses. And I also feel there needs to be more people from outside Chicago. I have the feeling sometimes that the people in Chicago forget about us that are out there on the ends, which are essential to make the market go. Maybe they don't realize that the market is only in Chicago—because it is. It could be in Des Moines, IA, if somebody wanted to put it there and wanted to establish it there. But I think it would help for the leadership to be broadened and that it would add market confidence out in the country.

In addition to that, with regard to your question of other contracts, it's my view that we have enough contracts now. I heard the other day that there was a proposal to begin trading car sales, monthly automobile sales. I really have a problem finding out what the economic function of that is. Again, I would feel that we would be better off to have the speculative money that's available in a few commodity contracts and have liquidity there than spreading it among a lot of other contracts.

I do feel that people can move the market. I think that has already been implied by what I said earlier. I think this is particularly true in the short term and it could be happening for a number of reasons.

I in fact think it has a longer term effect because I think markets are very psychological.

As far as market information is concerned, I would only say that I feel that some of the comments this morning have been a bit one-sided with regard to the Department of Agriculture and their crop reports. I still feel that it's the best reporting system in the world, and I have no question about their integrity. That does not mean that people don't make mistakes. They will make mistakes from time to time. I think what's happened in the last several months, the Department has said that it made an error in estimating the 1983 soybean crop and I think it's best to say that as quickly as possible and get on with it. But I have no question about the integrity of the system and I still think that it is by far the best in the world. I think our job should be to make them even better.

With that, Mr. Chairman, I appreciate being invited to participate in the hearing. Again, I compliment you on this very important issue and I certainly would be glad to respond to any questions you may have. Thank you.

[The prepared statement of Mr. Bell follows:]

PREPARED STATEMENT OF RICHARD E. BELL

I welcome this opportunity, Mr. Chairman, to appear before the Committee to discuss commodity futures markets.

I consider this an important and timely hearing and I commend you for calling it.

I believe, Mr. Chairman, that I bring a unique perspective to these hearings due to my experience in both government and business.

As you know, I spent the earlier part of my career, from 1959 to 1977, as an official of the U. S. Department of Agriculture (USDA), here in Washington and abroad as an agricultural attache at American embassies in Canada and Western Europe.

My last several years in government service were spent as Assistant Secretary of Agriculture for International Affairs and Commodity Programs. At that time, I also served as president of the Commodity Credit Corporation and as chairman of the Federal Crop Insurance Corporation.

During my latter years in the USDA, I worked closely with the Commodity Exchange Authority, which preceded today's Commodity Futures Trading Commission (CFTC).

Upon leaving USDA in 1977, I joined Riceland Foods, Inc. (RFI), a farmer-owned cooperative headquartered in Stuttgart, Arkansas. I serve as the cooperative's president and chief executive officer.

RFI is the leading grain marketing cooperative in the Mid-South, serving farmers in Arkansas and surrounding states. Annual sales average $650 million. One-half of the business is in export markets.

RFI is unique in that a large part of its business is in seasonal marketing pools whereby farmer-members turn over their crops at harvest to be marketed by the cooperative's professional staff on behalf of the farmer-members.

Nearly 70 percent of our business is done in this manner. Seasonal pool sales this past year were $413 million. The record year was $479 million in 1981-82.

RFI's farmer-members have invested heavily in facilities to help the cooperative's professional staff to market their crops. These facilities include country grain elevators, terminal grain elevators, barge-loading facilities, rice mills, soybean crushing plants, edible oil refineries and packaging and canning plants.

The commodity futures markets in Chicago are used extensively to market the crops delivered by RFI farmer-members and the products manufactured from those crops. Therefore, we have a vital interest in the proper functioning of commodity futures markets.

I believe that it is impossible, Mr. Chairman, to understate the importance of commodity futures markets to the operations of the U.S. marketing system for agricultural products. They make the entire system work.

Due to their importance, I believe that all sectors of American agriculture deserve assurance they are operating properly.

I wish to emphasize that I have great respect and confidence in the U.S. agricultural marketing system. It is one of the marvels of the world because of its effectiveness and efficiency.

It is unique because of the central role it assigns to futures markets. The central role of futures markets is one of the major reasons for the system's success.

Since futures markets are such an important element in our marketing system, they must be protected as a public instituion in the broadest sense. I believe, therefore, that it is essential that all sectors of the marketing system have confidence in commodity futures markets as an institution.

37-522 O—84——8

I feel, Mr. Chairman, that the institution is presently under stress. I believe that this stress is caused by vast change which is taking place in American business due to the rush of technological innovations and dislocations caused by the recent recession, and the loss of export markets.

Innovations related to computer technology and the proliferation of instant information systems has profoundly impacted agribusiness. Much of this change has occurred only in recent years.

I fear that our futures markets as an institution have been left behind in this rush of innovation and change. We are continuing to operate by the same rules that existed before these changes occurred. As a result, the entire system is not working as was intended.

I believe that the fundamental theory of our futures trading system is sound. It is based on the concept of many traders, trading many relatively small volumes, many times each day.

Under this system, no single person, firm or group dominates the market. Prices in the market accurately measure a consensus of many individual judgments of the supply and demand factors affecting the market for a specific commodity at a given time.

To make this system work efficiently, it is extremely important that all links of the marketing chain be involved in the market. In the case of grains and oilseeds, this means farmers, grain elevators, processors, exporters, wholesalers and speculators. Speculators are needed to provide the necessary liquidity to the market.

Two essential elements to the success of futures markets are the presence of an adequate number of participants and a method to ensure that no single participant has disproportionate influence over the market through excessive speculation.

This latter element has been held in check during most of the life of U.S. futures trading by a speculative limit on participants. In the case of grain and oilseeds, this limit has generally been three million bushels.

I believe that recent technological innovations and changes in business methods have caused this speculative limit to be often transgressed, perhaps unintentionally. These transgressions have led to volatile price movements within extremely short time periods.

This extreme volatility, which occurs apart from recognizable market factors, has driven many participants, especially smaller ones, from the market and has led to a general loss of confidence in the system. Many former participants, and some present ones, no longer believe that futures prices in Chicago, especially for soybeans, measure a consensus of individual judgments.

The relatively new features that appear at least partly responsible for this development are computer trading pools and managed accounts. Both have been present for some time, but have emerged as stronger factors in recent months. This seems to be especially true of managed accounts.

I believe that computer pools accentuate market movements, but have not led to the same short-term volatility as have managed accounts. The actions of computer pools are fairly predictable. After all, they all use similar machines, software and raw data.

The same cannot be said of managed accounts. Much of the short-term volatility in soybean futures in recent months has been caused by sudden, heavy trading by managed accounts.

A managed account, by my definition, is someone else's money being used by a trader to trade commodity futures. Short-term volatility, in this case, is illustrated by soybean price moves of 10 cents to 15 cents per bushel within a very few minutes. The moves often are in both directions within this time period.

Most of this short-term volatility has occurred at the market's opening, or in the final 15 minutes of a session. In nearly all cases, it is the result of traders of managed accounts either selling or buying huge volumes of contracts within short time periods.

These huge trading volumes by managed accounts within extreme short periods of time overwhelm the market. They immediately drive other participants from the market and cause them to fear re-entering it. Although this may not be a technical violation of present trading rules, it certainly violates the spirit of the three-million-bushel speculative limit. In my judgment, if left unchecked, this situation will substantially change the market as we have known it.

I believe there are several actions which can be taken to restore confidence to the market and return commodity futures to their intended position.

The Chicago Board of Trade should broaden its leadership to include all sectors of the market. Today's leadership is concentrated with people directly connected with floor trading.

I believe the leadership needs to be broadened to include more equal representation from such groups as farmers, elevator operators, processors and exporters, as well as floor traders and commission houses. I also believe more leadership should come from outside of Chicago.

Steps also should be taken to effectively reinstate the principle of speculative limits. This might be done by having different margin calls for different classes of traders.

Finally, the CFTC should examine more thoroughly the reasons for the short-term market volatility that has taken place on such days as April 11. This will mean examining trades during certain periods of the session. If such data are not available, I would propose that the CFTC find a means for acquiring them.

I appreciate this opportunity, Mr. Chairman, to appear before this Committee and discuss my concern regarding commodity futures markets. I will be pleased to respond to any questions.

Thank you.

Senator JEPSEN. I thank you, Mr. Bell.

It has been said on several occasions several times in different ways this morning that the Commodities Futures Trading Commission rules are probably adequate if they were properly enforced.

Mr. Stotler, you say in your prepared statement that the current self-regulation methods by the exchanges and the NFA under CFTC jurisdiction are adequate, if properly enforced. Are you suggesting that regulations may not be properly enforced?

Mr. STOTLER. No; I'm not really suggesting that they are not. There has been some criticism occasionally that the enforcement procedures could be improved. I merely state that I think that the rules are adequate and the CFTC limits are adequate, if enforced. And, of course, I believe it's in the best interest of the exchange itself to enforce the rules and I think they should be made to enforce them properly.

Senator JEPSEN. Mr. Raclin.

Mr. RACLIN. Sir, I feel very strongly that what is really happening is that these managed money accounts are trading for their own interests—which we expect them to do—in quantities and volume which are bigger than the average normal trader in the market does. And the result of it is that they are scaring, if you will, the local traders to death, and the outside speculators have moved into these pools. If they are limited—and I would point out that our firm, for example—I read in the Wall Street Journal—is about to embark on the offering of a $150 million commodity fund. If that thing is structured—I'm a director of that company and I haven't even looked at it, so I'm talking with complete assurance and absolute ignorance—so that we take 50 separate accounts, we have the ability in that account to—in theory—sell or buy 150 million bushels of soybeans at any given moment.

On the other hand, if we are restricted where the money manager of soybeans cannot trade in more than—for all those accounts—3 million bushels, we are on the same level playing field with Mr. Cargill or Mr. Stotler's customers.

I think that very fact would encourage the floor trader. He will not be faced with taking a position and having the roof fall in with one of these huge orders, which makes him gun shy. He will take any trades, and it will increase the liquidity, and by increasing the liquidity, the market will have decreased the price volatility.

I have no doubt that in the long run it's going to work out on supply and demand and I'm sure that's the case, but you've had a lot of people go broke on the short run. They have been in there and they buy something and literally with 10-percent margin—meanwhile soybeans dropped 23 cents in 1 day—triggering a margin call before they ever put up the original margin. You decrease their desire to take vertical price risks.

But the rules are in place. The same rules are in place that we've commented on this morning on rumors. The board of trade has these rules. I was involved in the *Rice* case when Daniel Rice was tried before the board of trade on a rumor. The rules say very definitely that you shall not spread rumors. Those markets are terribly sensitive, for example, to interest rates. And on the same day when it was said that the President was dead, it was also said that Volcker had resigned, implying higher interest rates, which cost more to carry grain or cost to carry commodities and down prices went. When the rumors were denied, prices went up.

Now it's almost impossible to find out who starts these rumors, but I think it's worth investigating who starts these rumors, and if they catch a long, putting out a bullish rumor—which is very difficult to do—why not ban him for life from trading. Make it tough enough—the same deterrent as capital punishment.

Senator JEPSEN. One of the favorite games around this establishment here is to start a rumor and then run around and confirm it. It has its impact and there's a willingness on the part of those reporting those things to run quickly, immediately, without checking on rumors, because they're more colorful and they make for better reading.

Merrill Lynch has started a huge new commodities futures mutual fund for the amateur speculator that you referred to.

Mr. RACLIN. Apparently so. I was president of a mutual fund when I was a partner and then an officer of Paine Webber, and I've had a fair amount of interest in commodity mutual funds. My own experience is, generally speaking, that the record is self-explanatory—that most mutual funds are no better than the money managers. The normal reaction is if they're so good, why aren't they doing it themselves?

Senator JEPSEN. I gather from what you've said, Mr. Raclin and Mr. Bell, and others this morning, that you feel that the commodity market can be influenced by buying and selling of large holdings legally under the rules; if you have 3 million bushels you can hold on opening and closing basis, and you could have more than one company so you could increase that by multiples.

Mr. RACLIN. The rule is very clearly written that it should be 3 million bushels and they wrote it properly for a contract market. I don't think it was thought at that time—I may be wrong, but at the time it was done, that you would have the ability to put 3 million on the Mid-American and 3 million on the Chicago Board of Trade.

I think that that could be very easily corrected if that is the desire—if this is perceived correctly—to cut down on all futures markets or all contract markets.

Senator JEPSEN. And a very large trader, Mr. Dennis, this morning repeatedly said that the reason it had no bearing on it is it could not affect the market.

Mr. RACLIN. In the long run.

Senator JEPSEN. Well, in the long run, is there anyone who disagrees with that statement? It is the law of supply and demand, and you can stretch it out, because I indicated earlier today it's not the long run I'm talking about; it's what happens in between.

Mr. RACLIN. Sir, I would like to interpose here, markets can be influenced. I would like to give you an example of the coffee market in London several years ago. Brazil desired to sell a huge quantity of coffee and the Government of Brazil employed one and then two futures firms which went into the futures market with market orders to buy 500 and 1,000 contracts at the market at a time, and the market over a period of days went up and they sold their cash and they then started to sell out their futures and took a loss on the futures. They did influence the market.

We saw that in the tin market where the Government of Malaysia did it. We've seen it in the silver market. It is not unheard of that speculative price elements do move those markets. Over the long run, of course, it will be all right. But in the short run, if you're a hedger like Mr. Mergell is, if soybeans can move 10 days ago from $7.75 to $8.15 down to $7.75 and yesterday was a good example where they opened 15 cents higher, went up 21 cents, and closed at $8, and you get these violent moves short run.

Senator JEPSEN. Does anyone here have any recommendations either now or that you would make for the record and submit in writing as to how we might improve or add to the commodities futures trading regulations?

Mr. BELL. Mr. Chairman, if I may, I would like to go back to your earlier comment. I feel that the rules that we have with regard to speculative limits are fine. I think the problem, as Mr. Raclin has implied, is applying it. And I feel that's a challenge either for the Chicago Board of Trade or the Commodities Futures Trading Commission.

I thought that Mr. Hieronymus had a very sound point earlier today when he suggested that we really need to have further studies by the CFTC on the reasons why these erratic fluctuations are occurring. I don't think anyone else, other than a Government agency such as that, can collect those data and I'm not sure the type of data that are required are available at the present time, but I would hope that if they're not, then the CFTC would find a way of acquiring them, at least for the purpose of study. The point I'm talking about is that it's my understanding that when a trade is completed on the floor of the Chicago Board of Trade that it does not have to be reported for half an hour. I'm not sure there's any information on the volume of trading that's taken place during time periods, and that's really what I think we're quarreling about.

So, I would think if I were going to have a recommendation, that one of the first ones would be that the CFTC initiate studies which would try to gather better empirical data on this problem.

Senator JEPSEN. Mr. Kohlmeyer.

Mr. KOHLMEYER. In response to your question regarding the adequacy of CFTC regulation and the regulatory function, I must say that I am not aware of any particular area that I would judge gets inadequate regulation from CFTC. In fact, it seems to me, as a regulatory agency with a budget and a staff which are of dwarf size by comparison with other Government regulatory agencies, I think they really do quite a good job.

I sense that today we have a little difficulty coming to grips with our various views on the impact of systems trading and managed funds on the markets, except that we all seem to agree that in the final analysis that they really don't change the course of history very much. We all seem to agree that they do have the ability to move markets for short periods of time to at least a limited extent, and I would share that view.

So far as I'm aware, the regulations, as they are applied to those managed funds, have been closely followed by the funds. They certainly have been thoroughly investigated, partially, sir, as a result of your interest in this subject, and apparently, those investigations have demonstrated that the rules and regulations have been followed.

So I take your question, then, really to be, should we consider creating some new regulations specifically designed to apply to those managed funds? I think that's a very complex issue, an issue which would involve, among other things, whether it's appropriate to impose position limits on individuals who choose to trade through managed funds that are different than if they chose to trade simply in their own name, in their own right. I'm not sure that at this stage that—I would want to think about it a lot more, but I'm not sure I would favor some sort of a restriction on trading limits for managed funds. It would certainly in current market conditions do some damage to the liquidity of the markets because I'm not sure that they would be replaced.

If fundamentals and managed funds are seen to be in conflict so often, I wonder if the perception of that conflict doesn't really stem from a feeling on the part of a lot of farmers that the markets aren't reflecting the value for their commodities that they think that they should, that is, that prices aren't high enough because, after all, their marketing services and marketing advisory services have I think pretty consistently, and especially last summer and last fall, told them the corn crop was in short supply and the soybean crop was in short supply, the former as a result of the drought and the acreage reduction program, and the soybean situation resulting from the drought. Therefore, there were a lot of inflated price anticipations on the part of a lot of producers and, I dare say, a lot of speculators, that thus far hasn't proven to be right. And when markets began to decline in late September, a decline that lasted as I recall for about 3½ to 4 months, there was great disappointment expressed by producer groups and others about the direction of prices. Yet, as I look back on it, it seems to me that in the clearer light of hindsight, I can find some very fundamental reasons why prices in the late summer got too high and very fundamental reasons why they in fact had to decline. Now that's hindsight, I'm the first to admit, and if I had that kind of foresight, I probably wouldn't be here today, but the dichotomy between the so-called systems trading speculator and the producer and consumer of agricultural commodities is sort of a love-hate relationship, and I'm yet to be persuaded in the current environment that one cannot really survive as well without the other as it can with.

Senator JEPSEN. That's very well put. It's a good statement to start winding this hearing down on. Do you have any closing statement, Mr. Bell?

Mr. BELL. No, sir.

Senator JEPSEN. Mr. Stotler.

Mr. STOTLER. I would like to merely point out that the implication to me that these funds might need to be regulated and that they may also trade in concept—in other words, follow the same system—I don't believe that they really all follow the same system. They have different systems and their records all indicate that they are in different commodities and follow different systems, so I don't think there's any trading in concert or at a particular technical point they all enter the market at the same time or go out of the market at the same market. I think they have the ability to move the market for a brief period of time, as any large position would have, but I think the usefulness that they provide to the market liquidity because they are replacing a lot of small traders in the marketplace with these funds is a benefit to the marketplace and a benefit to the users of the marketplace and I really can't see any need for changing the limits. There is a limit on at the present time and I think that limit is adequate and it's the same as the individual speculator and I cannot foresee any change in the regulation that would be helpful.

Senator JEPSEN. A final statement, Mr. Raclin?

Mr. RACLIN. No, sir; I don't think so. I think it's been said.

Senator JEPSEN. Well, I thank you. Depending on the witness, this committee has either wasted its time or uncovered an economic problem—some might say scandal—of global proportions. Likely, neither is the case. There is no question, however, that there exists a credibility cavern—gap is obviously an insufficient characterization—which is growing wider and wider between the futures market and those who have a physical interest in the commodity—or at least farmers and the International Association of Seed Crushers.

Calls to leave well enough alone or don't fix something that ain't broken are under-reactions, and pulling commodities off of the futures markets are over-reactions, in my opinion.

As I alluded to in my opening statement, there is a broad and deep public interest in the efficient and competitive determination of prices and futures markets which play a critical role in this determination process. The public, including the international market, is in need, and is deserving of, assurance that futures markets are receiving adequate regulatory oversight and that the self-policing of and by these markets is working.

We must begin to close this credibility gap before it engulfs all of us.

Broadening the representation of the board of directors of boards of trade and exchanges, the formation of a farmer and rancher advisory committee to the CFTC, and mandatory periodic reviews or assessments of the adequacy of rules and regulatons with respect to the highly dynamic, evolutionary nature of futures trading, particularly the growing influence of pool operators, commodity funds and computer-oriented money management accounts, are perhaps beginnings.

I trust, to the possible disappointment of some on both sides, that this hearing has neither been a whitewash nor a witchhunt. My purpose was not to create conflict, although that would have been a very populist thing to do at this point in time in my position, but rather help to resolve a conflict which threatens all interests. And to that end, I thank all of the witnesses here today and they've been very candid and straight from the shoulder and a combination of all the input today when the record is made I believe will be very helpful and constructive as we all move toward our common goal—and that is, confidence in the market, better utilization, better education of the prospective users of it which will benefit everybody, the producers, the processors, and the market makers, and our economy in this country and internationally also.

I thank you for coming today and I wish you a safe journey home.

This meeting is adjourned.

[Whereupon, at 12:55 p.m., the committee adjourned, subject to the call of the Chair.]

○