

Comments and Recommendations Of Commodity Markets Council
Before The
Commodity Futures Trading Commission
Agriculture Advisory Committee

December 6, 2007

Presented by Dan Brophy, Chairman, CMC Futures Committee

Issues: Role of Index Funds in commodity markets, revised definition of bona fide hedging, and Commitment of Traders (COT) Report

CMC worked closely with CFTC staff and Commissioners in 2005 and 2006 to bring about better industry understanding of the nature of Index Fund activity as “financial hedging” that is wholly legitimate in its purpose but is not responsive to price levels or supply and demand fundamentals. We now know that index hedging effectively transforms futures into investment securities. The nature of securitized futures contracts contrasts completely with “traditional” transaction-based, price-responsive hedging from commercial sources, which have always used futures contracts as a temporary proxy for a cash transaction.

The result of this collaborative effort was CFTC’s welcome release of a new COT Supplemental report capturing Index Fund financial hedges as a separate and distinct category.

By proposing to create the risk management exemption for Federal speculative position limits, the Commission has taken a needed additional step to deal on the regulatory level with the reality of this major new factor in commodities futures markets. CMC will review with its members the proposed new regulations and submit comments to the Commission prior to the January deadline.

Our comments today include some recommendations that will be part of our January submission, and also look beyond the implementation of new regulations to suggest to the Commission improvements in the means of reporting Index Fund activity to market participants.

CMC comments and recommendations

- The COT Supplemental Report has already become one of our industry’s most essential tools for analyzing markets.
- CMC recommends that the CFTC incorporate the COT Supplemental into a newly formatted COT Report, discontinuing the Supplemental and making the Supplemental data part of the standard COT Report data series as soon as possible.
- The Commission’s November 27 proposal generally describes Index Fund and similar financial hedges as “risk management positions.” CMC recommends an explicit

recognition that these “risk management positions” are a new variant of a *bona fide* hedge. Accordingly, CMC recommends the Commission include within the definition of *bona fide* hedging a new and separate category, Financial Hedgers, which would encompass the group of participants described in the proposed regulations. CMC will comment at a later date on the means by which these participants would qualify their status with the CFTC as Financial Hedgers within the rewritten definition of *bona fide* hedging.

- For purposes of reporting these positions to the public marketplace, the Financial Hedgers category would replace the Index Fund category in the COT reports.
- Apart from Financial Hedger positions currently captured in the Index Fund category of the COT Supplemental report, CMC understands that Index Fund positions also reside in the Commercial category reported in the COT Report. As it is currently configured, these financial hedges cannot be captured in the COT Supplemental Report. Moreover, a revised COT report incorporating the data now included in the COT Supplemental would not capture this activity.
- Because of this limitation, CMC recommends that, in addition to modifying the hedge definition to include financial hedging, the CFTC should include Index Fund hedges that now reside within the Commercial category in the new Financial Hedger category. By taking this step, the Commission will provide more transparency to an area of the market that has become opaque.
- CMC also recommends that the CFTC initiate a study of the recent trend toward “alpha” or “enhanced return” trading by Index Funds. While CMC recognizes the legitimacy of this activity, we believe that it is price-responsive, not passively managed and thus speculative in nature. It should be reported as such.
- CMC urges the Commission to revise its threshold measurement for reporting index trader activity. Under current policy, the CFTC reports index trading in a futures market if more than ten (10) index traders hold positions. As of today, CFTC reports this data for twelve (12) futures contracts. CMC believes the more relevant reporting objective is to identify the magnitude of Financial Hedger open positions relative to total open interest. This is the significant statistic for users of futures markets, in particular traditional hedgers concerned about financial order flows that can disrupt basis relationships or convergence during the delivery period. Hence, the relevant reporting threshold should be based on the percentage of open interest held by Financial Hedgers, regardless of the number of such firms holding positions. The absolute number of Index Funds holding positions in a futures market does not affect their impact. But the percentage of open interest cumulatively held by Financial Hedgers, open interest that represents investment securities that are not for sale regardless of price, can have a vast impact on a futures market. We recommend that the Commission work with each exchange to devise a reasonable reporting standard for Financial Hedger positions based on percent of open interest in this category.
- With respect to confidentiality and reporting thresholds for individual Index Fund participants, we argued before the Ag Advisory Committee in August 2006 that there was no risk that reporting requirements on Financial Hedgers would or could infringe

on proprietary information. We also argued that such a requirement would not provide competing market participants with an advantageous “window” into one firm’s activities or positions. Market developments since that meeting have only reinforced our position. Anonymous electronic trading has taken over the preponderance of daily volume in every major futures contract in just over one year and continues to gain share each month. The electronic markets that trade side-by-side now have better liquidity than pit markets. Activity initiated in the electronic trading environment – whether by Commercials, Financial Hedgers or other types of market participants - simply cannot be tracked by observers, certainly not the way pit trading was tracked in the past. The cottage industry that identifies and discloses to the marketplace an individual firm’s activities in trading pits has lost its information flow, its believability, and increasingly, its audience.

- Given the constant innovation in the index investing area, particularly invention of new index products, CMC recommends that CFTC begin reporting Financial Hedger open positions in the CBOT/CME soybean meal and Minneapolis Grain Exchange spring wheat markets, using a reasonable reporting threshold based on percentage of open interest worked out in cooperation with each exchange.

Issues: Speculative limits and international competitiveness of US futures markets
CMC comments and recommendations

- CMC supports an increase in non-spot individual and all months combined speculative position limits, as proposed by the Commission.
- US futures markets continue rapid growth, in large part because of the relevance of their products to the commercial hedging, financial hedging, and general international and domestic trading communities (including hedge funds). Every step, including the current CFTC proposal, which encourages broader participation in our markets attracts more volume and more liquidity. Volume begets liquidity, and liquidity begets further volume. Each of these factors builds beneficially on itself, tending to reduce bid/ask spreads and build depth of order book in every market.
- CMC supports any effort, including this proposal, which attracts more participants and more order flow. We commend the Commission for taking this initiative.
- Consistent with longstanding CMC policy, CMC again asks the Commission to grant each exchange authority to set its speculative position limits, subject to Commission guidelines and oversight. Core Principle 5(d) of the Commodity Futures Modernization Act requires designated contract markets to adopt position limits where necessary and appropriate, subject to the oversight of the Commission. However, as you know, a small subset of agricultural commodities remains subject to a duplicative regulatory structure which requires an exchange to change its rules and then petition the Commission to modify its regulations before an increase can be implemented. This process can take a year or longer.
- Elimination of this regulatory redundancy would fully implement the core principles of the CFMA for all agricultural commodities. CFTC would still retain all its

oversight powers. The change would be consistent with the intent of the CFMA to permit more exchange self-regulation in their markets.

- Beyond the discussion about intent of the CFMA, we should all recognize that every exchange today is under pressure to expand its user base, keep customers satisfied, stay competitive with over-the-counter markets, and compete domestically and internationally with other exchanges. Every SRO, whether demutualized or not, whether a public company or member association, must operate responsibly and in strict compliance with applicable laws and regulations, or otherwise face legal and financial catastrophe. In our view, vesting exchanges with the flexibility to set their own speculative position limits poses no risk of irresponsible decisions that would harm the trading public, and in no way diminishes or negates the CFTC's authority. Yet granting this freedom would give an exchange one additional step to take, as it deems appropriate, to attract new order flow or to enhance or defend its competitive position domestically or internationally.
- While it may seem improbable in today's commodities environment, the Commission should take into account the possibility that a given futures contract might be successful one day and subsequently lose a large percentage of its open interest within a short period of time. In such a situation, with its interest in market integrity at stake and a close familiarity with the users of its contracts, the exchange is better positioned than the Commission to respond on a timely basis to reduce speculative position limits as it deems prudent. Reasonable application of an exchange's business judgment in this case should be synchronous with federal regulatory authority over position limits. Self-regulation by exchanges works elsewhere, and should work in these circumstances.
- CMC is fully aware that the above arguments conflict with past Commission policy and regulatory history. However, we have great confidence in the well-tested system that intertwines CFTC oversight powers, strong CFTC staff, exchange self-regulation, and quick-response incentives at the exchange level. We believe this existing system, with its overlapping strengths and checks, can easily and successfully accommodate a new regime of exchange-determined position limits that assures market integrity and simultaneously fosters beneficial growth in volume and liquidity from broader market participation.
- CMC understands that some agricultural producer organizations still believe that activities of large speculators in futures markets pose a threat to their members. From the perspective of CMC, this is simply not the case. Futures markets in the enumerated commodities have grown immensely in the last decade. Without question, price volatility has increased. But it would be difficult to argue that speculative activity has influenced any price trends of significant magnitude or duration. Record high prices in agricultural commodities developed because of worldwide demand trends, weather, and other factors such as currency fluctuations and economic development. Just as exchanges have benefited from higher volumes, producers have benefited from higher prices. Speculative activity in futures markets may influence day to day prices, but is powerless in the face of larger, fundamental forces related to

the factors we have mentioned. Our markets today reflect global economics and trends, not speculative buying power. If prices begin to retreat tomorrow, speculative activity will follow that retreat, not cause it.

- In the event the Commission were to allow exchanges to set their own position limits, the Commission should use its persuasive powers and oversight authority to insure that each exchange cooperates with its sister exchanges that list identical contracts (such as ICE U.S. and NYMEX cotton) or related contracts (such as CBOT, KCBT and MGEX wheat contracts).
- With respect to international competitiveness and price discovery, our general experience is that users worldwide trade a given contract for a myriad of reasons -- ranging from its hedging or other commercial utility; its relevance as a proxy for a financial or commodity instrument; its liquidity and the depth of its order book; its volatility; its speculative appeal; the level of exchange fees or government taxes, and so forth. The domicile of the contract may or may not be a factor, whereas liquidity is a major factor. As an example, MATIF or LIFFE wheat contracts more closely track EU wheat markets, but liquidity in those futures contracts is insufficient to support large commercial order flow. As a result, US wheat futures, which represent an inferior hedge, capture European wheat hedging business because of superior liquidity and lower entry/exit costs.
- In summary, CMC asserts that the best way for an exchange to draw maximum order flow from all sources, domestic and international, is to have systems and policies in place that encourage low-cost, high efficiency futures markets. In all cases, the most efficient and lowest cost markets are those with maximum order flow and liquidity, which minimize bid/ask spreads and lower users' costs incurred entering or exiting the market. CMC supports exchange and CFTC policies that provide the most attractive trading and execution environment. As a general policy matter, exchange-controlled, flexible position limits would be one step in a continuing process to provide the most attractive business climate for US futures exchanges.

Issue: Ethanol as an Agricultural or Energy Commodity, and the related issue of Agricultural Swaps

CMC comments and recommendations

- CMC believes that ethanol is an energy commodity, and recommends that the Commission take this view in its consideration of the issue. More broadly, we recommend that, where possible within its existing regulatory authority, CFTC harmonize the regulations for agricultural swaps with those for swaps on non-agricultural commodities
- In making this recommendation, we are not prepared to debate the fine points of law or regulatory history. We leave complex legal and regulatory issues to be argued by the capable CFTC and exchange staffs with expertise in these areas.
- Our recommendation in this case recognizes an obvious commercial reality: participants in the cash ethanol trade want their transactions cleared and guaranteed

by a central counterparty, in this case the CME clearing house. CMC believes that regulations should promote, not obstruct, legitimate commercial activity. If participants in the OTC trade in any agricultural or other commodity want clearing services from any US exchange or independent clearing entity, the Commission should have the regulatory latitude to accommodate that demand. Legally important but outmoded and economically artificial distinctions should not impede development or delivery of services and products the market wants.

- It is important to recognize that the existing comprehensive regulatory structure provides significant customer protection against fraud and abuse. “Bucket shops” may still exist, but only outside an effective, proven structure in which CFTC plays a fundamental part. A clearing house cannot settle an instrument without a valuation price that is determined in a transparent environment and available to the clearing entity and both counterparties. An OTC transaction introduced into the clearing process through an FCM will not subject one of the parties to the transaction to a “heads-I-win, tails-you-lose” one-sided daily mark or final settlement that is characteristic of the “bucket shop” enterprise. The nature of the clearing and settlement process effectively excludes this risk, and at the same time provides a credit guarantee which is clearly of increasing value to OTC market participants.
- While we respect the responsibility and burden the CFTC carries in interpreting and enforcing the law, the debate in this case illustrates a central risk factor in the international competitiveness of US exchanges: product innovation and the needs of today’s market users outpace the law and regulation.
- As a single trade organization, we realize the limited influence our voice carries. Yet we have a responsibility to do what we can to persuade the Commission to unite the commodities industry and futures exchanges to ask for reforms that meet market needs and keep US exchanges healthy and competitive.
- In recent years, as part of the broad trend of global economic growth, commodities futures markets worldwide have exploded in activity, volatility and popularity with investors and speculators. Any notion that risks in certain “enumerated” commodities can be seen as controllable, or that any participant or group of participants in these markets can somehow be protected or shielded from existing risks, by the Commission or any other governmental entity, is outmoded. These risks are embedded in the climate of today’s commodities markets, and they reflect economics, not manipulation or speculative excess. No participant in any sector, including the agricultural sector, can avoid or ignore the inherent risks. The fact is that the agricultural community needs access to new products to manage those risks. Law and regulation which impede that access do no service to the public.
- The commodities industry, the US futures exchanges and the CFTC need to work together, not to navigate the maze of existing law that is in some cases unsuited to today’s business environment, but rather to find ways to accommodate the demand for better risk instruments. These include customized OTC products like swaps, clearing services, and central counterparty guarantees to participants in OTC transactions. Part of this effort may involve more commercially-oriented regulation, part may involve asking for improvements in existing law.

- **With these realities in mind, CMC makes the following recommendations:**
 1. As a first step, the Commission should approve the CME Group and ICE U.S. petitions involving grain and soft commodity swaps.
 2. Wherever possible, the Commission should support in its future regulatory interpretations harmonious treatment of agricultural and non-agricultural swaps.
 3. Wherever possible, the Commission should support in its future regulatory interpretations those industry and exchange product initiatives which bring into a cleared environment OTC agricultural products that are now uncleared.
 4. The Commission should research (via surveys, direct contacts and other steps) the needs of the OTC marketplace for new products and clearing services.
 5. Based on the research suggested above, and with further consultation within the commodities trading community, the Commission should request changes in law to accommodate the product innovation that is demanded by the industry and expanding in pace and scope daily. CMC will gladly lend its voice and resources to any Commission effort in this area