



Comments and Recommendations

Commodity Futures Trading Commission
Agriculture Advisory Committee
Presented by Dan Brophy, Chairman, CMC Futures Committee
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Convergence and Basis

CMC Position: Over the last four years, the grain industry has seen CBOT Wheat convergence seriously diminish. Convergence in CBOT Soybeans and Corn has diminished somewhat over the same time frame. In addressing this problem, a basic principle should inform any debate about solutions: balance among market participants must be maintained. Changes in contract design should not leave one group of users at a significant disadvantage versus another. The CBOT is ultimately responsible for maintenance of its contracts, and we have strong confidence in the exchange's ability and determination to work with its various constituencies to develop a solution or series of solutions. We recognize that a degree of urgency should drive the CBOT effort.

Comments and observations:

- Despite the convergence issues, volume in CBOT grain futures contracts continues to grow. This is clear evidence of market acceptance. It is also evidence of health and utility of the products – the exchange is still the preferred, liquid venue.
- All modifications under consideration offer advantages and disadvantages. Bearing in mind the importance of balance, CMC at this time cannot recommend a single modification or series of modifications that we regard as a complete solution.
 - Demand Certificates or “Forced Loadout”
 - It is not good policy to recreate the current problem the short hedger has with punitive contract terms imposed in the inverse on the long hedger.
 - A true demand certificate (or forced loadout) is not a workable tool. It would drastically shift the balance of the current contract in favor of the short hedger at the expense of the long hedger.
 - With annual production and year-around storage, the grain markets are distinct from the sugar and energy markets – where demand certificates seem to work.
 - New Delivery Locations
 - Adding delivery locations might marginally improve convergence but would not likely resolve an ongoing severe convergence problem.
 - Disadvantages include the possibility of more basis volatility and disruption in local grain bidding structure between those elevators newly included in the delivery mechanism and those still outside it.
 - Increased Storage Charges
 - Higher storage charges would marginally improve convergence but would not likely resolve a severe convergence problem.

- Disadvantages include the possibility of excessively high storage rates disrupting the ability of elevators not included in the delivery mechanism to compete with those within it. If storage rates are set high enough, bidding grain into the delivery mechanism could become a source of consumption of grain, altering normal commercial flows.
- Change of Settlement Mechanism from Physical Delivery to Cash Settled Index
 - Cash settlement to an index should be among other alternatives considered by the CBOT.
 - Cleared OTC basis and calendar swaps are similar products which may be important in providing for short hedgers concerned about basis exposure a means to offset that exposure in the OTC market. CMC strongly supports CME's swaps proposal as further explained below.
 - National basis swaps may merit consideration for the same reason.
- Special Comment on Hedge Exemptions

CMC Position: Despite the views of some market participants, it is unclear whether the index fund hedge exemptions previously granted by the Commission are having any long-term influence on the price of commodities traded in US markets. To the contrary, all indications thus far from studies done on market performance suggest that index funds are not responsible for high commodity prices.

We recommend that the Commission continue its analysis of index fund participants under the premise of "innocent until proven guilty" to ensure that the commodities industry does not lose critical liquidity and trade in futures markets to off-exchange or foreign markets as a result of actions taken in response to political rhetoric or presumptions. Until such time as any empirical evidence can be offered to support the notion that index fund exemptions are distorting market prices, we encourage the Commission to continue its practical approach of placing a moratorium on any new exemption requests, reviewing and studying existing exemptions and their market impact, and providing the markets with greater information transparency through the development of more detailed reporting of non-traditional hedgers' positions in commodities markets.

Margin Requirements

CMC Position: CMC believes that margin requirements should be the exclusive province of exchange-owned or independent clearinghouses.

- Clearinghouses are responsible for financial integrity of their clearing firms and customers, and preservation of the exchange's own reputation. They know their markets, firms and customers.
- Clearing houses interact with and monitor each market minute-to-minute. They have great expertise to assess market risk, firm risk posed to the clearing house relative to each firm's financial resources, and total risk underwritten by the mutual risk pool of the clearing house itself.
- Clearinghouses have highly sophisticated risk assessment capabilities and software – particularly for real-time risk evaluation.
- CFTC audits clearinghouses regularly to assess the health and sufficiency of these capabilities.
- Outside interference from regulators or legislators would disrupt the clearinghouse systems that have been decades in development and have proven successful in contending with markets even more stressful than today's markets.
- Margin levels must be set with care and appropriate understanding of consequences :
 - It is easy to impose high margins with the intent of dealing with a specific risk or problem, and unwittingly trigger the negative consequence of diminished liquidity and participation.
 - Loss of liquidity can easily exacerbate exactly the risk being targeted with high margins.
 - The best decisions about margin levels are made on the spot by people closest to the situation.

Credit

Comment and observation:

- CMC compliments the efforts by the American Bankers Association, the National Grain and Feed Association, and other organizations to address the general issue of credit lines for country elevators, including operating lines for carrying inventories.
- Restoring the confidence of country elevators and their bankers in the reliability and validity of convergence will bring about a rapid improvement in the credit climate for financing futures margins.

Exchange-Cleared Agricultural Swaps

CMC Position: CMC reiterates its comments delivered to the Commission in December 2007. Specifically, we support the approval of the CME Group petition to clear OTC Corn Basis Swaps and OTC Calendar Swaps for Corn, Wheat and Soybeans. More generally, if participants in the OTC trade in any agricultural or other commodity want clearing services from any US exchange or independent clearing entity, CMC believes the Commission should have the regulatory latitude necessary to accommodate that demand.

- The existing regulatory structure provides significant customer protection against fraud and abuse. 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 necessity of specific regulatory approval to clear OTC agricultural swaps 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.
- The commodities industry, the US futures exchanges and the CFTC need to work together 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 and 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 petition involving grain swaps.
 2. Where possible, the Commission should support in its future regulatory interpretations harmonious treatment of agricultural and non-agricultural swaps.
 3. Where 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. In consultation within the commodities trading community, the Commission should request changes in law to facilitate 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.