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Comment on the U.S. Commodity Futures Trading Commission (CFTC) Advanced notice of proposed rulemaking (ANPRM) and request for comment: agricultural swaps (17 CFR Part 35)

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The Institute for Agriculture and Trade Policy (IATP) is a non-profit, 501.c3 non-governmental organization, headquartered in Minneapolis, MN with offices in Washington, DC and Geneva, Switzerland. Our mission states, "The Institute for Agriculture and Trade Policy works locally and globally at the intersection of policy and practice to ensure fair and sustainable food, farm and trade systems." To carry out this mission, as regards commodity market regulation, IATP has participated in the Commodity Markets Oversight Coalition (CMOC) since May 2009, and in international regulatory meetings, most recently, the European Commission's public hearing on commodity derivatives on September 21 in Brussels. We have submitted comments on CFTC rule-making, most recently on March 10, and on the EC's DG Internal Markets draft directive consultation papers.

IATP is grateful for the CFTC's transparent and ambitious rulemaking process to implement Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank). We are aware of the financial service industry pressure that the Commissioners and staff are under to exempt their firms from Dodd-Frank requirements.[1] However, the CFTC's impartial and full implementation will benefit all stakeholders in commodity markets. The following response to the ANPRM comprises a general comment on agriculture and Over the Counter (OTC) trading practices and data reporting, followed by responses to some of the 27 questions posed by CFTC staff.

General comment

The CFTC requests comment on factors concerning the development of a rule on agricultural swaps, i.e. as a non-technical definition, the off-exchange (Over the Counter) trading of agricultural futures and options financial flows without the prospect or costs of the physical delivery of a commodity. This request for comment occurs in the midst of grave international concern about the consequences for food security of opaque physical and futures markets in agricultural commodities. An emergency September 24 intergovernmental meeting hosted by the United Nations Food and Agriculture Organization noted "unexpected price hikes and volatility" were "major threats to food security" and agreed that among the root causes of these threats are "lack of reliable and up to date information on crop supply and demand and export availability", "insufficient market transparency", and the "impact of "financialization" on futures markets".[2]

The CFTC does not have regulatory authority over physical markets and supply and demand information about them. Nevertheless, the agency should consult with the U.S. Department of Agriculture, which has such authority, and the Department of Justice about whether off-exchange trading of agricultural futures and options contracts may increase the likelihood of cross-market manipulation between futures and physical markets and other violations of U.S. law. (The French government, following its studies of extreme price volatility in the oil and wheat markets likely resulting from cross-market manipulation, proposed on August

27 that the European Commission draft new legislation to create a European commodity regulatory authority.[3]) Even if markets are not manipulated in the legal sense of the term, extreme price volatility resulting from speculative trades based on unanticipated outlook reports in physical stocks, such as the Russian and Ukrainian wheat shortage and the recent USDA outlook for corn, should be a matter of interagency concern for reasons of market integrity and of food security.

Commodity traders are extending their market reach beyond serving as intermediaries between producers and buyers, to control most segments of global and national farm to fork supply chains.[4] The longer and more complex these supply chains become, the greater will be the temptation for firms to manage their financial risks, as well as their commercial risks in physical hedging, through off-exchange futures and options trading. Swaps dealers have sought to maintain their trading information advantage in opaque markets by claiming that they too merit the status of physical hedgers seeking to manage "commercial risk" in bilateral swaps with non-financial firms. To implement the Congressional intent of Dodd-Frank, the CFTC must ensure that the bill's very narrow end-user exemption for commodity swaps pertains only to *bona fide* physical hedging of commercial risk for commodity producers, distributors and end-users and not to all financial risk, as proposed in the International Swaps and Derivatives Association definition of "commercial risk".[5]

The Bush administration CFTC staff decision to interpret the Commodity Futures Modernization Act of 2000 (CFMA) as allowing swaps dealers to trade agricultural (and other commodity) futures and options contracts without position limits and without regard to the physical delivery of a commodity greatly changed the structure of who traded, why, and with what effect on price discovery and risk management capacity for physical hedgers. According to an analysis by Michael Masters and Adam White of CFTC Commitment of Traders reports and other data, from 1998 to 2008, "Physical Hedger positions have risen 90%. During this same time, Speculator positions have grown by more than 1300%."[6] This analysis underestimates the disparity between physical hedgers and speculators because, as Masters and White state in a footnote, "Any Traditional Speculators using the swaps loopholes show up here as Physical Hedgers."[7]

While the Master and White analysis of long passive investment composition also includes oil, gas, gold and silver swap trades, the portion of agricultural open interest traded by physical hedgers vs. index and traditional speculators likewise shows a huge shift in the composition of traders towards speculation during the ten-year period. For example, in 1998, physical hedgers held about two-thirds of wheat contracts bet to increase in price (long open interest): by 2008, they controlled only about 16 percent, with commodity index speculators controlling about two-thirds. Index fund speculator "weight of money" adds liquidity to the market. However, excess liquidity, whether invested in equity or commodity instruments, can swamp a market, rather than provide the means for executing and clearing trades.[8] Whether index funds or notes are traded OTC or on exchanges, their excess liquidity distorts commodity prices for the *bona fide* physical hedgers who, unlike index speculators, actively manage their contracts with respect to market fundamentals and their commodity uses.

When deciding whether and how to propose a rule for agricultural swaps, the CFTC's protection of the public interest in market integrity (Commodity Exchange Act, Sec. 3) requires that the price discovery needs and trading practices of *bona fide* physical hedgers take regulatory priority over other investors in commodity markets. But enabling the continuation of agricultural swaps trading faces a difficult challenge. Any such rule will have to be designed so that swaps enable significant price discovery for physical hedgers and do not induce speculator driven price volatility, whether through OTC "weight of money" or information advantage with respect to exchange traders.

In August 5, 2009 testimony to the CFTC, former CFTC Commissioner and Department of Justice prosecutor Michael Greenberger said that agricultural swaps are *per se* violations of the CFMA.[9] The ANPRM notes that "There is limited legislative history regarding the CFMA to explain Congress' intent in excluding "agricultural commodities" from the Sec. 2 (g) swaps exemption." Commissioner Greenberger's interpretation of the agricultural commodities exclusion awaits a plaintiff with little fear of commercial retaliation to test whether the Bush administration CFTC carried out the will of Congress in the CFMA exclusion of agricultural commodities from the swaps exemption. Commissioner Greenberger's interpretation is not probative, and Dodd-Frank's grant of authority to the CFTC gives the agency discretion about whether or not to write a rule to permit the continued trading of agricultural swaps. Nevertheless, his interpretation is sufficiently authoritative to serve as a cautionary guidepost as the agency deliberates whether agricultural swaps trading complies with the CFMA and serves the Commodity Exchange Act's significant price discovery parameters for agricultural commodity hedgers.

Comments in response to some questions posed by the ANPRM

1. **How big is the current agricultural swaps business . . . ?:** As indicated in the 2008 Masters-White analysis of long open interest composition, cited above, index and traditional speculators predominate over physical hedger contracts in all agricultural commodities listed. Sometimes, the predominance is overwhelming, e.g. index investors holding 61 percent of live cattle contracts bet long. In 2008, most index speculation was done OTC, although since the bursting of the commodities bubble more long passive investment has moved to Exchange Traded Funds and Notes, about which IATP is likewise concerned, despite the greater transparency of exchange trade data reporting. ETF passive "weight of money" can distort price discovery even if trade data transparency has improved over the inconsistent, incomplete and delayed reporting of OTC swaps. Goldman Sachs, one of the five largest swaps dealers, advised a tactical retreat in 2010 from investing through index funds. However, the firm remains bullish on commodities, albeit more in energy commodities, in which it also is allowed to own physical stocks.[10] IATP has not been able to analyze the supplementary Commitment of Traders reports to determine the size of the agricultural swaps market, but on the basis of anecdotal evidence believes it to be large, although smaller than in most commodities in 2010. For this reason, IATP has not answered those questions that request a quantified response.

7. **What would be the practical and economic effect of a rule requiring agricultural swaps transactions (other than those eligible for the commercial end-user exemption) generally to be cleared?** The CFTC requests responses to this question from swaps dealers and swaps participants. IATP is neither, yet there is a public interest in mandatory clearing that should be expressed. The failure to clear trades, combined with Securities Exchange Commission capital reserve waivers for a half dozen highly favored banks that were also the major swaps dealers,[11] exposed the entire financial system to gargantuan and grotesque levels of counterparty credit risk. Clearing manages counterparty credit over time by requiring sufficient collateralization to protect counterparties from defaulting on the swap. Whether or not the CFTC and SEC curtail High Frequency Trading in the wake of the May 6th "flash crash", the myriad trading of contracts is sufficient reason, if any more were required, to extend mandatory clearing as broadly as permitted under Dodd-Frank. Agricultural

swaps are a minor part of the half percent of commodity based swaps in the $600 trillion notional value swaps universe, according to December 2009 Bank of International Settlements reporting. Nevertheless, for agricultural swaps participants trying to manage risks in the midst of growing climate change induced volatility, mandatory clearing is essential. At the September 21 EC public hearing on commodity derivatives, IATP learned that some producer cooperatives were considering participation in the agricultural swaps market as a way to hedge against below cost of production prices for agricultural raw materials. We would hope that the higher collateralization and business conduct standards of mandatory clearing would help discourage producers from participating directly in agricultural swaps or indirectly through Commodity Pool Operators. (These last two sentences are also in response to CFTC question 13.) Although mandatory clearing of agricultural swaps would likely shrink market liquidity, we believe that the excess liquidity thus drained would clarify and enhance significant price discovery for physical hedgers.

9. **Have current agricultural swaps/ATO participants experienced any significant trading problems, including: (a) economic problems . . .?** IATP does not have direct knowledge of economic problems experienced by swaps participants but we do have anecdotal knowledge about the effect of a swaps dominated market on producers and distributors. In May 2008, Tom Buis, then president of the National Farmers Union and William Dunevant, then the president of one of the three largest cotton traders, told the House of Representatives Committee on Agriculture that, as Dunevant phrased it, "Futures markets are broken for agriculture." Futures prices and cash market prices were not converging at the expiration of a contract, as they usually do in orderly and regulated markets. The lack of convergence meant that futures prices could not serve as reliable benchmarks for forward contract prices, and as a result firms as small as country elevators and as large as Cargill stopped forward contracting, and a cash management crisis loomed for many farmers and ranchers who relied on forward contracting. One final anecdote: at the October 29, 2009 meeting of the Agricultural Markets Advisory Committee (AMAC) one agenda item was how to explain poor futures and cash price convergence in wheat contracts. A representative of the Chicago Mercantile Exchange mooted various possible factors in poor wheat contract design, such as variable storage rates and delivery points, which would explain poor convergence. But a lobbyist for the American Baking Association intervened to ask, in effect, why do we devote so much AMAC discussion to contract design, when the failure of exchange and swap dealer self-regulation, particularly in CFMA "position accountability," sent torrents of liquidity into the market that made price convergence impossible? However relevant CME or any exchange contract design may be to improving convergence, the contract design focus of the AMAC price convergence discussion in August 2010 indicates that there is still denial among some market participants to that futures markets were broken for agriculture in 2008 and may be broken again if passive investors return to dominate agricultural markets. A 2010 Organization for Economic Cooperation study purporting to show that neither swaps dealers nor index funds drove agricultural price volatility in 2008 is another symptom of this denial. The OECD study was eviscerated by a Better Markets Inc. review that IATP encourages all CFTC commissioners and staff to read.[12]

20. **Should agricultural swaps be permitted to trade outside of a DCM [Derivatives Clearing Mechanism] or SEF [Swaps Execution Facility] to the same extent as all other swaps?** No, they

should not be permitted to trade to the same extent, given the economic structure of the underlying assets of agricultural derivatives.

22. **If not, what other requirements, limitations or conditions should apply?** As the cash prices of agricultural commodities become more volatile, due to climate change related supply factor variability, IATP believes that producers may be tempted to manage their price risks through agricultural swaps to avoid the higher transaction costs of exchange trading and to benefit by the information advantage of residual opacity in swaps data reporting. Particularly as direct agricultural subsidies could be eliminated in the 2012 Farm Bill and the EC's 2013 Common Agricultural Plan, the search for farm and ranch level income assurance may drive more producers to rely in part on swaps trading. Given the volatility of projected and actual supply and demand information of the underlying assets of agricultural commodities, we believe that most retail investors will hedge unsuccessfully through agricultural swaps. Therefore, in principle, we oppose a CFTC rule to allow retail investment in agricultural swaps. IATP believes that if agricultural swaps are to be traded by institutional investors, they should be centrally cleared, both for reducing counterparty credit risk to the financial system and for increasing the efficiency of CFTC monitoring and enforcement at a time when federal regulatory budgets will be tightly constrained, both for reasons of real budgetary competition and by those who seek to undermine CFTC's regulatory effectiveness in implementing Dodd-Frank. A higher collateral and capital requirement should be applied to any bilateral swaps a CFTC rule would allow.

24. **In general, should agricultural swaps be treated like all other physical commodity swaps under Dodd-Frank?** To reiterate, IATP believes that agriculture swaps do not serve the price discovery and risk management needs of agricultural commodity hedgers and opposes in principle a rule to allow retail agricultural swap investment. IATP believes that each category of commodity swaps poses specific regulatory challenges because of the economic and environmental characteristics of the underlying asset of the swap. The economic fundamentals of agriculture will be more vulnerable than any other asset category to the short term effects of weather and the longer term effects of climate change. This vulnerability will persist not only in terms of supply and demand and price volatility in U.S. regulated markets, but in the exposure of retail and institutional investors to agricultural swaps, either through indexed investments or non-indexed trading, putatively to diversify financial risk exposure in other asset classes. IATP believes that because of the underlying vulnerabilities of agricultural assets, the collateral, capital reserve, business conduct and other requirements of clearing organizations should be higher and more stringent for agricultural swaps than for other physical commodity swaps. We hope to see the day when leverage for agricultural commodity swaps will be deemed a bad credit risk, but that assumes that there will be fundamental reform of the credit rating agencies, which is beyond the CFTC's regulatory remit. Finally, we believe that the public interest requirement of the CEA as regards agricultural commodities trading includes the maintenance of orderly markets in the service of food security. As the aforementioned FAO report suggests, continued financialization of agricultural commodity markets, particularly through increasing trade in agricultural swaps, is inimical to fulfilling that public interest objective.

IATP wishes to conclude by thanking the CFTC Commissioners and staff for their energetic and dedicated public service in implementing Title VII of Dodd-Frank. We look forward to submitting future comment as IATP and jointly with the CMOC to assist the CFTC in this endeavor.

[1] E.g. "Wall Street Lobbyists Besiege CFTC to Shape Rewrite of Derivatives Rules", Bloomberg News, October 14, 2010.

[2] "Final Report," Extraordinary Joint Intersessional Meeting of the Intergovernmental Group on Grains and the Intergovernmental Group on Rice, Committee on Commodity Problems, United Nations Food and Agriculture Organization, September 24, 2010 (CCP:GR-RI 2010/2), paragraph 2.

[3] For the original French language proposal, see http://www.tradeobservatory.org/library.cfm?refID=107769 For an unofficial English translation of this proposal, see http://www.tradeobservatory.org/library.cfm?refID=107771

[4] Javier Blas and Kevin Brown, "Food traders share global ambitions", *Financial Times*, September 26, 2010.

[5] http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=26171

[6] Michael Masters and Adam White, "How Institutional Investors Are Driving Up Food and Energy Prices," The Accidental Hunt Brothers, July 31, 2008, at 34. http://www.loe.org/images/080919/Act1.pdf

[7] Ibid., footnote to Table 10, at 34.

[8] Gillian Tett, "Debate on the structure of the equity market is long overdue," *Financial Times*, August 20, 2010.

[9] http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/hearing080509_greenberger.pdf

[10] Sharman Mossavar-Rahmani et al, "Commodities: A Solution in Search of a Strategy," Investment Strategy Group, Goldman Sachs, January 2010 at 11.

[11] Stephen LaBaton. "Agency's '04 Rule Let Banks Pile Up New Debt, and Risk," *The New York Times*, October 3, 2008.

[12] http://www.iatp.org/tradeobservatory/library.cfm?refID=107621