March 28, 2011

Mr. David Stawick
Secretary of the Commission
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, NW.
Washington, DC 20581

Re: Notice of Proposed Rulemaking – Position Limits for Derivatives (RIN 3038-AD15 and AD-16)

Dear Secretary Stawick:

The American Feed Industry Association (AFIA) applauds the Commodities Futures Trading Commission (CFTC) for moving quickly, through its *Federal Register* release of January 26, 2011, to propose a new position limit structure for physical commodity futures and swaps as called for under section 737 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (P.L. 111-203). We appreciate the opportunity to submit these comments as the CFTC works to craft its proposed rule.

The AFIA is the principal organization representing the American animal feed industry and its suppliers. Our membership includes over 500 domestic and international companies, plus state, regional, and national associations. AFIA companies today produce over 75 percent of the commercial feed and pet food manufactured in the United States each year. As such, they are significant contributors to our nation's food safety, nutritional health, and environmental stewardship. The U.S. feed industry is also the single largest purchaser and user of major classes of American agricultural production, including feed grains, oilseeds, and processed meals and co-products. These commodities are critical inputs in the high-quality feed that American farmers and ranchers rely on to raise the safe, wholesome, and affordable meat, poultry, eggs, milk and fish and American consumers enjoy every day.

As a result, the America feed industry is also a major user of agriculture-based derivatives markets,[1] including both exchange-traded futures contracts as well as over-the-counter products. These derivative products allow our members companies not only to hedge their exposure to price fluctuations in these commodities, but also to determine the prices of inputs and goods produced. Animal feed today represents approximately 70 percent of the on-farm cost of raising

[1] Many AFIA members also used futures and/or swaps to manage risks associated with energy, interest rates, currencies, and other commercial exposures. In this letter, however, we focus specifically on the impact of the CFTC's rule on the 28 referenced physical commodity contracts, and primarily those in agriculture.

2101 Wilson Boulevard, Suite 916, Arlington VA 22201 USA
Telephone (703) 524-0810 • Fax (703) 524-1921
afia@afia.org • www.afia.org

livestock and poultry in America. When input prices, as reflected in futures markets, either (a) become distorted and fail to accurately reflect true supply and demand conditions or (b) become unduly volatile, the pain is felt not only by AFIA members but throughout the supply chain, from farmers and ranchers to consumers at the grocery store.

Summary:

Futures contracts on agriculture commodities were established as far back as the mid-1800s to serve this very purpose, that is, to provide commercial producers and end users of critical goods with an efficient mechanism to manage risks and determine fair prices. The Commodity Exchange Act (the Act), which first placed agricultural futures markets under federal oversight in 1921, made this purpose explicit, stating in section 3 that the goal of the Act was to serve the "national public interest" in these markets "as a means for managing and assuming price risks, discovering prices, or disseminating price information through trading in liquid, fair and financially secure trading facilities," and included the specific mission "to deter and prevent price manipulation or any other disruptions to market integrity."

The futures trading system encourages and requires speculative participants to provide the markets with liquidity and depth. But here too, the Act recognizes a clear limit to this utility: "Excessive speculation," it states in section 4a, "causing sudden or unreasonable fluctuations or unwarranted changes in the price of such commodity, is an undue and unnecessary burden on interstate commerce in such commodity." Since the 1930s, the most consistently effective and recognized tool to address the danger of excessive speculation has been position limits.

Today, the need for effective position limits in markets for agriculture commodities is heightened due to recent fundamental changes in market structure. AFIA has been particularly concerned that a sharp increase in financial investors, permitted by various means to avoid speculative position limits, has distorted the effectiveness of these markets. The CFTC itself recently found that as much as 80 percent of market activity is now conducted by speculators, and price swings often appear unconnected to normal underlying forces of supply and demand.

This newest class of commodity investor includes Wall Street banks, index funds and exchange traded funds (ETF) which, in many cases, use the markets to exercise "passive long" investment strategies – buying and holding portfolios of long positions as an "investment" in rising prices. These financial speculators, by the sheer power of their size and capitol, cannot help but to artificially influence commodity prices to the detriment of bona fide hedgers, creating a paper demand for commodities unrelated to any commercial reality.

This concern has been documented by repeated studies, reports and analyses by governments, economists and reputable academic institutions (we count at least sixty), including The World Bank, Massachusetts Institute Technology and the London School of Economics, Princeton University, Rice University, Columbia University, University of Chicago, New York University, Texas A&M University and the International Monetary Fund, just to name a few.

A sound regulatory system supporting an efficient, well-functioning market in exchange-traded and over-the-counter derivatives must start with sound and enforced speculative position limits.

These position limits must provide the flexibility needed for bona fide hedgers to conduct commercial businesses, but also must protect the market itself from the undue influence of excessive speculation as envisioned by the Act.

Proposed Position Limits: AFIA generally supports the structure that the CFTC has proposed for spot month, non-spot month, aggregate single-month and all-months-combined position limits in the 28 referenced contracts. This proposed structure will bring a consistency and transparency to the markets, which was lost with the passage of the Commodity Futures Modernization Act of 2000. We do hope that CFTC will strongly consider the following in finalizing this proposed rule:

- AFIA supports the CFTC's proposed approach of relying substantially on currently-existing federal and exchange-set position limits for agricultural commodities to establish limits under the new system. (See Appendix A of the proposed rules for Spot Month and section 151.4(d)(3) "Legacy Limits" for Non-Spot.). These limits have been in place for decades and, when applied strictly, have largely provided a stable market for both bona fide end users and their speculative counterparts. We are concerned by any approach that would result in raising these existing limits, as follows:

    - *Spot Month*: First, section 151.4(a) proposes to apply existing Spot Month Limits (Appendix A) only during an initial transition period, after which they would be replaced by new limits set by a formula: (a) one quarter of the estimated deliverable supply for physical-delivered contracts and (b) up to five times that amount for certain participants in cash-delivered contracts. To the extent this formula results in a large expansion of Spot Month limits, AFIA is concerned it could open the door to new waves of non-commercial longs entering these markets and distorting prices. We are particularly concerned at the proposal to establish "conditional spot month position limits" at five times the spot month limit (125 percent of estimated deliverable supply) if the trader does not have a hedge exemption, if the positions are exclusively in cash-settled contracts, and if the trader holds physical commodity positions less than or equal to 25 percent of deliverable supply. This appears to allow extraordinary, large speculative positions in sensitive markets, exacerbating the potential for price distortion discussed above.

    - *Non-Spot Months*: Second, section 151.(4)(d) proposes to apply the Legacy limits on a permanent basis, but the CFTC, in its *Federal Register* release (p. 4760), raises doubt as to whether it plans to keep this approach in its final rule. It requests comment on "whether the legacy limits should be retained" or "whether the levels should be increased" to specified higher levels. Once again, AFIA is concerned with any formula that results in a significant expansion of these limits, which, as with the Spot Month levels, could open the door to new waves of non-commercial longs entering the markets and disporting prices. We note that, with respect to both the spot and non-spot limits, the proposed annual review process would allow the CFTC an opportunity to make adjustments in the future without moving to an arbitrary higher limit in the first year. Further, the CFTC should

reserve to itself the authority, during periods of excessive price volatility, potential supply disruption, or other indications that markets are not performing to the benefit of bona fide hedgers and market users, to review and adjust any speculative position limits it establishes under this proposed rule on an expedited basis.

- AFIA supports the direction of the Dodd-Frank Act in insisting that position limits be assigned by CFTC, not the exchanges. In today's competitive marketplace among exchanges and non-exchange forums, there is pressure to trade increased volumes of similar or "look alike" contracts to avoid losing market share to competitors. Under these circumstances, the CFTC must assign aggregate limits to prevent the overwhelming of finite physical markets.

Exemptions for Index Funds: AFIA is pleased with the CFTC's decision in 2009 to withdraw the two staff "no action" letters (# 06-09 and 06-19) that had provided certain Wall Street firms an exception to speculative position limits for index fund investments based on so-called "passive long" positions. We believe these index fund positions played a large role in distorting price levels in the past, as discussed above, and we believe they may continue to do so today. The combination of (a) the "grandfather" for pre-existing positions acquired in "good faith" (section 151.9 of the proposed rule) and (b) the current lack of speculative position limits on over-the-counter markets, has allowed these index position to continue to grow. Since 2009, they have expanded to some $206 billion -- almost the same as at their 2008 peak – and are today dominated by three funds that control 94 percent of the total. (See Illustration) AFIA urges the CFTC to address this continuing concern by:

- Completing the setting of limits on over-the-counter markets as proposed in this rulemaking package. In this regard, we note that the CFTC is not required to prove that excessive speculation causes harm before imposing limits on speculation. The relevant finding is already contained in the Act. Rather, the CFTC has been directed by Congress under Section 4a of the Commodity Exchange Act to <u>prevent</u> such harm <u>before</u> it occurs.

- Setting a realistic phase-out process for any of the "grandfathered" positions that exceed the new limits. The pre-existing positions that exceed the implemented position limits must not be allowed to be held indefinitely.

AFIA also supports the "look through" reporting requirements that will identify individual investors and determine whether or not they meet the bona fide hedging exemption, per the proposed new definition.

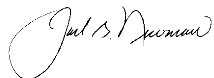
Costs to Bona Fide End Users: Finally, we urge the Commission to be cognizant in all of its rule-making initiatives of the need to minimize cost to all market participants. In this regard, AFIA takes this opportunity to reiterate comments we submitted early in the Dodd-Frank implementation process on a number of issues outside of this immediate rulemaking (primarily involving regulation of the Swaps market) that remain unsettled at this point, as follow:

- That rules governing the end user exception to the requirement for mandatory clearing of swap transactions be broad enough to cover the necessary commercial hedging operations of feed producers;
- That definitions of terms such as "swap dealer" and "major swap participant" be drawn narrowly so as not to inadvertently apply to commercial firms engaged in legitimate risk management;
- That rules covering margin, capitol, and other costly regulatory elements be limited so as to apply only to financial entities, and not to commercial hedgers.
- That rules require that financing costs charged for each transaction be disclosed by the provider as part of the appropriate reporting requirements.

For your reference and greater detail, attached is AFIA's comment letter of September 15, 2010 on these points.

AFIA appreciates the opportunity to provide comments. Please do not hesitate to contact me if I can provide further information or you have questions regarding the feed industry's position on this proposed rule. AFIA looks forward to providing further comments and working with the Commission to ensure commodity markets remain an effective tool for the end users.

Sincerely,



Joel G. Newman
President & CEO
American Feed Industry Association

Illustration