American Bakers Association

The Voice of the Baking Industry Since 1897

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March 28, 2011

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

Re: RIND 3038-15 and 3038-AD16; Proposed Rule on Position Limits for Derivatives

Dear Secretary Stawick:

The American Bakers Association (ABA) is the Washington D.C.-based voice of the wholesale baking industry. Since 1897, ABA has represented the interests of bakers before the U.S. Congress, federal agencies, and international regulatory authorities. ABA advocates on behalf of more than 700 baking facilities and baking company suppliers. ABA members produce bread, rolls, crackers, bagels, sweet goods, tortillas and many other wholesome, nutritious, baked products for America's families. The baking industry generates more than $70 billion in economic activity annually and employs close to half a million highly skilled people.

The baking industry has battled increasing market volatility, specifically in the wheat market, for a number of years. Current wheat market volatility represents millions of dollars daily in undue financial risk to bakers and all other traditional wheat market participants, both producers and end users. Extreme volatility, whether it increases or decreases futures prices, dramatically undermines the utility of the futures markets to our members. In order to decrease market volatility and allow the markets to return to reacting to fundamental supply and demand factors, ABA strongly urges that the Commodity Futures Trading Commission (CFTC) move forward with implementing contract limits on all index funds operating within the wheat futures markets, keeping existing limits at the current level, while simultaneously removing hedge exemptions for these same index funds. In addition, index funds are erroneously defined as commercial hedgers (with specific hedge exemptions) while their actions and intent in the market indicate that these entities should instead be designated as speculators.

Historical Intent of the Wheat Futures Markets

Since the inception of grain exchanges over 150 years ago, bakers and other wheat users have utilized these markets to purchase necessary ingredients. The wheat futures markets were created to allow producers (sellers) and wheat users (buyers) to "price their goods efficiently and manage risks association with price changes."[1] A third entity is also needed to create adequate liquidity in the markets; to buy and sell when wheat users and producers respectively are not doing so.

[1] Senate Permanent Subcommittee on Investigations, *Excessive Speculation in the Wheat Market*. Pg. 55

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While these market investors (speculators) are critical to the function of the wheat market, the primary purpose the market is to "address price risk management needs of buyers and sellers [and to] promote fair trade and to prevent trade abuses in wheat, oats and corn."[2]

The bottom line is that futures markets cannot function correctly should the original intent change. As stated in the Senate Permanent Subcommittee on Investigation's report on excessive speculation in the wheat market:

> "The history of the commodity futures markets demonstrates that futures markets cannot exist if they do not accomplish their intended purpose of enabling the producers, merchants, and end-users of a commodity to establish prices and effectively manage risks."[3]

Unfortunately, the original intent of these wheat and other agricultural markets have seemingly changed. These markets have been altered as new investment opportunities in agricultural commodities have arisen. With the influx of these "buy and hold" investors, commodity prices rose to record levels in 2008 driven in part to the impact of index funds investing in the markets.

Impact of Index Fund Activity in the Wheat and Agricultural Markets

Index fund investors increase market volatility when they enter the market using a buy and hold strategy on an exchange platform not originally created for financial investment purposes. These investors treat the agricultural markets as an asset class such as they would with stocks. Unlike the traditional speculator, who often acts as a medium between agricultural producers and end users through buying and selling contracts, index speculators buy and hold contracts by simply rolling their long-only positions to the next spot month.

The result of this activity in the markets is increasing volatility. While there are many factors driving volatility, including supply and demand, weather patterns across the world, and grain quality, the impact of the index funds on the wheat market cannot be understated. Index fund investments have dramatically increased since 2003, from an estimated $15 billion dollars to over $200 billion in 2008, meaning that index funds held between 35 percent and 50 percent of open interest between 2006 and 2008.[4]

In 2008, the U.S. Department of Agriculture issued this statement regarding volatility in the wheat markets:

> "The funds held an increasingly large percentage of open interest in the futures markets for agricultural commodities, as well as of nonagricultural commodities such as metals and energy. These investors only had a financial interest in the markets and did not intend to take delivery of the agricultural commodities. Indeed, it is likely that in general, neither the investor nor the financial managers that directed the funds' investments knew much about the fundamentals of the agricultural commodity markets. It is unclear to what extent the effect of these new investor interests had on prices and the underlying supply and demand relationships for agricultural products. However, computerized

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[2] Minneapolis Grain Exchange: About MGEX: <http://www.mgex.com/history.html>
[3] *Excessive Speculation in the Wheat Market.* Pg. 56
[4] Ibid, Pg. 6

trend-following trading practices employed by many of these funds may have increased the short-term volatility of the agricultural prices."[5]

Index funds continue to play a major role in the wheat markets. Figure 1 (appendix) shows the open interest owned in relation to actual US soft red winter wheat contracts from 1998 to 2010. Index funds have taken a large long only position in the soft red wheat market since 2005, correlating with an increase in market volatility (see Figure 2) and monthly trading ranges (Figure 3). Open interest for SRW CY 2010 was 469,056 contracts, while index funds own 342 percent of SRW contracts and 44 percent of all wheat contracts traded on the three major wheat exchanges. The sheer position of the index funds forces the markets to react differently to even subtle supply and demand factors. For decades the wheat markets functioned properly, with traditional market participants weathering fundamental supply and demand concerns across the world. But now, with the influx of index funds in the markets, the exchanges are much less effective as a medium for true price discovery.

Removing Hedge Exemptions

Index funds are erroneously defined by CFTC as commercial hedgers and thus have received exemptions from contract limits. Similar to action in 2009 to cut back on these exemptions,[6] the CFTC must move forward with removing all contract limit exemptions for index fund investors in the agricultural markets to decrease volatility and to allow for true price discovery. These investors currently operate in the markets under no natural limit unlike all traditional commercial hedgers, such as wheat producers and bakers. Index funds are not true commercial hedgers as they do not "produce or consume the commodity in its ordinary course of business."[7] As such, index funds should not be given hedge exemptions but should be classified as non-commercial participants such as the speculators, both large and small, therefore required to operate in the markets under contract limits.

Increase in Speculative Limits

ABA strongly opposes increasing speculative limits above current contract limits. Since increasing speculative limits in 2005, the required wheat hedging margins at the CBT have increased 114% from the initial $700 per contract to the current requirement of $1500 per contract. During a nine-day time span in October of 2006, these required margins were raised by $450, a 56% increase due to the upward volatility of the wheat market. Any increase in hedging margins is particularly hard on small businesses, requiring them to shift critical monetary resources to this unanticipated requirement.

If speculative limits are increased, ABA anticipates hedging margins could continue to increase, forcing small businesses to allocate more financial resources to this portion of their business to the detriment of their core business needs. This could cause the country elevator, small flour

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[5] Ronald Trostle, USDA Economic Research Service, *Global Agricultural Supply and Demand: Factors Contributing to the Recent Increase in Food Commodity Prices* (July 2008, Revised).
[6] *CFTC Withdraws Two No-Action Letters Granting Relief from Federal Speculative Limits on Soybeans, Corn and Wheat Contracts*, August 19, 2009. Found at <http://www.cftc.gov/PressRoom/PressReleases/pr5695-09.html>
[7] Holbrook Working, Economic Functions of Futures Markets, reprinted in Selected Writings of Holbrook Working (Chicago Board of Trade, 1985), Pg. 274.

miller or regional baker to alter their hedging strategies to the point where they will look at alternative hedging mechanisms or forego hedging in the agricultural futures market altogether.

In addition, increasing the speculative position limits for commodities bought and sold on the Chicago, Kansas City and Minneapolis Exchanges would again harm the original intent of these markets, which was to allow commodity producers to sell their product to entities, including bakers, who use the physical product. Any increase in speculative limits may also increase market volatility, decrease market participation and could create an atmosphere where a few speculators could control major portions of the wheat market.

Conclusion

The Commodity Exchange Act states that "excessive speculation in any commodity under contracts of sale of such commodity for future delivery…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."[8] Today's volatility, caused in part by the impact of index funds in the market, more than qualifies as excessive speculation since it has caused unreasonable and unwarranted fluctuations in the wheat markets. The assumption that index fund activities in the wheat market are passive and have no impact is erroneous, especially considering that this segment of market participants effectively own 342 percent of this year's soft red wheat crop.[9]

ABA strongly urges the CFTC to move forward with removing the hedge exemption status from all index funds operating within the wheat futures markets, keeping the limits at the current level, while ensuring that index funds cannot receive such exemptions in the future. Designating all index funds as non commercial participants will allow the markets to once again react appropriately to fundamental factors.

Sincerely,

Robb MacKie
ABA President & CEO

Appendix

<u>Figure 1</u>

[8] *Commodity Exchange Act, s 4a(a).*
[9] Commodity Futures Trading Commission, *Commitment of Traders Reports*, 18 March 2011.

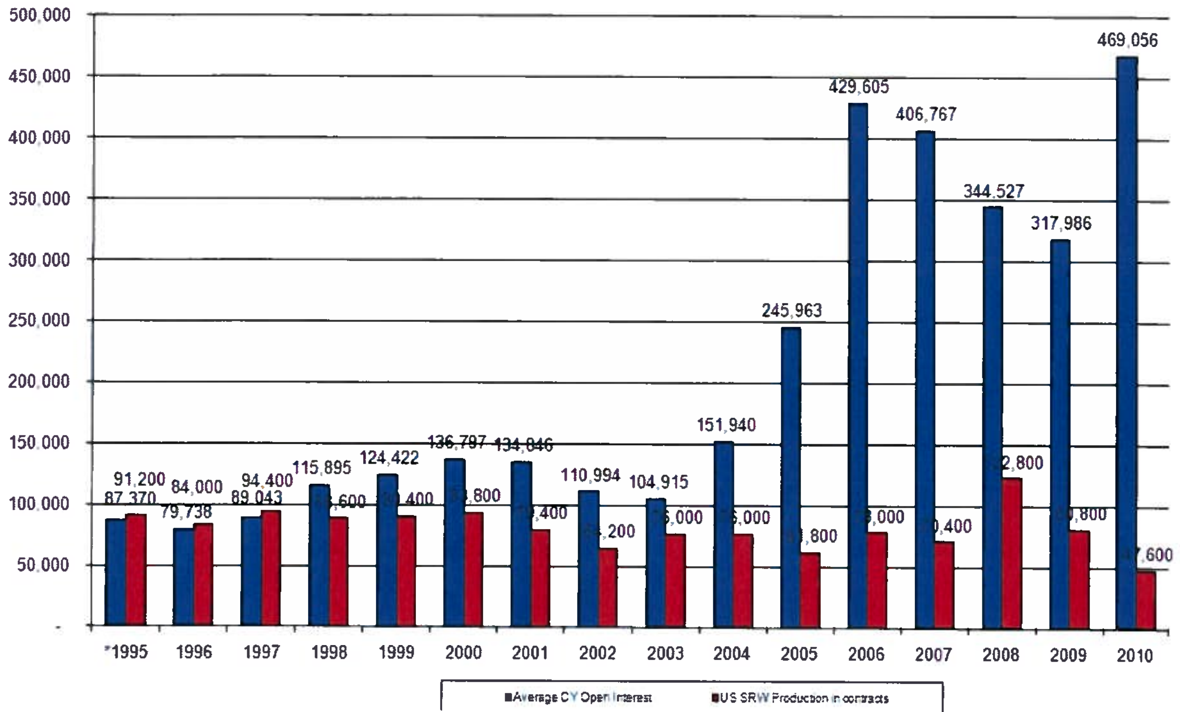


Figure 2

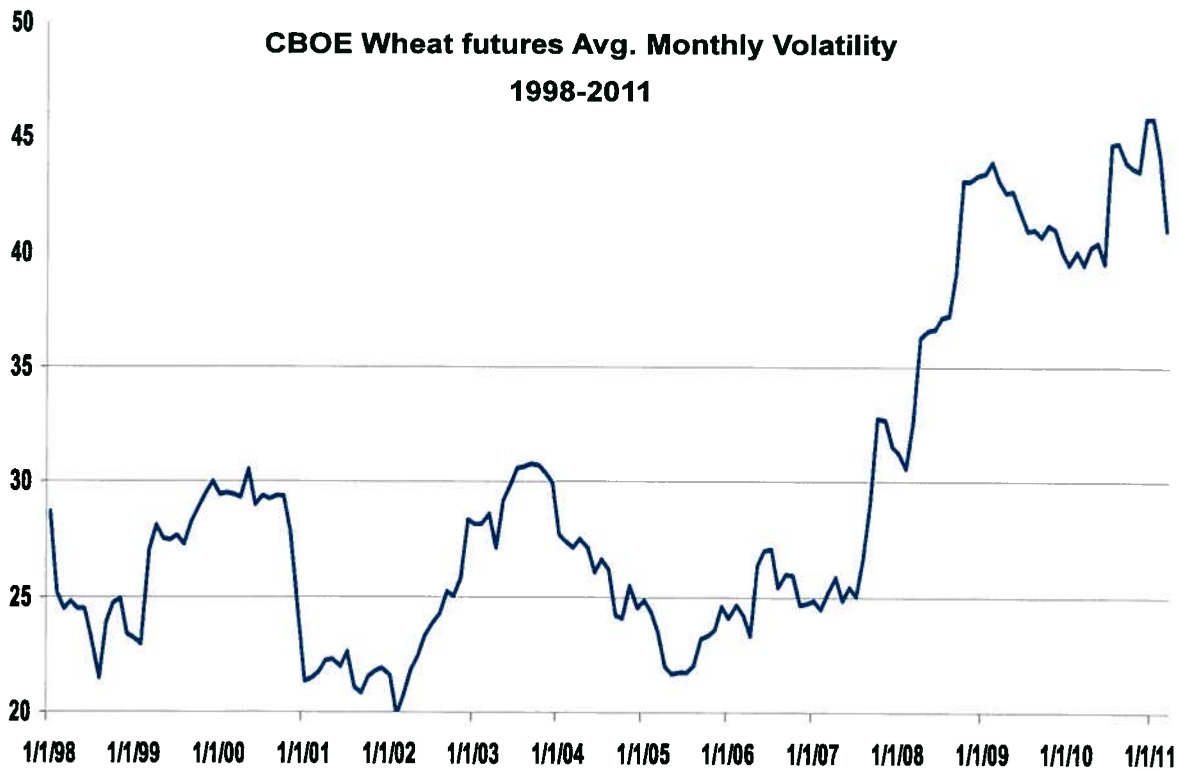
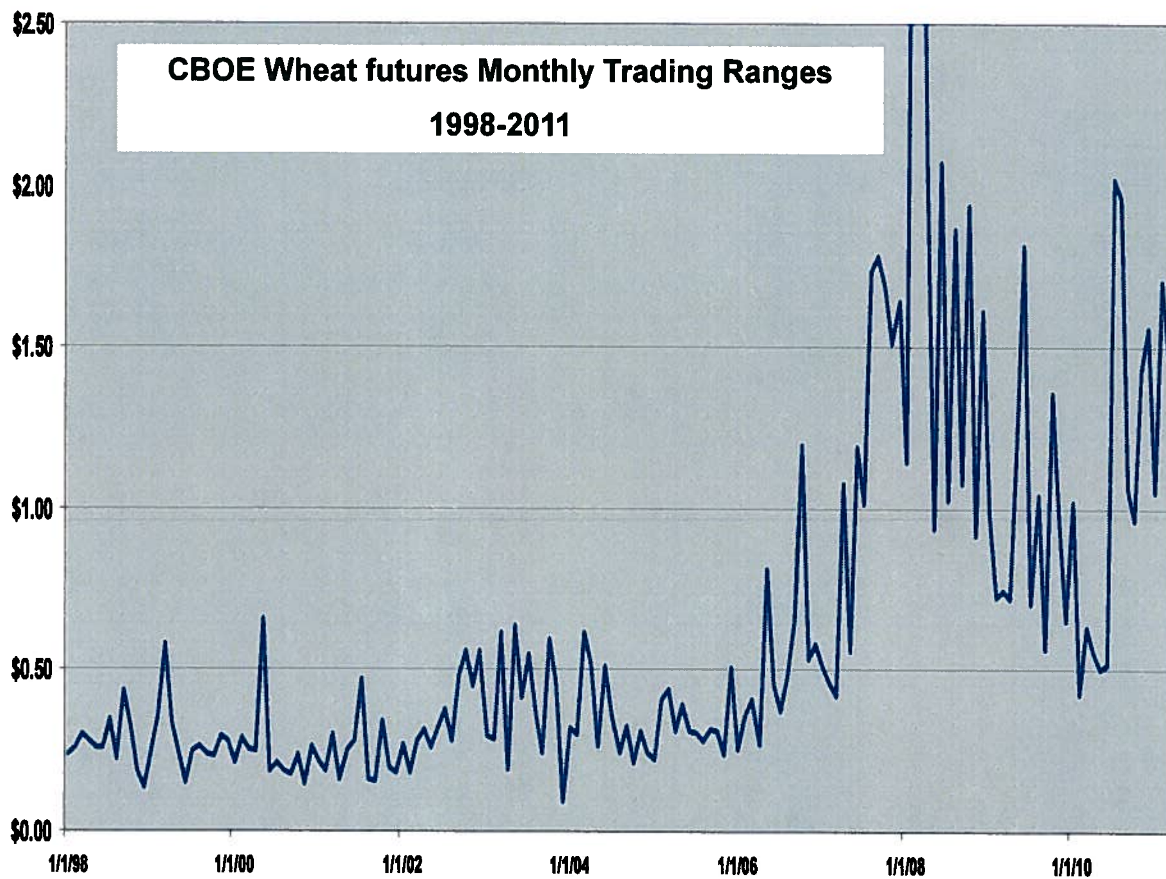


Figure 3


CBOE Wheat futures Monthly Trading Ranges
1998-2011
$2.50
$2.00
$1.50
$1.00
$0.50
$0.00
1/1/98
1/1/00
1/1/02
1/1/04
1/1/06
1/1/08
1/1/10