COMMODITY FUTURES TRADING COMMISSION TRANSITION TO CONGRESSIONAL INTENT

The facts, unmistakable in the aftermath of an historic period of excessive speculation, clearly establish that the Bush Administration's Working Group on Financial Markets (Treasury, Federal Reserve, Security & Exchanges Commission, and the Commodity Futures Trading Commission) was erroneous in asserting that the skyrocketing prices of fuel and food in the first 7-months of 2008 were based on supply demand factors. Now that the bubble has burst, the Working Group is attempting to deal with the market realities, but only as to Credit Default Swaps (CDS) and other Over-the-Counter (OTC) instruments – the unregulated market. Recently, it has begun considering clearinghouses for such instruments. But, it is not attempting to define such instruments or require transparency by identifying the traders and requiring that they report their market activity.

While the Congress and the public are attempting to become better informed about the machinations of the CDS market, efforts are now underway by those who created these questioned CDS instruments to establish a clearing mechanism that would be overseen by the Federal Reserve, an agency lacking experience in regulating such trades.

Further, the Working Group has never acknowledged that in many of the traditional futures contracts that market fundamentals bore little or no relationship to the market prices. That is exemplified by today's crude oil prices down substantially – over $100 a barrel –from the peak price four months ago.

The speculative excesses have caused severe financial hardships worldwide resulting in the Group of 20[1] (G20) November declaration calling on world governments to better regulate their futures markets, emphasizing the lack of regulation as the root cause of the financial crisis. The European Commission, too, has recommended that the EU raise with U.S. Government officials the role of hedge funds and other investment funds in the U.S. agricultural futures markets, warning that these funds have "increased the risk for speculative bubbles in agricultural commodities futures markets." The report noted, "[T]here is a need to avoid the effects that excessive speculation has on food prices," and concluded "the degree of volatility observed in recent months benefits neither producers nor consumers."

[1] Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, Mexico, Russia, Saudi Arabia, South Africa, South Korea, Turkey, United Kingdom, United States, and the European Union.

Congress Authorized Futures Trading in Agricultural Commodities for Price Discovery & Hedging

The U.S. Congress authorized contract market designations in the agricultural and non-agricultural commodities for the purposes of trading in futures contracts primarily to:

- Hedge against price risks;
- Discover prices through vigorous competition; and
- Facilitate commercial transactions.

Congress acknowledged that while futures contracts offer an investment opportunity, this role was subordinate in importance to the commercial uses of these contract markets. Given the intent of the Congress, there is little doubt that the CFTC erred in granting Hedge Exemptions to Index, Retirement, and other speculative funds not physically involved in the markets in which they were speculating.

The fact that the CFTC has stopped granting Hedge Exemptions is an admission of this fundamental policy mistake, which is crucially implicated in recent market disruptions causing severe losses for the primary commercial market: producers, processors, users, and consumers who utilize such markets for price discovery and hedging purposes. The very individuals for whom these contracts markets were created have been subject to unrestrained volatility and unreasonable margin requirements unrelated to either supply-demand conditions or weather events.

Adverse Impact on Markets Sanctioned by Congress

The commercial trade has been subject to unwarranted and severe financial strain – a strain never realized before in the history of the U.S. futures markets. Credit lines and lender's perceptions of client risk have been tested well beyond the norm. The cause is straight forward: Investment funds and OTC operatives flooded the futures markets with record amounts of cash to the extent that the trading fundamentals were thrown out of balance resulting in a widened basis thereby making these markets illiquid for those for whom Congress created these markets. To meet margin calls, exorbitant amounts of cash were required causing many commercials to withdraw their hedges. Lacking the financial ability or willingness to hedge in the futures market, the result is that in the agricultural markets merchants and cooperatives cannot offer farmers, processors, and manufacturers forward prices. This situation also precludes these entities from using the futures market. For farmers and processors, the historically-high grain prices touted last summer were unavailable in the cash market, but only available to the speculators in the futures markets – speculators with no connection to the commercial market.

The producer or manufacturer cannot take a forward contract to a banker to secure financing. The banks financing producers, merchants, cooperatives, and manufacturers no longer have confidence in the futures market. Therefore, they are reluctant or unable to provide the necessary margin funding.

The presence of large speculative funds and index funds in the energy and agricultural futures contracts distorted the futures and the physical or cash markets of these commodities. The abundance of unregulated cash allowed these funds to overwhelm these markets negating their primary purposes. The fear exists that this could happen again.

The confidence of the commercial trade and the lending institutions must be restored. This can be accomplished only if the CFTC fulfills its statutory role as an independent regulator to prevent "excessive speculation … to the detriment of the producer or the consumer and the persons handling commodities and the products and byproducts thereof in interstate commerce rendering regulation imperative for the protection of such commerce and the national public interest therein."[2]

Market fundamentals should dictate trading activity in the futures markets. This can be accomplished by repealing the Hedge Exemptions rectifying the policy error instrumental in undermining the markets basic economic purpose. The trading activity of the past year clearly demonstrates that the notion (current CFTC policy) that the speculative funds are passive investors is oxymoronic.

Speculative funds are welcome in the markets, but their activity must be tempered, monitored and regulated. Consideration should be given to requiring such funds to allocate a dollar amount to a particular commodity and if said amount is exceeded, then, federal speculative position limits should be imposed.

Reconsider Speculative Position Limits

Congress, through the CFTC, has imposed speculative positions limits in futures contracts to reduce the potential for market disruption or manipulation. But such limits are no longer effective for two reasons: First, the CFTC has granted Hedge Exemptions to the investment funds allowing them to exceed the limits; and Second, large traders were permitted by Congress, through the Swaps Exemption, to operate outside the regulatory framework altogether.

Swaps transactions are permitted to take place off-exchange where each party mutually agrees to satisfy each other's credit standards and to remit margins to one another as the underlying market fluctuates. Such transactions have the characteristics of

---

[2] 7 USC 5

an exchange-traded futures contract, but are traded OTC and are not subject to any regulatory oversight.

Such transactions pose problems when one of the parties to the Swap has a "Hedge Exemption" that exempts his or her on-exchange futures trading from position-size limits. The Swaps dealer would take an equal and opposite position in the futures market to the Swaps trade. For example, should a pension fund desire to purchase $20 million in long exposure in a commodity, it can purchase this exposure from a Swaps dealer. The dealer, now short the price of that commodity via the Swap, enters the futures market to hedge his position by buying futures in that commodity. Given that he is a "hedger," the CFTC allows him to trade futures in excess of the normal speculative position-size limits. This has created a situation where such large investors can trade in any contract in any size they desire without regard to position limits. They are not limited by the CFTC. Only a Swaps dealer can limit such trades, and it is unlikely that a Swaps dealer would turn a deaf ear to a financial entity awash in cash.

These arrangements, along with the billions of dollars invested in index funds, bring so much cash into a market that the traditional speculators cannot take a short position to match the institutional longs. This leaves it up to the commercials to offset these positions. But lacking the huge margin requirements, they cannot do so. That has been the situation this past year as the funds continued to purchase futures. Unwilling to assume such margin risks in such a volatile futures market, the commercials were forced to remain passive not only in the futures, but in the physical markets as well. The result: markets with no economic purpose for the commercials. Therefore, no business was done. Producers, lacking a price, could not properly plan and processors had to buy hand to mouth. Simply put, the investment funds have negated the real purpose of the futures markets causing severe disruptions in the agricultural and energy marketing process.

All Trading Activity Should Be Reported, Monitored, & Regulated

The facts are indisputable, other than the commercials utilizing the contract markets for price discovery and hedging purposes (who report regularly on their trading activity), the other market players, the speculative funds, were functioning in the same market place with distinct and unfair advantages. The result has been markets devoid of transparency leaving the CFTC with no ability to track positions or transactions critical to their functioning. This explains the concerns of the G20 and the European Commission.

In many instances, the CFTC was unable to discern what went wrong or who was responsible. Full market transparency would enable the CFTC to know what was taking place in the markets under its responsibility allowing it to make sound regulatory decisions. Today, lacking the appropriate information, the markets cannot be properly monitored.

Simply put, there is a void of critical information. Because the OTC markets lack supervision and reporting requirements, regulators lack vital data on the activity in this fully developed market. There is no information on the aggregate of the totality of these positions, rendering ineffective the systems designed to provide oversight and transparency. In contrast, a commercial hedger in the cash markets is required to provide the CFTC with massive amounts of information – cash purchases, sales and its current inventory.

To achieve the necessary market transparency, the current regulatory exemption for the OTC markets should be repealed. The Swaps market should be subject to regulation, if not required to be exchange traded. Transparency is the one constant these markets lack and must embrace. To assure maximum transparency, the full reporting or aggregation of all transactions by all participants in Swaps, other OTC contracts, and exchange transactions should be required.

Consider Delivery Requirement for All Market Participants

Another regulatory alternative is to consider requiring delivery of all futures market participants. This would necessitate the speculative funds to comport to the same prudential conduct as the commercial market participants, result in more accurate price discovery, and limit excessive price fluctuations to supply-demand, weather, or political conditions. The entry of a so-called “passive longs” into a contract market should not be the sole determinative of price as it has been this past year in the energy and some of the agricultural contract markets.

Summary

There are a myriad of policy issues that must be quickly addressed by a Commodity Futures Trading Commission committed to sound regulatory principles. Therefore, care must be taken to recruit candidates to serve as Commissioners and as members of the professional staff who are mindful of the primary purposes for which Congress authorized trading in these contract markets. Further, the staff must be substantially expanded to effectively monitor and regulate the futures markets.