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Commodity Futures Trading Commission

Agricultural Outlook Forum
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Commodity Futures Trading Commission

Mission Statement

To Protect Market Users and the Public from Fraud, Manipulation, and Abusive Practices Related to the Sale of Commodity Futures and Options, and to Foster Open, Competitive, and Financially Sound Commodity Futures and Option Markets.

The Role of Commodity Derivative Markets

- To provide a venue for producers and consumers to hedge their commercial risks.

- To provide a price discovery function for the market.
  - Well functioning markets assist in stabilizing prices by providing signals to producers to increase production of key commodities that are in short supply.
  - The more commercial participants use the market to hedge, the more efficient this price discovery function becomes.

- Markets should design futures contracts so that they are useful to a wide variety of hedgers in a particular commodity.

The Role of Market Regulators

- The regulators' role is to ensure stable and orderly markets.
- Regulators should not prevent or limit volatility that occurs due to a change in supply/demand fundamentals.
- Nonetheless, regulators can act to enhance transparency which may assist in preventing major price fluctuations.
  - (*e.g.*, by requiring timely information to the market, regulators can increase granularity by reducing the impact of any new information)

Objectives of Title VII

Reduce systemic risks through:

- Comprehensive regulation of swap dealers and major swap participants (i.e. persons other than dealers who may pose systemic risks)
- Clearing for standardized swaps
- Transparent trading of standardized swaps on regulated swap execution facilities, including real-time reporting of transaction data
- Centralized repository for all swap data, available to all regulators

Overview of the Dodd-Frank Provisions Relating to Agriculture

- Some things remain unchanged under Dodd-Frank
  - Forward contracts still excluded from CFTC jurisdiction and forward contracting transactions can continue as before, with no change
  - The rules for exchange-traded futures, and options on futures, will not change (contracts for future delivery and options on such contracts are excluded from the "swaps" definition)

Agricultural Swaps Under Dodd-Frank

- Dodd-Frank defines “swaps” very broadly and implements major changes for agricultural commodity swaps
  - The broad definition of “swap” in §721 of the bill covers not only traditional swaps (including “agricultural swaps” and “commodity swaps”), but also “**options of any kind”**
  - Under §723 of the bill, “any swap in an agricultural commodity” will be prohibited **when Dodd-Frank takes effect**, unless traded pursuant to an exemption under §4(c) of the Commodity Exchange Act
    - Section 4(c) exemptions already in effect when Dodd-Frank was enacted are grandfathered until the Commission decides otherwise

Affected Agricultural Swaps

- Under §723 of Dodd-Frank, four types of ongoing agricultural swap transactions will be affected:

  1. OTC agricultural commodity swaps, currently trading under the Part 35 rules, are grandfathered and may continue for now;
     - It is anticipated, however, that post-Dodd-Frank regulatory reforms will substantially revise, or possibly completely replace, Part 35

  2. Exchange-cleared OTC agricultural swaps already trading pursuant to §4(c) exemptive orders (e.g., CBOT corn and soybean basis swaps and calendar swaps) are also grandfathered and may continue for now;
     - However, any new cleared OTC agricultural swaps would require a new §4(c) order

  3. Agricultural trade options (now defined as swaps) in the **enumerated commodities** (wheat, corn, etc.), trading under the §32.13(g) **exemption** from the agricultural trade option (ATO) rules, are not covered by a §4(c) order, are not grandfathered, and will become illegal, absent a §4(c) exemption, when Dodd-Frank takes effect
     - Note: the basic §32.13 ATO rules are effectively moot because no one is currently registered as an agricultural trade option merchant under those rules

  4. ATOs in **non-enumerated** agricultural commodities (e.g., coffee, sugar, cocoa), trading under the basic trade option exemption (§32.4), are likewise not grandfathered and will also become illegal, absent a §4(c) exemption, when Dodd-Frank takes effect

- Proposed rule would permit all commodity options and agricultural swaps to transact subject to the same laws and regulations, as amended by Dodd-Frank, applicable to any other swap.

Agricultural Commodity Definition

- The Dodd-Frank agricultural swap provisions apply to “any swap in an agricultural commodity”
- Commission issued proposed definition for “agricultural commodity” drawing a line between:
  - Products that are derived from living organisms and are used for human food, animal feed or natural fiber (covered by the definition); and
  - Plant or animal-based industrial products, such as butanolor denatured ethanol (outside the definition)

Speculative Position Limits for Agricultural Commodities

- Dodd-Frank also requires the Commission to issue speculative position limits for agricultural commodities

- The Commission has proposed position limit rules which are out for comment, including position limits that will apply to many agricultural commodities (see Position Limits NPRM, 76 FR 4752). The position limits, as proposed, apply only to specific "referenced contracts" (rather than on a categorical or definitional basis), and many of the reference contracts identified in the proposal happen to be agricultural.

Position Limits

- The CFTC was directed in its original 1936 statute to set position limits to prevent excessive speculation and under this authority imposed position limits on certain agricultural commodity futures contracts.

- Commission regulations currently include Federal speculative position limits for:
  - Chicago Board of Trade Corn, Oats, Wheat, Soybeans, Soybean Oil, and Soybean Meal;
  - Minneapolis Grain Exchange Hard Red Spring Wheat;
  - Kansas City Board of Trade Hard Winter Wheat, and
  - ICE US Cotton.

- Other commodities are subject to position limits set by U.S. exchanges
  - The CFTC may bring an enforcement action based on violations of exchange limits, as in a recent case involving CME rice

Dodd-Frank Act Position Limits Requirements

- The Dodd-Frank Act mandates that the CFTC establish, as appropriate, aggregate position limits on all physical commodity derivatives positions across US futures exchanges, FBOTs providing "direct access" to American entities, and swaps that are either "economically equivalent" to a commodity futures contract or serve a "significant price discovery function."

- The legislation provides that position limits should:
  - Diminish, eliminate, or prevent excessive speculation;
  - Deter and prevent market manipulation, squeezes, and corners;
  - Ensure sufficient market liquidity for bona fide hedgers; and
  - Ensure that the price discovery function of the underlying market is not disrupted.

- Under Dodd-Frank, CFTC must "strive to ensure" that
  - Trading on FBOTs are subject to comparable limits;
  - Any limits imposed by the CFTC do not shift trading to FBOTs.

Clearing

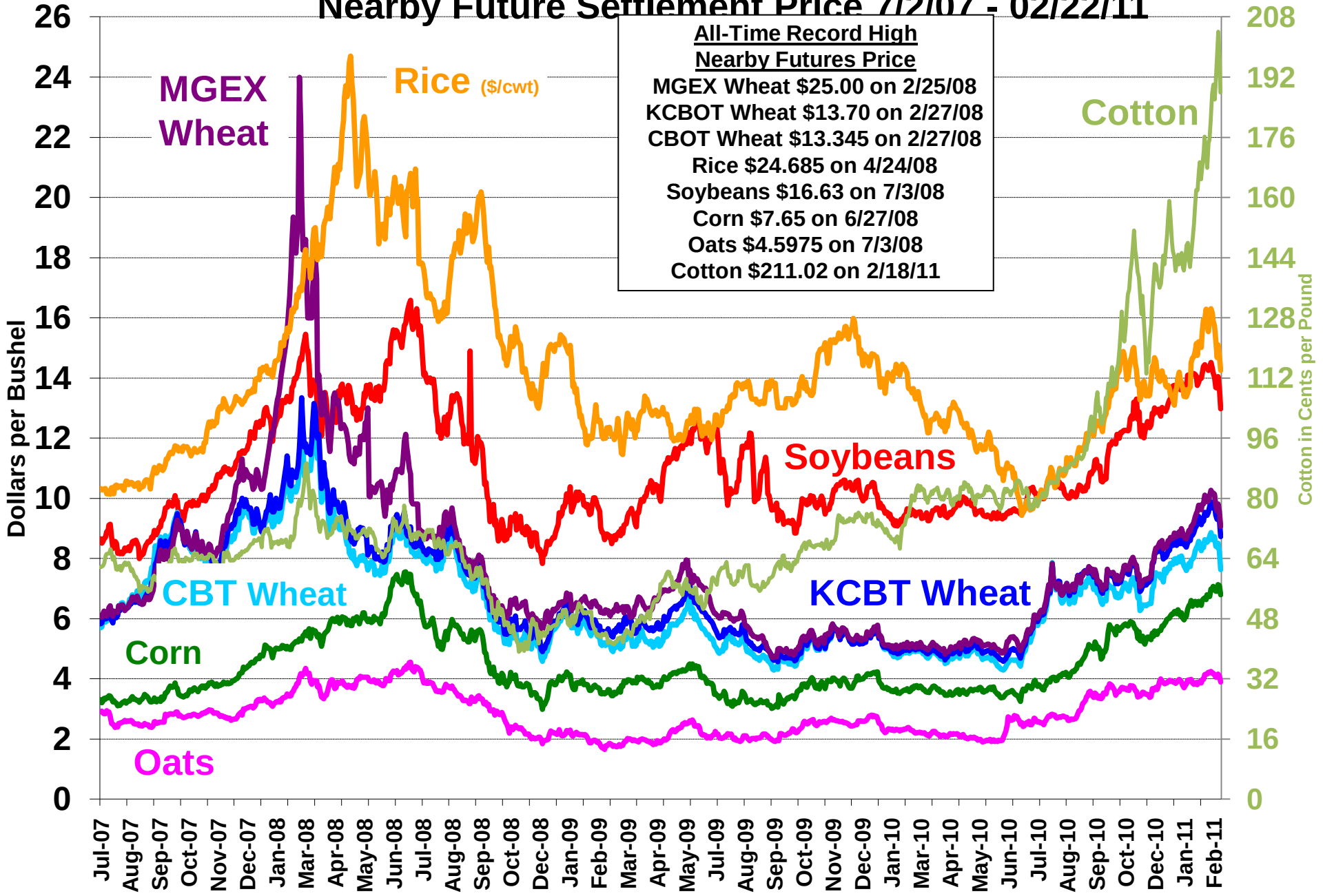
- Title VII requires that the CFTC will, on an ongoing basis, review swaps and categories or classes of swaps with a view to determining whether clearing should be mandated.
- Factors to be considered include: the existence of significant outstanding exposures; trading liquidity; and the availability of appropriate operational expertise and resources.
- Where the CFTC determines that a particular type of swap should be cleared but no clearing organization accepts the swap for clearing, the CFTC may investigate and take appropriate action.

End-User Exception to Clearing

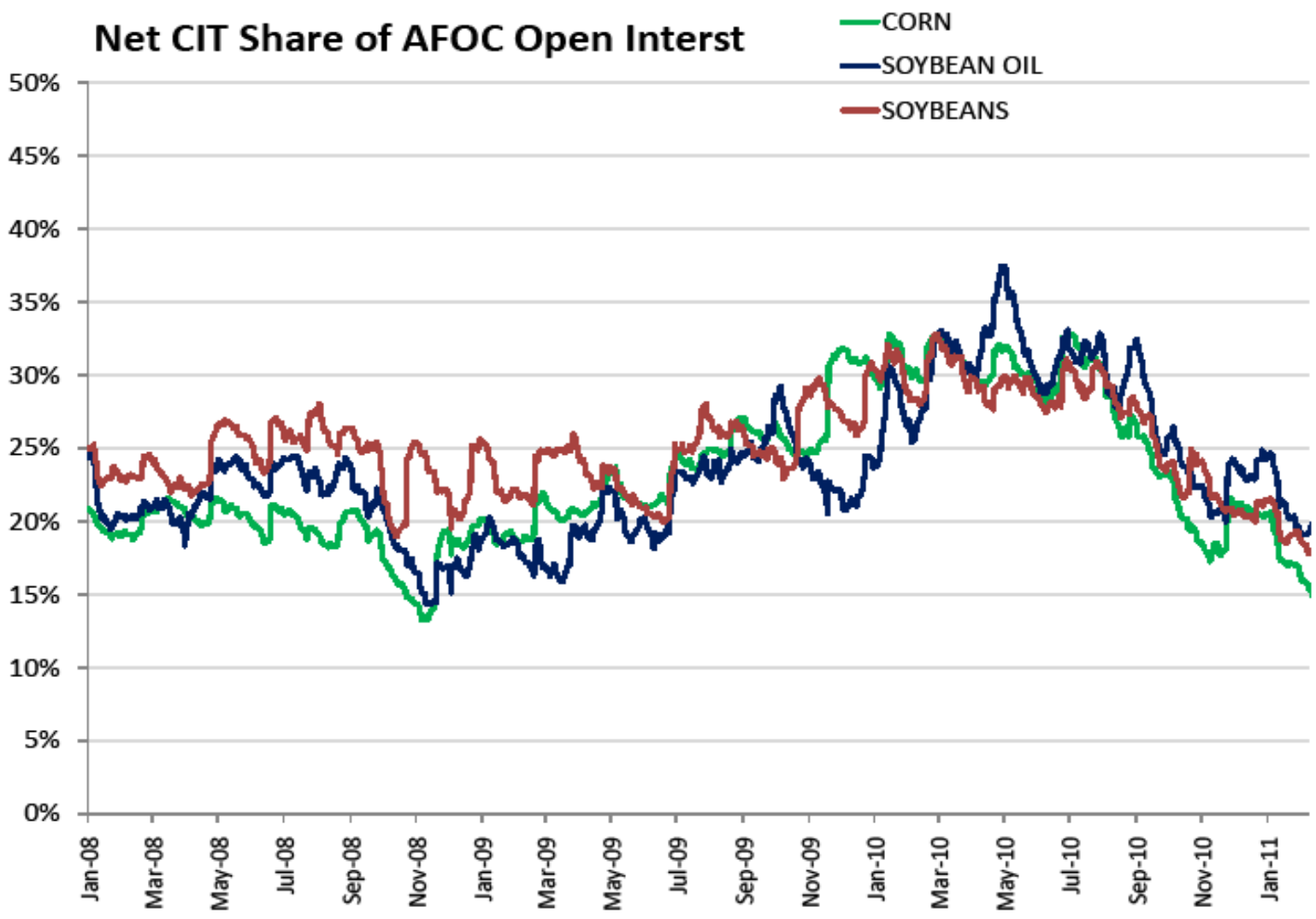
- The end-user exception to clearing covers counterparties that: are not financial entities; are using swaps to hedge or mitigate commercial risks; and have notified the CFTC and/or SEC as to how they generally meet their financial obligations associated with non-cleared swaps.
- The CFTC is directed to consider whether to exempt depository institutions, farm credit institutions and credit unions with less than $10 billion in assets from the financial entity category.
- Where clearing is not required, the non-swap dealer and non-major swap participant counterparty may nonetheless elect to require that the swap be cleared.
- The appropriate committee of a public company's board or governing body must review and approve any decision to rely on an exemption from the mandatory clearing or exchange trading requirements.
- Special rules for affiliates.

Major U.S. Grain/Soy/Cotton Futures Prices

Nearby Future Settlement Price 7/2/07 - 02/22/11



Source: FutureSource data service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Possible Causes of Volatility

- Changes in demand?
  - (*i.e.* an increase in demand from emerging markets)
- Unexpected weather?
- Supply constraints?
  - (*i.e.* government export bans)
- Political uncertainty?
  - (*i.e.*, military conflicts impacting export ability)
- Market Manipulation/Excessive Speculation?

Recent Export Bans on Commodities

- Wheat:
  - Russia: August 2010 to July 2011 (the ban brought about an 8% spike in futures prices on Aug. 5, 2010); India, almost continuously since 2007; Argentina: 2008 (also, high export taxes in 2010); Ukraine: 2008 and 2010; Pakistan: 2004-2007
- Corn:
  - India: July to October 2008; Ukraine: export limits since October 2010
- Cotton:
  - India: April 2010 to present (the ban was extended in Sept. 2010, contributing to a 15-year high in cotton prices); Egypt: 2008
- Sugar:
  - India: June 2006 to January 2007, and at other points in time since; Bangladesh: March 2010 to present
- Onions:
  - India: December 2010 to present
- Cocoa:
  - Ivory Coast: Jan. 24, 2011 to Feb. 2011.

- The announcement of these bans often lead to large price spikes on the day of their announcement.

Implementing Dodd-Frank

- Two Principles We Are Following:

  1. comply fully with the statute's provisions and Congressional intent to lower risk and bring transparency to these markets

  2. consult heavily with both other regulators and the broader public, including many participants in the futures markets

Conclusion

- Congressional mandate to establish rules to implement Dodd-Frank by July 15, 2011

- Two paths to follow:
  1. Set an example for the rest of the world to follow by developing carefully crafted rules that address the abuses that led to the financial meltdown; or
  2. Develop rules that are too timid to prevent another financial crisis or too restrictive and possibly drive business to less regulated markets.

- The choice is truly in the hands of the public. The Commission will not be making final decisions until the public has had the opportunity to comment on all of these rules.

Thank You!
Questions?