Agricultural Commodities Markets

CFTC Agricultural Forum Discussed the Impact of Speculative Activities on the U.S. Agricultural Commodities Markets

SUMMARY

On April 22, 2008, the Commodity Futures Trading Commission (CFTC) held a forum to discuss the functioning of the agricultural commodities markets. The forum focused on the significantly increased prices and volatility in the agricultural commodities markets, the lack of convergence between the futures and cash prices of agricultural commodities and the impact of the increased prices and current margin requirements on the financing system for the agricultural industry. An unprecedented number of representatives of major agricultural markets players participated in the forum, including:

- government agencies (for example, United States Department of Agriculture),
- futures exchanges and clearing houses (for example, CME Group and ICE Futures),
- producers, grain elevators and other agricultural industry players (for example, the National Association of Wheat Growers and every other significant agricultural trade association),
- credit providers (for example, Farm Credit Administration), and
- index funds, index traders and other financial players (for example, PIMCO).

This memo highlights the discussions during the forum regarding the activities and roles of the speculators (including hedge funds and other managed money traders) and index products (including swaps and funds indexed to various diversified commodity indices that are based in part on agricultural futures markets prices) in the agricultural commodities market and certain proposed restrictions on such activities.
BACKGROUND
In the past year, U.S. agricultural commodities markets have been faced with significantly and rapidly growing prices of agricultural products. According to the data provided by the CFTC, in the last three months, the agricultural staples of wheat, corn, soybeans, rice and oats have hit all-time highs. Accompanying the growing prices, volatilities in the agricultural markets increased dramatically. Meanwhile, the lack of convergence between the futures and cash prices of agricultural commodities has been an issue, where the futures and cash prices have not approached their historical price relationship at futures expiration. Non-convergence in the last two years and particularly recently has been large by historical standards. As articulated by some of the attendees at the forum, all of these issues raise questions regarding whether the agricultural markets are not effectively serving their function of providing price discovery and risk mitigation.

Some commentators attribute the agricultural market disruption to new market players, such as index providers, fund traders, asset managers and other speculators. The new participants deny such claims and argue that their involvement benefits the market by enhancing its liquidity.

The CFTC held this agricultural forum, among other reasons, to address the reasons behind the market distortion and to determine what new restrictions, if any, need to be considered.

CFTC PRESENTATIONS
The CFTC staff presentations spent a significant amount of time discussing the role and impact of speculators and index providers. Based on the research of the CFTC staff, although they did witness an increase in net long positions by index traders in the past two years, such an increase was only marginal in terms of market share percentage, since the overall open interest had been growing concurrently. Nevertheless, index products represented a very significant percentage (40-60%) of the open interest in major agricultural commodities. The CFTC data indicated that the participation of managed money traders was relatively stable when the 2007-08 price increases in agricultural commodities occurred.

Increased Prices and Volatility
The CFTC staff gave a number of explanations for the increased prices and volatility of agricultural commodities based on economic fundamentals:

- depreciation of the U.S. dollar,
- occurrence of the credit crisis,
- strong demand worldwide for agricultural commodities,
- rising petroleum prices and the impact on energy prices,
- increased production of renewable fuels made from grains and the reallocation of planting acreage from agriculture to energy,
increased world wheat consumption,
climate conditions including drought in Australia,
tight grain and soybean stocks,
reduction of and restrictions on world exports of grains, and
higher transportation costs.

Lack of Convergence
With respect to the lack of convergence between the futures and cash prices of agricultural commodities, the CFTC staff indicated they were still studying the data but did not believe that speculators were responsible for non-convergence. The increase in delivery and storage costs for agricultural products was a focus of their non-convergence analysis.

Conclusion of CFTC Presentations
The CFTC staff concluded that they had not found any relationship or correlation between speculative activities, on one hand, and the growing price, increased volatility or the lack of convergence, on the other hand.

CRITICISM OF SOME FORUM PARTICIPANTS AND THEIR PROPOSED RESTRICTIONS
Several forum participants blamed the index providers and speculators for the disruption in the markets. They argued that index funds and speculators were not serving an economic purpose because they were undermining instead of providing a means for *bona fide* hedgers to hedge. As for index funds, forum participants argued that they systemically hold a net long position, pushing up the price of commodities.

Proposed Restrictions
Some participants recommended imposing the following restrictions on the index funds and speculators:

- not to approve the CFTC proposals that would increase the speculative limits and provide an additional position limits exemption for certain risk management purposes for index funds and pension funds. Both the CFTC and the CME agreed that current market conditions mandated holding off on these initiatives for now;
- to require all market participants to disclose to the regulators their over-the-counter derivatives positions (including swaps) in addition to their exchange-traded positions. This proposal has also been suggested with respect to energy and resonated with certain CFTC Commissioners;
- to require the index funds and speculators to post 100% margin for their investment in agricultural commodities;
- to require speculators and index funds to take physical delivery of agricultural commodities (not clear how this would work); and
- to reexamine the definition of “hedging” to limit its coverage.
DEFENSE OF INDEX FUNDS AND INDEX TRADERS

The representatives of pension funds and asset managers defended themselves against the claims that they were responsible for the market distortion.

Fully-Collateralized Investment in Commodities

Fund representatives pointed out that index funds’ investments in agricultural futures are not leveraged, because each dollar they invest in the commodities markets is backed by one dollar of assets in the fund. In other words, the funds effectively trade on 100% margin.

Passive Traders

The index funds are passive traders and therefore could not be a source of the increasing volatility.

No Trading in the Spot Month

Index funds do not trade agricultural commodities in the spot month and therefore could not be responsible for the non-convergence between futures and cash prices.

Empirical Evidence

The participants gave some empirical evidence to rebut the claimed connection between the index funds’ activities and the rising prices: several commodities (including rice and Minneapolis wheat) were not in many or any indices, but still had very rapid recent price increases.

Other Arguments

Some pension fund representatives emphasized the importance of their access to commodities markets to diversify their portfolio and hedge against inflation, stressing that these were important investment opportunities for the teachers and civil servants who were represented in these pension funds. Fund managers argued that greater restrictions on financial investors could actually push more trades into the unregulated markets or onto non-U.S. exchanges.

OTHER SUGGESTIONS

Besides the debate and recommendations relating to the impact of speculators and index providers on the agricultural markets, certain other suggestions were made during the forum.

- New Commodities Products: CME Group requested that the CFTC approve its application for facilitating the trading and clearing of corn basis swaps and calendar swaps for corn, wheat and soybeans.

- Option Rules Reexamination: A trade association suggested that the CFTC should reexamine its agricultural trade option rules and consider providing more latitude for agricultural trade options. The CFTC’s Acting Chairman appeared interested in this proposal.

- Further Investigation on Cotton Markets: As part of an extensive discussion, participants urged the CFTC to further investigate the cotton market’s anomalous price behavior in early
March 2008, when the cotton price rose dramatically and then fell without any fundamental bullish news, in order to avoid a similar problem in the future.

PUBLIC COMMENTS SOLICITATION

During the forum, the CFTC clearly expressed its reluctance to adopt any single-solution proposal to correct the market distortion, and did not show huge enthusiasm for imposing any new restrictions on speculators in the near term. At the end, the Acting Chairman of the CFTC promised to post the transcript of this forum, as well as some written materials, on their website (www.cftc.gov) and encouraged the public to submit written comments by May 7, 2008.

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