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COMMITTEE ON COMMODITY PROBLEMS

EXTRAORDINARY JOINT INTERSESSIONAL MEETING OF THE INTERGOVERNMENTAL GROUP (IGG) ON GRAINS AND THE INTERGOVERNMENTAL GROUP ON RICE

Rome, Italy, 24 September 2010
Red Room

AGRICULTURAL FUTURES:
Strengthening market signals for global price discovery[1]

1. Agricultural Commodity investing is big business. Following the 1990's deregulation of the financial service sector in the US and in Europe, financial firms have poured colossal sums of money into commodity futures exchange products in hopes of capturing outsized returns from the volatile foodstuff market. Agricultural trading volumes have tripled on the world's most renowned exchange - CME Group[2], and doubled on Euronext Liffe's soft commodity complex during the last decade. Euronext Liffe has also developed liquid contracts in wheat and rapeseed. Described as "benchmarks," the price discovery in these contracts reverberates globally, often creating profound impacts on domestic policy-making in virtually every country. High volumes, however, have brought charges of excess speculation that is proving potentially disruptive to vast segments of the population. Whether speculation is causing prices to rise and whether producers benefit from high prices realized in futures contracts are central questions for debate. In addition, food price volatility needs addressing.

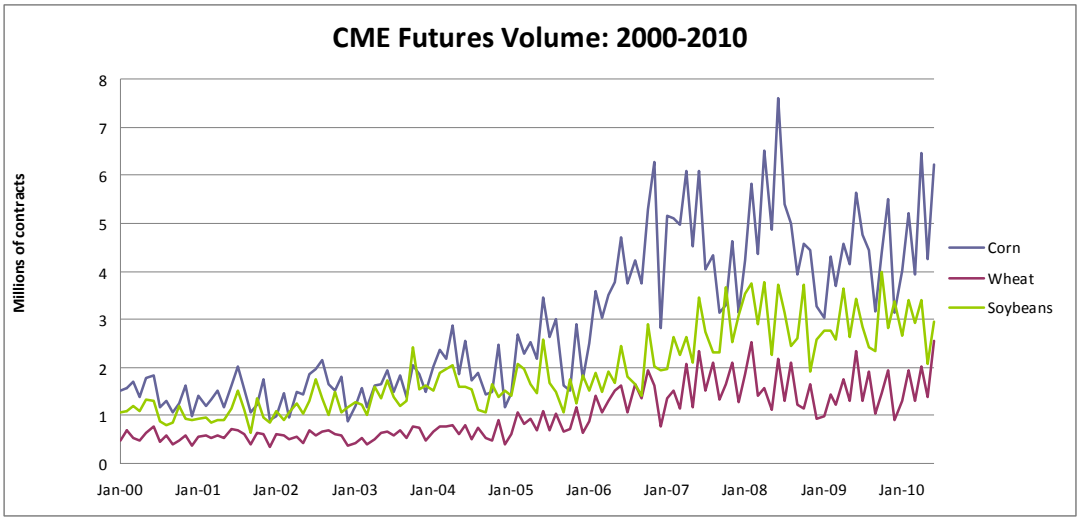
2. Globally, futures trading in agricultural markets have grown exponentially since 2000. Emerging markets exchanges such as China's Dalian Exchange and India's Multi-Commodity Exchange have experienced greater volume surges than CME or Euronext Liffe, but have not attracted large global investment flows. Currency inconvertibility, strict position limits, frequent government interventions in both the futures and physical markets or prohibitions against direct foreign investment have constrained emerging commodity markets growth globally. Indeed most recent agricultural exchanges developed as a response to markets liberalization and have focused on producer pricing. Following the abolition of government price supports in 1995, the South

[1] This document is courtesy of Ann Berg, Consultant, Senior Commodity Trader. The views expressed herein do not necessarily reflect the official opinion of the Food and Agriculture Organization of the United Nations.

[2] The CME Group now comprises the Chicago Board of Trade and the New York Mercantile Exchange.

African Futures Exchange[3], for example, designated over 100 warehouses as delivery points in its wheat and maize contracts to best suit producer risk management needs; India's and China's exchanges seek to promote producer marketing power and rural development.

CME futures volumes for corn, soybeans and wheat: 2000-2010



3. Elsewhere, many exchanges have created contracts to suit their domestic commercial base. The Tokyo Grain Exchange (TGE) for example launched a yen denominated maize contract in 1992 that specified physical delivery of US origin maize to Japanese ports. Argentina's and Brazil's exchanges, such as the Rosario Futures Exchange (ROFEX) and the Bolsa di Mercadorias & Futuros (BM&F) feature contracts customized to their export markets.

4. Although dwarfed by financial futures notional volumes which have exceeded one quadrillion dollars since 2006, volumes of agricultural futures are remarkable for their size as a multiple of physical crop productions. The CME Soft Red Wheat contract for example, which is used domestically to hedge a crop of about 400 million bushels (10 million MT), experienced a trading volume in 2008 of 90 billion bushels, the equivalent of trading the entire crop each business day.

I. REGULATORY BACKGROUND

5. Speculation and price distortions on commodity futures markets have existed as long as the markets themselves. Market manipulations – especially "squeezes" or "corners" – were alleged at least once every ten years at the Chicago Board of Trade after its establishment in the mid 19th century. In response, the US government enacted legislation in 1922 to exert regulatory authority over commodity futures exchanges and strengthened that authority in 1936 under the Commodity Exchange Act. The CEA made market manipulation a criminal act and placed limits on individual trader's positions. In 1974, the US Congress established the Commodity Futures Trading Commission, vesting it with broad oversight and anti-fraud powers.

6. An important role of the CFTC is to approve position limits and the specifications of all futures contracts listed on US exchanges to ensure that they are resistant to manipulation. In 1996,

[3] SAFEX is now the Johannesburg Stock Exchange

it issued an ultimatum to the CBOT to revise its longstanding corn and soybean contracts[4], advising that the contracts no longer complied with the Commission's mandate "to prevent or diminish price manipulation, market congestion, or the abnormal movement of such commodity in interstate commerce." [5]

7. The CFTC also has authority over futures traders and trading firms, including commercial traders. In 1989, when it perceived that a large commercial exporter was distorting the price of CBOT soybeans, the CFTC ordered the firm to substantially reduce its soybean long positions prior to the May and July delivery periods.

8. Finally the CFTC supports market transparency. Each week it publishes the Commitment of Traders Report (COT). This report, gathered from the US exchanges, categorizes the long, short and spread positions of producer/users, swaps dealers, and managed money funds, giving a clear picture of the market make-up for each futures contract.[6] As a member of IOSCO,[7] the CFTC promotes information sharing on a global basis and the adoption of "best practices" for overseeing futures contracts. It also holds roundtables on various futures issues which are open to the public. Most recently, it held a roundtable focused on the lack of convergence between cash and futures prices[8] in the Chicago, Kansas City and Minneapolis wheat contracts.

9. The European countries have very different futures trading regulatory models from the US. In the UK, the Financial Service Authority – a non-governmental organization – is granted statutory powers to regulate futures markets. As of June 2010, it announced a restructuring plan to be completed by 2012 to deal more adequately with systemic issues, particularly in the banking sector. Despite its endorsement of IOSCO principles, including the Toyko Communcique,[9] according to the FSA website, "[it] does not have dedicated rules for commodities and commodity derivatives markets." Established in 2000 in the wake of the Barings Bank failure, the FSA originally viewed commodity futures trading as a professional users' market and left its monitoring to the exchanges. By 2007, it recognized the growing volume in commodity futures and expressed the potential need for increased futures oversight. Most recently, following allegations of disorderly markets associated with the taking of large cocoa deliveries on Euronext Liffe cocoa contract by a hedge fund, it is assessing its regulatory role over commodity futures markets in the forthcoming restructuring.

10. Elsewhere in Europe, exchange products are under the purview of the national financial regulators. For example, the *Autorité des marchés financiers* oversees the former MATIF[10] milling wheat contract. Similar to the FSA, the *AMF* has few delineated supervisory powers over futures exchanges, relying on exchanges to self-regulate. However, in response to the current run-up in wheat prices, the French government is calling for international reform to be introduced in the 2011 review of the Markets and Financial Instruments Directive (MIFED).

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[4] CBOT corn and soybean contracts were launched in 1877 and 1936 respectively.

[5] The CBOT refigured the contracts from a Chicago/Toledo warehouse receipt system to an Illinois River shipping certificate system.

[6] See addendum

[7] International Organization of Securities Commissions

[8] For various reasons the futures prices have tended to trade at a large premium (as much as 20%) to the underlying cash price for the last few years.

[9] In 1997, regulators from 17 countries including the UK, US, Japan, issued a communiqué (the Tokyo *Communiqué*) endorsing two guidance papers, one on best practices for the design and/or review of commodity contracts and another on market surveillance and information sharing. The guidances represent the first occasion on which regulators responsible for overseeing commodity derivatives markets agreed to international standards for the supervision of these markets.

[10] MATIF merged with LIFFE in 1999

II. SPECULATIVE LIMITS AND INCREASED VOLUME

11. Since the CEA enactment, US exchanges have placed limits on speculative trading in primary agricultural contracts. These limits increased dramatically beginning in the 1990's from the standard 600 contracts for grains and soybeans to now several thousand, although the spot month limit remains 600. In addition, the CME restricts any non-commercial entity from holding more than 600 shipping certificates or warehouse receipts received on delivery. Bona fide hedgers are exempt from all limits. The granting of hedge exemptions[11] to index funds by the CFTC is currently under review.

CME Group agricultural positions limits – number of contracts and metric tonne equivalent

Contract	Spot month	Single month	All months
Corn	600 (76.2 thousand MT)	13500	22,000 (2.79 million MT)
Soybeans	600 (81.6 thousand MT)	6500	10,000 (1.37 million MT)
Wheat	600 (81.6 thousand MT)	5000	6,500 (890 thousand MT)
Rice	600 (54.6 thousand MT)	1800	1800 (163 thousand MT
Oats	600 (51.6 thousand MT)	1400	2000 (170 thousand MT)

12. The Euronext Liffe wheat, rapeseed and corn contracts have conservative all months limits compared to CME's. Applied to speculators and hedgers alike, the futures delivery process of these contracts is intended to act as a price signal system and not a supply sourcing mechanism. Similar to CME's tiered structure – limits must be reduced prior contract expiry. The London Clearing House, not the exchange, determines the limits for the most actively traded grain and oilseed contracts.

Euronext Liffe agricultural positions limits – number of contracts and metric tonne equivalent

Contract	Spot month	All Months
Milling wheat	2000 (100 thousand MT)	4000 (200 thousand MT)
Rapeseed	1200 (60 thousand MT)	2400 (120 thousand MT)
Corn	1200 (60 thousand MT)	2400 (120 thousand MT)

13. In contrast to all other exchange agricultural contracts, Euronext Liffe's sugar, coffee and cocoa contracts have no limits. The lack of limits allowed purportedly a single hedge fund to take delivery on the 2010 July contract of approximately 240,000 MT of cocoa -virtually all of the deliverable supplies and equivalent to 7% of the global production. Experts noted that the July price became so elevated that contract shorts shipped cocoa from New York warehouses to the Euronext Liffe delivery ports of Amsterdam, Antwerp and Hamburg to make delivery. Euronext Liffe recently announced it would collect internal numbers on the trading types and entities participating in the soft commodity sector and produce a report similar to the CFTC's COT report. To date, neither Euronext Liffe nor LCH have announced any plans to impose position limits on soft commodity futures.

[11] A hedge exemption allows an index fund to exceed the speculative limits

14. Several factors have contributed to increased global speculative volume in foodstuffs.

- Markets liberalization and decline of price supports, particularly in the EU under the Common Agricultural Policy
- Deregulation of the financial service sector in the US that allowed proprietary trading by banks
- Declining margins in securities trading
- Diversion of foodstuffs into fuel products
- Rising demand for food in emerging markets
- Under-investment in agriculture due to prolonged low food prices
- Lack of price transmission to producers
- Sudden governmental interventions in the export market such as export bans, tariffs and quotas
- Ease of access to electronic market place
- Restructuring of primary exchanges from member organizations to for-profit corporations

III. GOING FORWARD

A. REGULATORY HARMONIZATION

15. The US model for creating a regulatory framework may be a good starting point for regulators in the Europe . Endorsement of IOSCO principles, for example, is ineffective without collecting information about trading activities and promulgating appropriate rules and regulations. Also, over 150 years of futures trading history demonstrates that position limits are necessary in commodities of finite supply to curb excessive speculation and hoarding. As far as agricultural commodities are concerned, FAO could lead this harmonization process, working with other international organizations.

B. INCREASED TRANSPARENCY

16. The most common question in futures markets is: To what degree is speculation driving prices versus commercial activity? Before the advent of electronic trading, various brokerage houses provided informal summaries of trading activities by players from the trading pits each day. Today, the exchanges themselves or their clearinghouses[12] can address this question with great precision. The electronic marketplace produces instantaneous audit trails of order flow and transactions that are segregated by types of traders. The exchanges could furnish this data to the CFTC and have it published daily so that speculative versus commercial buying/selling could be quantified. Such information would greatly augment the market snapshot provided by the COT report by identifying trading types that are moving prices up or down. Exchanges in other countries should also adopt such reporting requirements.

C. GOVERNMENT POLICY

17. Sudden government interventions such as embargoes, heightened export tariffs or quotas have triggered dramatic futures price spikes over the last few years and are counterproductive.

D. PRICE TRANSMISSION TO PRODUCERS

18. Poor price transmission from futures markets to producers is a critical issue for markets. The dilution of price from futures to growers results in a weak supply response several factors contribute to poor price transmission:

- Domestic price protections
- Opaque local markets

[12] The CME Group clears its own trades internally, London Clearing House clears commodity futures transactions on Euronext Liffe.

- Exploitive lending and buying practices by middlemen
- Long supply chains
- Futures delivery points geographically very distant from growing areas.

19. Although most of these issues need addressing on a country by country basis, the last issue of delivery points can be addressed either by existing exchanges or by the creation of new ones. For example, although most of the world's cocoa production is in Western Africa – cocoa traded on the Euronext Liffe[13] contract is priced basis delivery in northern European ports such as Amsterdam, Antwerp, and Hamburg. A commodity and/or a futures exchange, in the major producing countries of Ghana or Cote D'Ivoire could help in price transmission from the European demand centers to growers.[14]

20. Similarly, in a market such as rice, commodity exchanges could aid regional pricing needs. Because of the varieties of rice and consumer preferences, no single contract can act as a global proxy mechanism. The most heavily traded contract – the CME rough rice contract - prices un-milled rice delivered in Arkansas warehouses and is most suited to domestic growers and millers. In Thailand, the government conducts open auctions for export procurement via the Agricultural Futures Exchange of Thailand. This model is an attractive mechanism for signaling prices to farmers and could be replicated elsewhere, especially in countries with extensive rice protection policies. Several Latin American exchanges organize the trading of agricultural "tariff packages" as a means for ensuring transparency and price efficiency for the importation of "sensitive" goods, such as rice and maize. This too is a valuable price transmission model provided by exchanges.

E. VOLATILITY

21. Volatility in commodity foodstuffs is a result of both fundamental factors and speculative inflows of managed money. Sharply differing opinions exist on how institutional money flows have changed the nature of the markets, particularly since the expansion of limits. While financial firms argue that they add volume and liquidity to the market, others maintain that large order size creates volatility and jagged price swings. In the August 2010 price hike of wheat, the CME wheat price moved up limit and down limit within two consecutive days. High frequency trading is also a controversial issue – one that a CFTC editorial recently stated needed "reining in," commenting that "*parasitical trading* does not truly contribute to fundamental market functions."[15]

22. Much debated also is the effect of passive fund money (index funds and swaps dealers), with experts on both sides arguing whether they have caused chronic price elevation and steep contango[16] in some futures contracts. In its 2009 Trade and Development Report, UNCTAD contends that the massive inflow of fund money has caused commodity futures markets to fail the "efficient market" hypothesis, since the purchase and sale of commodity futures by swap dealers and index funds is entirely unrelated to market supply and demand fundamentals,[17] but depends rather on the funds' ability to attract subscribers. Despite the risk transfer nature of futures trading, in which gains and losses are equally offset, passive funds have successfully packaged and sold futures contracts as an alternative investment class to institutional investors. However, most would agree that these passive funds do not affect volatility levels since their only trading activity is a forward "roll" of their positions and the timings of these rolls are announced in their prospectus. In the CME wheat contract, swaps dealers comprise about 40% of long open interest

[13] The US InterContinental Exchange lists a cocoa contract with deliveries in New York harbor points.

[14] Efforts are under way in Ghana and Cote d'Ivoire to address commodity pricing

[15] "Rein in the Cyber-Cowboys," Bart Chilton, CFTC Commissioner, *Financial Times*, Sept 6

[16] Contango is a market structure characterized by each successive futures contract trading at a higher price than the previous one.

[17] Trade and Development Report, 2009, Chapter II, "Financialization of Commodity Markets," UNCTAD.

or almost one billion bushels (27 million MT) - equivalent to 2 ½ the size of the US soft red winter wheat crop. Managed money (which includes active hedge funds and passive index funds), comprises another 20% of long open interest as of September 2010.

23. To address volatility levels, futures exchanges have relied on both position limits and price limits. Possibly some other volatility tools could be introduced:

- Limit the size of market orders entered within a particular time period
- Ban high frequency trading
- Apply spot month limit positions for longer time period prior to delivery month
- Change physical delivery contracts to cash settlement
- Settle contracts every month – either by delivery or cash
- Allow shipping certificates or warehouse receipts to expire within one year of issuance
- Reduce leverage by increasing margins
- Reduce existing position limits

24. None of these solutions is without controversy or downsides; many would be resisted by exchanges since some would tend to reduce volume and therefore profits.

25. Alternatively, exchanges might consider the development of a global contract, tracking "cheapest global wheat," for example. Although such a contract would have to be carefully constructed, there is a precedent: the Euronext Liffe white sugar contract (launched in 1983) is a global free-on-board contract with deliveries in 41 countries and 5 continents. Exchanges could construct a similar contract for wheat or alternatively develop an index to reflect wheat prices in several large producing countries (besides the US and EU) such as China, India, Argentina, Canada, South Africa and Australiawhere commodity futures contracts serve as producer pricing mechanisms. Similarly, an index such as the one published by the International Grains Council could be expanded to include more countries. A global wheat contract could give governments an alternative view to the current commodity futures prices and enable better price transmission to producers.

26. Due to several structural changes in both the futures markets and the underlying agricultural commodities markets, prices and volatility levels will probably remain elevated for the foreseeable future. Higher prices will be necessary to encourage greater productivity and infrastructure development. Volatility, however, can be addressed in part by the exchanges and regulators. Finally, the world community needs to commence a debate on whether today's primary futures exchanges still maintain their relevance to the underlying commodity markets as price discovery and risk transfer venues or whether they have transformed into a contest of players seeking triumph in "a zero sum game."