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Comments to the CFTC

I attended the CFTC Agriculture Web Forum on 22 April 22, 2008 as a member of the public viewing on the web. This was extremely useful and enlightening. Thank you for opening up such as significant event to the public.

I have the following suggestions to improve CFTC reporting:

1. Compare the total product represented by all long contracts to the estimated inventory of product expected to be delivered during the period for each commodity.

2. Require reporting on all OTC swaps by major traders (especially non-commercial traders)

3. Report Commodity Pools (and future contracts held) that are the basis of Commodity Linked Discount Bonds or other Commodity Linked Structures in the OTC market.

Discussion on Suggestion 1:

The example of the Cotton spike in early March (discussed in detail in the Web Cast) indicates that things are occurring which cannot be explained by market fundamentals. The addition of Index fund figures by the CTFC has aided in understanding what is occurring in the market. A participant mentioned that index funds alone can account for 40-60% of the value of some futures markets.

The Cotton Board member asserted that during that period index traders owned more contracts than represent the entire inventory of cotton during that period.

The CFTC must compare the total product represented by all long contracts to the estimated inventory of product expected to be delivered during the period ofr each commodity. This should be included in the weekly Commitment of Traders report. Futures contracts must represent real product even if the buyer is non-commercial and does not want to take delivery.

Discussion on Suggestion 2:

I have been researching the commodity crisis for about 3 months. During the course of my research, I have become deeply concerned about the impact of financial instruments on commodity prices including Index Funds and MMIs but also the unregulated OTC Derivatives Market in Commodities.

I noted the comments of one participant (I believe he was the Cotton Board representative) who asked the CFTC in include all exposures by major traders on the Over the Counter markets. He specifically mentioned swaps but I am also concerned about Commodity Linked Discount bonds and Commodity Linked Structures. These markets were once under the CEA (Commodities Exchange Act) but were exempted from regulation in 2000.

I noted the comments of Doug Grisham of Grisham Capital who stated that index fund managers need to be allowed to handle a virtually unlimited number of contracts. He said that if they are not allowed to do that, they would go to the OTC swaps market. He mentioned that the futures market is regulated while the OTC derivatives market is not.

I suspect that the MMI's and the Index fund managers are already in the OTC derivative market. I have a chart (ref - Mike Rothman - Integrated Oil Update – ISI December 19, 2006) that shows that the OTC Commodity Derivative Market grew from $910 Billion to $5,850 Billion from June 2004 through June 2006. I could not find the figures through 1st Q 2008. I do not have the break out between swaps, commodity linked discount bonds or commodity linked structures (basically CDOs based on the notional cash flow from commodity pools). Needless to say, this figure is far above the value of all above ground commodity inventories at any given time.

The CFTC must require reporting by all non-commercial major traders to report all OTC positions – whether they are in swaps or other commodity linked derivatives.

Discussion of Suggestion 3:

In addition, the CFTC should add another category. Major Non-Commercial traders should be required to report any future contract that is the basis for issuing a Commodity Linked Discount Bond or other Commodity Linked Structure. Since the OTC derivative market is virtually unregulated, it is unclear what the relationship is between commodity linked derivatives and the value of the commodity pools they are linked to. Are these new financial instruments causing increased purchases in futures contracts? Are they driving up prices? Are they reported by MMI's or index funds as commercial hedges when they are bought for a non-commercial purpose?

(Note that Commodity Linked discount bonds are based on commodity pools.
They use statistical methods to establish predicted cash flows from trading in commodities and issue bonds with notional interest rates to sell to investors. Some of these issuers also sell other Commodity Linked Structures - the equivalent of CDOs – Collaterized Debt Obligations – based on packages of commodity linked discount bonds. Of course, CDOs were the source of the sub-prime mortgage meltdown threatening the economy today. I have been unable to find sources on the aggregate investments in Commodity Linked Discount Bonds or other Commodity Linked Structures.

They became popular about the same time as the large increase in total OTC commodity derivatives (2004-2007). Since both are supposedly based on activity of commodity pools, the public needs to know if these are impacting the direct market.)

Discussion on the impact of Non-Commercial Traders:

I have been looking at the impact of non-commercial traders in the commodity market for the past three months. Despite studies that index fund managers, MMIs, etc. are relatively passive compared to direct market participants that must hedge real risks on a day to day basis, the fact that too much money is chasing the same amount of product must increase prices in the long run.

I believe that is what happened in the cotton market in early March.

Index funds must buy long, hold contracts and sell them before delivery.

They then must buy replacement contracts. If they are really trading 40-60% of the market value without any restraint, this should force prices up over the long run. A minor spike initiated by commercial traders can cause a large untenable spike in the price since so much excess money is in the market.

Inviting these players to develop short funds won’t help, since their decisions are still not based on the fundamentals of product supply and demand. They are creating a market driven by investment supply and demand (the amount of funds that the investment community wants to use to diversify into commodities), not product supply and demand.

One cause of this problem is the new orthodoxy by the investment community that a balanced portfolio should have 5% in commodities. My own broker has told me that. This should be discouraged. The government needs to 'jawbone' the investment community into lowering this proportion (approx. $5 Trillion if 5% of all liquid investments are put into the commodity market). This 'jawboning' could start with 401K and retirement funds which are dependent on tax-deferred status. Since the commodity crisis is threatening national security due to food riots throughout the world, the government should suggest that pouring investment money into markets designed to hedge risk by actual commodity producers is not helpful. This may reduce the 'investment supply' without direct regulation.

Some level of non-commercial (speculator) activity helps the market by providing liquidity. However, speculator activity should not overwhelm the futures market by forcing too much money into a market or pushing aside the real players who are hedging risk for producers, shippers or buyers of product. That is the real purpose of the futures market.

Thank you for your consideration.