EXPLANATORY NOTES

BACKGROUND

The Commodity Futures Trading Commission has begun releasing quarterly data on index investment activity in commodity markets. Commodity index investment is activity typically characterized by a passive strategy designed to gain exposure to commodity price movements as part of a portfolio diversification strategy. Exposure to commodity price movements can be based on investment in a broad index of commodities, a sub-index of related commodities, or a single-commodity index.

The index investment data is an outgrowth of Recommendation 2 of the **September 2008 Staff Report on Commodity Swap Dealers & Index Traders (September 2008 Report)**.[1] The data expands upon the information found in the September 2008 Report by reporting the gross long and gross short notional values and equivalent number of futures contracts for each U.S. market.

SCOPE OF DATA COLLECTED

To capture relevant information of index activity in commodity markets, the Commission sought information about the index activity of a variety of investors. The investors engaging in index activity in commodity markets include index funds, swap dealers, pension funds, hedge funds and mutual funds. They also include exchange traded funds (ETFs), exchange traded notes (ETNs) and similar exchange-traded products that have a fiduciary or other obligation to track the value of a commodity or basket of commodities in an essentially passive manner.[2] Investors use two principal means to engage in index investment activity–direct investment in futures markets and indirect investment through over-the-counter (OTC) swap agreements with financial firms. The Commission already had access to information concerning the direct investment in futures markets. To obtain the necessary data on OTC swap agreements, Commission staff issued a "special call" to financial firms pursuant to Commission Rule 18.05. This "special call" is ongoing.

Staff originally issued 43 "special call" requests for details of entities' market positions associated with physical commodity futures, including their index investment activity. Sixteen of the requests were directed to large swap dealers known to Commission staff to have significant commodity index swap business. Fourteen of the requests were directed to known commodity index funds (including asset managers and sponsors of ETFs and ETNs whose returns are based upon a commodity index). The remaining thirteen requests were directed to large swap dealers not known to engage in significant commodity index swap business. The entities subject to the special call include well-known financial institutions that are among the largest international swap dealers. The new data is from all the swap dealers and index funds that are known to be significant users of U.S. futures markets for index-related positions.[3] These entities include every swap dealer that has been granted a specific exemption from Federal speculative position limits for their index investment activity and two entities that had received "no action" letters allowing them to exceed certain Federal speculative position limits to operate commodity-based index funds.

The entities subject to the "special call" provide, among other things, the total notional value of their commodity index business, whether it is on their own behalf or on behalf of a client. The total notional value is detailed separately for U.S. markets and non-U.S. markets.[4] Additionally, for each commodity in these indices that is traded on a U.S. designated contract market, the entities provide the equivalent number of futures contracts. In providing this data, the swap dealers provide information about their entire OTC book related to commodity index investments, not just the "netted" amount that may ultimately be managed in the futures markets.

The "special call" letters did not specifically define index investment activity. Commission staff engaged in extensive discussions, however, with entities to ensure that they understood what information the "special call" required them to produce, and to ensure that the understanding was consistent across entities. Staff also was able to compare data received in response to the "special call" to existing position data routinely collected and reflected in the Commission's large-trader reporting system. These comparisons found generally that swap dealers' OTC positions reported in response to the "special call" were consistent with their futures positions as reflected in the large-trader reporting system.

CONTENT OF THE INDEX INVESTMENT DATA

The index investment data details the notional values and the equivalent number of futures contracts for all U.S. markets with more than $0.5 billion of reported net notional value in any one quarter. Using quarter-ending dates, the data shows the gross long, gross short, and net notional values with the corresponding equivalent number of futures contracts held across all contract months on the relevant dates.

- **Notional values.** For swaps and leveraged swaps, notional value is the dollar amount on which periodic payments are calculated. For index funds, notional value is normally the value of invested funds; but for leveraged funds the notional value may be some multiple of the invested funds.
- **Equivalent number of futures contracts.** The notional value would represent the equivalent number of futures contracts if those contracts are invested on-exchange on a particular day. Since the equivalent number of futures contracts does not necessarily represent actual open positions on a futures exchange, care should be exercised in making direct comparisons to exchange open interest.

Investors may be long and/or short a commodity index and the net impact on a specific market is the net of the positions. This is particularly true where swap dealers engage in chains of matched swap agreements, e.g., Swap Dealer A executes an index swap with a client and then hedges with an opposite swap with Swap Dealer B, who then hedges in the futures market. Dealer A's special call data for that transaction will show essentially equal long and short index investment in each commodity, while Dealer B's data for that transaction will show long index investment in the individual futures markets used as hedges. A similar effect occurs when a portfolio manager with a long commodity index exposure through a long-term swap agreement may establish a short commodity index exposure when the commodities component of the total portfolio has grown beyond the desired percentage allocation. As such, short commodity index positions often offset an existing long position. Therefore, the gross notional values and positions shown in the additional data provide a broad view of index investment activity, but the net values are a better measure of the impact of index investment on a specific market.

POTENTIAL LIMITATIONS OF THE INDEX INVESTMENT DATA

The index investment data comes from the "special call" issued to swap dealers and index funds as outlined above. It is possible that entities with relevant information have not yet been identified by Commission staff and that some small traders, over whom the Commission has no authority to issue a "special call," may have relevant information that is not included.

Commission staff did not independently examine the original books and records of each entity responding to the "special call." The entities were advised in the "special call" letter that failure to provide full and complete information could result in an enforcement action. In addition, the extensive discussions staff had with the entities were designed, in part, to ensure a consistent understanding of the requirements of the "special call" and to ensure that each understood the seriousness of its obligation to provide the requested information. Staffing limitations and time constraints required staff to rely on these factors as substitutes for examination of books and records. While staffing limitations still exist, the extreme time constraints surrounding the initial collection of information and preparation of the September 2008 Report have eased. As such, the entities and Commission staff have been able to refine the processes by which the information is reported, assembled and processed.

The "special call" letters did not specifically define index investment activity. In spite of the extensive discussions with entities to ensure they understood what information the "special call" required them to produce, it is possible that some entities misunderstood what was required of them and did not produce all relevant information. For instance, commodity index business is largely associated with baskets or sub-baskets of commodities. Thus, it is possible that responders may have erroneously omitted some single commodity index activity or short commodity index positions entered to re-balance the allocation between particular commodities in a portfolio.

The index investment data represents the Commission's best effort to provide a one-day snapshot of the positions of swap dealers and index funds. The snapshot includes the positions held across all contract months at the end of each quarter. These figures do not reflect trading activity or position changes taking place during each quarter.

COMPARISONS OF THE INDEX INVESTMENT DATA TO THE COT-SUPPLEMENTAL

In January 2007, the Commission began using data from its daily large-trader reporting system to publish a Supplemental report to its weekly Commitments of Traders report (COT-Supplemental), which seeks to show "Index Trader" positions in selected agricultural markets. The COT-Supplemental classifies all the positions of a trader engaged in commodity index trading based upon the preponderance of the trader's trading strategy. That is, if a preponderance of a trader's trading is index related, then all of the trader's positions get classified as index related for COT-Supplemental purposes. As such, the published aggregate futures position in the COT-Supplemental may overstate or understate the actual amount of index trading (overstate it to the extent the positions reflect other trading strategies, and understate it to the extent that index positions are internally netted against non-index positions before the net position is brought to the futures markets).[5]

The index investment data is more comprehensive than the COT-Supplemental in that it covers more U.S. markets (not just selected agricultural markets). However, because the information is separately prepared from the "special call" data, it takes more time to prepare, is published less frequently and is not published as close to the "as of" date as is the COT-Supplemental.

The "special call" requires entities to detail the actual values of commodity-index investment related to each U.S. futures market.[6] Because those values are included in the index investment data, it is more precise than the data in the COT-Supplemental.

FOOTNOTES

[1]**http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/cftcstaffreportonswapdealers09.pdf**

[2] These investments are typically very explicit as to the selection of the commodity/commodities, the weightings assigned to each commodity, the selection of futures months, and the roll period.

[3] Commission staff routinely updates its database of Index Traders. The list of entities currently required to comply with the "special call" is updated as the financial industry landscape changes and entities merge or go out of business. As new traders are identified, their information is reflected in the index investment data and the COT-Supplemental generally without revising past reports. However, after publication of the September 2008 Report, staff identified two additional traders with relevant index

investment activity. Data from these traders was included in the current and previous quarterly snapshots, and therefore slightly revises the data in the September 2008 Report.

[4] Each of the “U.S. Markets” includes all index investments in markets relating to or referencing that U.S. futures contract. For example, for WTI Crude Oil, the U.S. market notional value includes the NYMEX “Light ‘Sweet’ Crude Oil” market as well as the NYMEX “Crude Oil Financial” market and the ICE Futures-Europe “WTI Crude Futures” market. The settlement prices of the latter two are referenced to the NYMEX “Light ‘Sweet’ Crude Oil” price.

[5] These limitations are discussed in notices the Commission published as it began that data series.
http://www.cftc.gov/ucm/groups/public/@commitmentsoftraders/documents/file/noticeonsupplementalcotrept.pdf

[6] This data is not available through the Commission’s daily large-trader reporting system and therefore is not available for the COT-Supplemental.