



CFTC COTTON REPORT CONCLUDES THAT MARCH 3-5, 2008 FUTURES PRICE SURGE FUELED BY PROPERLY HEDGED MERCHANTS WITH SHORT POSITIONS

On January 4th, the Commodity Futures Trading Commission (CFTC) released its long-awaited investigative report¹ on the activity in the ICE No. 2 Upland Cotton Futures and Options Contracts that resulted in disruptive market activity on March 3-5, 2008.

The investigation, conducted by the CFTC's Division of Enforcement (DOE), commenced in late March of 2008. DOE completed its investigative report in June 2009 concluding that:

- After analyzing the futures trading activity in the critical time periods and throughout the three days, Enforcement did not detect any unusual or suspicious trading patterns by any market participant that would suggest that they sought to, or had the ability to manipulate the price of cotton futures upward.
- The data shows that eight of the ten largest longs were inactive during the critical time periods. In addition, traders active in the futures and option markets prior to the futures contract price reaching limit up were generally cotton merchants who held significant net short positions and whose activity appears to be consistent with reducing short positions to limit potential margin calls.
- Other traders identified in the analysis either also held short positions, traded insignificant volumes overall, traded in a manner that was indicative of scalping, or were basically flat, meaning that they had little motive to manipulate the price of cotton futures.
- Accordingly, analysis of the trading activity of March 3rd – 5th did not uncover evidence that any market participant with a long futures position engaged in trading activity to manipulate the price of cotton futures to benefit its long futures position or an option or OTC position.

In reaching those conclusions the report noted that:

- The trading activity of the largest longs was not consistent with activity that would cause an increase in the price of cotton futures or options.
- Many market participants active in the futures and option markets before futures prices reached limit up were cotton merchants.

¹ The 26 page report is available at:
<http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/cottonfuturesmarketreport0110.pdf>

- During critical time periods before futures prices reached limit up, no participant in the option market established a significant long position or sold a significant existing option position.
- The merchants with large short positions were hedged, holding sufficient physical cotton to deliver against their contracts. There was no shortage of physical cotton and certified stocks were rising.

The report's narrative specifically notes that:

By the early morning of March 3rd, a substantial number of the merchants attempted to reduce their short positions by buying cotton futures electronically on ICE US once the electronic trading began at 1:30 am. The impact of this rush for cover was a further increase in the price of cotton futures contracts, particularly the May 2008 contract -- this resulted in the limit up price being reached at 4:33 am, and the market locked limit up for the day at 6:48 am. At this point merchants had to wait several hours until the cotton option pit opened at 10:30 am to try to offset losses. ICE Clear U.S., consistent with their rules (and anticipated by some merchants), used the options price ("synthetic futures price") as the basis for the mark-to-market calculation for open futures positions. As a result, merchants were required to meet significant mid-day and end of day margin calls.

The merchants with short positions had to scramble to cover their exposure and limit losses. ICE Clearing US was calling for higher margins; other traders were holding out for higher bids due to their increased exposure and uncertain access to a locked market. The risk and volatility discouraged new entrants into the market.

Generally, the small number of banks who customarily service cotton merchants tended naturally to become more nervous. This was complicated by the fact that the value of stored cotton, which was a large part of the collateral used by merchants for financing, did not rise proportionally with the futures creating another squeeze on credit availability.

It appears that a number of cotton merchants holding significant short futures positions and concerned about their lines of credit to maintain those positions, desired to offset at least a portions of their positions. In some cases, these merchants established long positions in the options market – i.e. a synthetic futures position –, which created an economically offsetting position, essentially protecting against further losses. In other cases, merchants were able to offset futures positions prior to prices hitting the limit. Finally, others held their futures positions and posted additional margin.

While each of these strategies represented a different approach to dealing with a short position that had accumulated large losses, there are significant differences between them. In the cases of merchants who either offset their futures position directly or through synthetic futures positions, they essentially locked in any losses that had accrued on the position. In addition, by closing out or neutralizing

their position, they had essentially lifted their hedge against their cash market position. In the case of merchants who posted additional margin, those traders continued to face the risk of rising market prices, but maintained their hedge against falling prices.

It is not clear that hitting the price limit or the combination of hitting the price limit and using the implied futures price to set margins, created additional hardship or losses that otherwise could have been avoided given the state of the market at that time. Had the limit not been in effect, traders seeking to buy futures would have had to pay a higher price than the limit price of March 3rd. Moreover, closing out positions would have locked in losses, which presumably would have reduced a trader's capital that could have been posted as margin. Therefore, it is not clear that reducing a position would allow a party's financing to cover additional losses; it would only have the effect of eliminating an exposure to additional futures losses.

Overall, there is no evidence that the existence of price limits, coupled with the use of implied futures prices to calculate mark-to-market, resulted in an improper market price being used to calculate mark-to-market. Certainly, from the perspective of traders holding losing short positions, the use of a settlement price above the limit price worked against their immediate financial interest. However, from the perspective of the clearinghouse and financial integrity of the market, there would have been additional risk to default taken on if the limit price, which was obviously not a true market price, was substituted for a clearly identifiable market price that was above the limit price.

In the weeks following the market events of the week of March 3rd, ICE U.S. stopped calculating mark-to-market using synthetic prices. On June 11th, 2008 ICE U.S. made a rule amendment that removes the requirement that synthetic prices be used to calculate mark-to-market when futures prices are locked limit up or limit down. They also developed rule amendments that expand the daily price limits applicable to cotton futures and that apply the same price limit to cotton options. According to ICE U.S. the cotton options rule will become effective "on a business date when the applicable technology systems are able to accommodate options price limits..." To date, ICE U.S. has not implemented the amendment, so options are not yet subject to price limits.

The CFTC staff recommends that the ICE take the following actions:

1. That ICE U.S. analyzes, in light of historic price volatility, the expected frequency with which the current price limits will restrict trading.
2. That ICE U.S. evaluate whether, in conditions of rapidly rising prices and extreme price volatility, the newly expanded price limits will allow the cotton market to operate efficiently and facilitate the price discover and risk management functions.
3. That ICE U.S. notifies the Commission of whether it intends to implement the dormant Rule 10.09(b) and subject cotton options to price limits. If so, ICE U.S.

should provide the Commission with an update on the status of the technology upgrades needed to implement the dormant rule.

CFTC CHAIRMAN BLAMES OTC DERIVATIVES FOR FINANCIAL CRISIS

Last week, in a New York speech to the Council on Foreign Relations, Commodity Futures Trading Commission Chairman, Gary Gensler, singled out derivatives as the principal cause of the 2007-2008 world financial crisis. He opined that those who originate and deal in these instruments and the instruments themselves must be regulated if another crisis is to be averted. Not mincing words, Gensler said, "Some opponents of reform - some I would say in this room - would say this really wasn't at the centre of the crisis, the crisis was about mortgage underwriting practices, the crisis was about not enough capital in the banks and so forth. But I believe that the over-the-counter derivatives marketplace was in fact part and parcel to this crisis."

Participating in the meeting were representatives of Goldman Sachs, Gensler's former firm, Barclays Capital, Credit Suisse, JP Morgan and Morgan Stanley.

When asked who in his opinion opposes the reforms in the OTC markets, Gensler said, "Many people in this room. You can look at the program ... primarily the five or six largest Wall Street firms. They have a fiduciary duty to shareholders to maximize profits. The information advantage is theirs right now."

Gensler downplayed risks of regulatory arbitrage, as some industry participants fear may be possible, if U.S. and Europe end up diverging in their approach to OTC derivatives reform. He said a European Commission proposal on reform was consistent with U.S. efforts to the extent that it would require all standardized derivatives to be cleared and centrally traded. Gensler estimated that 80-85 per cent of the OTC derivatives market is located in Europe or the U.S. He also said he was confident that international regulators would cooperate to establish a consistent regulatory scheme.

FEDERAL RESERVE BANK OF NEW YORK CALLS FOR TRANSPARENCY IN SWAP MARKET PRICING

A staff report² on derivatives, issued by the Federal Reserve Bank of New York last week, recommended that the legislation under consideration by the Congress to regulate the derivatives markets should require the use of electronic trading platforms for all market participants such as that utilized in the corporate bond market.

The report suggested that a reporting system similar to the Financial Industry Regulatory Authority's Trade Reporting and Compliance Engine, or Trace, also could help investors to "shop around" for prices and more easily determine whether to accept bids and offers

² The report was authored by Theo Lubke and Ada Li of the Federal Reserve Bank of NY and Darrell Duffie of Stanford University.

quoted by dealers. While such a system may not be as beneficial for the most customized contracts, “there is a wide range of actively traded derivatives for which Trace-like price reporting could offer substantial improvements in market efficiency,” the report concluded.

CFTC LIKELY TO REVEAL PROPOSED POSITION LIMIT RULE HEARING THIS WEEK

At 1 p.m. this Thursday, January 14th, the Commodity Futures Trading Commission (CFTC) will hold a public hearing to consider the issuance of a proposed rule on energy position limits and hedge exemptions on regulated futures exchanges, derivatives transaction execution facilities, and electronic trading facilities.

The public meeting will be webcast on the CFTC’s Internet site: <http://www.cftc.gov/>

NCC STATEMENT ON CFTC COTTON INVESTIGATION

The National Cotton Council (NCC) welcomes the release of the Commodity Futures Trading Commission (CFTC) investigation into the abnormal price fluctuations that occurred in the cotton market in February and March of 2008.

Although the investigation found no evidence of direct manipulation by market participants, the influence of index and commodity funds in the market remains a problem. Cotton’s vulnerability to manipulation is greater than other agricultural commodities due to the overall size of traditional hedgers and the size of the exchange. In addition, there is a critical lack of transparency in over-the-counter trades.

The National Cotton Council remains concerned about the ability of the futures market to serve as an effective tool for hedging physical cotton. U.S. cotton merchandisers suffered extensive financial losses as a result of the volatility in ICE cotton futures in late February and early March 2008. Cotton farmers faced contract failure due to bankruptcies by some merchandisers. As a result of the lingering financial losses, traditional merchandising relationships between growers and buyers have changed. To date, no regulatory change has been promulgated that would prevent a recurrence of the events in early 2008.

The NCC supports CFTC’s decision in 2009 to disaggregate the Commitment of Traders report. However, more needs to be done to address the concerns of the industry. For example, hedge exemptions and eligibility for hedge margin levels should be limited to those actually involved in the physical handling of the agricultural commodity.

In addition, all contract and over-the-counter market participants should be subjected to speculative position limits. These changes, though not an exhaustive list, would largely be addressed with legislation currently being debated in Congress. However, absent

legislative progress, CFTC should use their regulatory authority to initiate the much-needed changes. The continuing lack of confidence in the market must be addressed, and the industry will welcome the opportunity to work with the CFTC and Congress to take actions necessary to restore confidence in the important price discovery and hedging functions of the market.

DODD'S RETIREMENT MAY BOOST CHANCES FOR REGULATORY REFORM

The announcement that [Senator Christopher Dodd](#) (D-Conn.) will retire after 30 year in the Senate, has improved the odds that financial regulatory reform could move through the legislative process this year. Dodd is Chairman of the Senate Banking Committee which, shares oversight of the regulatory reform legislation. His remaining priority is to reform finance regulations.

Dodd has had a close working relationship with the Banking Committee's ranking Republican, [Richard C. Shelby](#) (Ala.), which should be a positive in taking on what is a massive and complex issue. In November, Dodd unveiled an 1,136-page draft bill that adopted many of the administration's proposals but also put him at odds in certain areas with both the Administration and House lawmakers, as well as several moderate Democrats on his own committee.

The Senate Committee on Agriculture also has an oversight role on this legislation.

ECWG EXPRESSES CONCERNS ON TENOR TO USDA.

The Export Credit Working Group (ECWG), which includes representation of the American Cotton Shippers Association, sent a letter to Jim Miller, USDA Under Secretary for Farm and Foreign Agricultural Services conveying concerns regarding current tenor restrictions recently implemented by USDA on the FY2010 GSM-102 Export Credit Guarantee program (GSM program).

The ECWG is an informal working group that has worked with USDA/FAS, USTR, and other policymakers to maintain the viability and enhance the effectiveness of the GSM program since prior to the launch of the World Trade Organization Doha Round in 2001.

The ECWG's letter addressed the potential impact of the tenor restrictions on perceptions of official U.S. support for the GSM program. The group explained that tenor (the time allowed for repayment- or length of a loan), along with fees, is the critical driver of the GSM program's viability. It is precisely because of its importance that U.S. competitors have consistently sought to reduce the tenor of the GSM program in the current WTO Doha Round negotiations. The group expressed concern that the tenor restrictions imposed on the FY2010 program would be perceived as an indication of waning U.S. support for the GSM program, at a time when efforts to re-start the Doha talks are underway and when, to their understanding, a dialogue has been established with Brazil

regarding the WTO Cotton/GSM arbitration panel award. The letter noted that, according to the formula established by that panel, the tenor of GSM guarantees has no impact on calculations of the amount of retaliation to which Brazil may be entitled.

A second concern addressed relates to the long-standing issue of USDA's country risk rating methodology and the fact that the risk ratings resulting from that methodology were used as the basis for determining the tenor restrictions imposed on the FY2010 program. They noted that the 2008 Farm Bill requires USDA "to develop an approach to risk evaluation that facilitates accurate country risk designations and timely adjustments to the designations (on an ongoing basis) in response to material changes in country risk conditions, with ongoing opportunity for input and evaluation from the private sector."

The ECWG acknowledged that USDA refrained from implementing the proposed fee schedule, which would have increased fees for nearly all active GSM markets, with the start of the FY2010 GSM program. The ECWG said they were "troubled that USDA imposed restrictions on the equally crucial element of tenor, and, moreover, that it based these restrictions on country ratings that are the product of what we have long maintained is a flawed risk-rating process." The ECWG has supported a tenor of up to three years for all programs and stated in a February 2009 letter, "If USDA/FAS is considering limiting the tenor for a particular program to less than three years, it should consult with industry, in advance, to gauge the impact on program utilization and exports."

Recognizing that, notwithstanding the tenor restrictions, GSM program utilization has been strong for the limited, \$1.2 billion in FY2010 allocations announced on November 13, 2009, the ECWG is concerned that as credit conditions continue to improve in numerous export markets, the tenor restrictions will increasingly mitigate against GSM utilization and thus limit U.S. exports. Particular concern was expressed for prospective GSM utilization and exports for "under-graded" countries such as China, Russia, and Indonesia.

The ECWG expressed its inability to understand the rationale for reducing tenors at a time when country risk conditions are improving in markets that have traditionally been the most active users of the program, including investment grade countries such as Korea, Brazil, and Russia. They said that if the rationale is to accelerate repayments to minimize the total future volume of GSM guarantees outstanding, they noted that the 2008 Farm Bill placed no such restrictions on the volume of GSM guarantees that may be outstanding at any given time. The Act does require USDA to operate the program in a manner that will "maximize the export sales of agricultural commodities," and "maximize the export guarantees that are made available and used during the course of a fiscal year."

The letter closed by emphasizing the group's long-standing interest in supporting the work of USDA/FAS to meet the direction of the Farm Bill regarding implementation of the GSM program.