NAVIGATING THE WAVES OF CHANGE

FARM BUREAU - CONFRONTING THE ISSUES

Futures Contract Regulation
Policy Development May 2011

Issue:

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) represents some of the most sweeping changes to financial markets in decades. Bona fide hedgers using forward contracts, commodity futures or options on commodity futures will not be affected. However, the new law will increase regulation of agricultural swaps and agricultural trade options. Some believe the proposed regulations will negatively impact agribusiness firms, particularly farmer-owned cooperatives.

Background:

Prior to Dodd-Frank, derivatives were traded on the over-the-counter (OTC) market. The OTC market is less formal than an exchange market. The OTC market does not use standardized contracts – all contract terms are negotiated between the buyer and seller. Instead of a clearinghouse, a network of swap dealers go either long or short to complete the transaction and profit from spreads and transaction fees. Swaps were not cleared through a clearinghouse and margin accounts were uncommon prior to Dodd-Frank. The swap dealer absorbed the default risk of the customer and vice versa. Dodd-Frank will place the agricultural swaps and agricultural trade options under the Commodity Futures Trading Commission (CFTC), which will bring oversight to the market and will provide market transparency and price discovery information.

The restrictions in Dodd-Frank are generally focused on those involved in speculative use of financial derivatives. Yet, implementation could be complicated since it is very difficult to know the nature of the trade – hedging vs. speculation – without complete knowledge of the trader's business and position in both the derivative and spot market. Furthermore, the same participant will likely be categorized differently depending on the particular circumstances of a specific trade.

Generally, the potential impact of Dodd-Frank on agribusiness falls into five categories:

<u>Regulation of swaps:</u> Before Dodd-Frank, there was very little regulatory oversight of the swaps market. A swap is an agreement between counterparties to exchange cash flows over some period of time. Under Dodd-Frank, the CFTC will be responsible for agricultural swaps and will determine which types of swaps must be cleared through a clearinghouse. All swaps must be reported. Benefits of regulation include oversight and transparency to the market with one single regulator (CFTC). Costs include potential loss of highly customized OTC trades which may reduce risk management alternatives. Reporting and record-keeping requirements increase costs but also increase transparency.

<u>Clearing and collateral requirements:</u> Before Dodd-Frank, clearing and margins were not required for OTC markets. Under Dodd-Frank, cleared swaps will require margin accounts unless the participant is a bona fide hedger. Bona fide hedgers will not have to meet the margin and clearing requirements. Potential benefits are reduced systemic default risk where a large party defaults and affects many other market participants. Potential costs include inefficient clearing requirements, increased costs of record-keeping and reporting. Also, the margin accounts may not be sufficient if the requirements are poorly designed in measuring the swap's risk.

<u>Position limits:</u> Prior to Dodd-Frank, no limits existed for OTC derivatives and certain nontraditional financial traders were granted hedging exemptions. Under Dodd-Frank, CFTC will set position limits and nontraditional financial traders may not be granted hedging exemptions. Bona fide hedgers are exempt from position limits.

Limits on trading positions are designed to prevent market concentration, manipulation and “excessive speculation.” Speculators benefit the market by reducing the per trade fixed cost of the market. Restrictions on speculators’ positions may reduce market liquidity, meaning that the transaction to buy or sell may not be completed when desired due to lack of market participants. Position limits could be skirted by breaking one large position into several smaller positions. The amount of speculation would not be reduced but the cost of participating in the speculative fund would increase due to decreased economies of scale and increased trading costs.

<u>Hedging exemptions:</u> Prior to Dodd-Frank, CFTC granted hedging exemptions to some nontraditional financial traders in agricultural markets. Dodd-Frank defines a bona fide hedge more narrowly. The potential benefit is that CFTC may more narrowly define hedging and exclude nontraditional financial traders participating in agricultural markets. A potential cost is that large financial firms may choose to participate in other markets (perhaps overseas), thus reducing market liquidity and increasing the cost of risk management as the fixed costs are spread over fewer market participants.

<u>Agricultural swaps:</u> Prior to Dodd-Frank, agricultural swaps were allowed between “eligible swap participants” with no clearing or margin requirements. Under Dodd-Frank, swap transactions (including agricultural swaps) are limited to eligible contract participants (ECPs). ECPs would be large investors like a commodity pool, an insurance company or an individual with more than $10 million in assets. Agricultural producers using swaps as a hedging tool would need an excess of $1 million net worth. A potential benefit of limiting participants is that the agricultural swaps market is available to “informed” traders that understand the underlying commodity market. Potential costs include reducing the risk management options to those who do not meet the trading requirements established by CFTC. The net worth requirements for hedging with agricultural swaps might limit some producers from using this risk management tool, though it’s uncertain how many producers ever used swaps to manage risk.

Questions:

Are there circumstances where agricultural firms, including cooperatives, should be exempt from some or all of the provisions of Dodd-Frank? If so, what are those circumstances? What is it that would make agriculture-related participants “special”?

Are agricultural producers concerned about the potential for restricted use of Ag Trade Options?

What is the proper balance between necessary regulation and maintaining a competitive environment for domestic market participants? Will Dodd-Frank reduce risk management opportunities by pushing business to overseas markets and exchanges?

What are appropriate position limits?

Farm Bureau Policy:

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Lines 11-14: We support the use of off-exchange agricultural trade option contracts in commodity marketing, which would include complete risk disclosure, vendor integrity and the opportunity for cash settlement of the option.

Lines 37-40: We will urge CFTC to increase oversight of futures exchanges and floor traders to ensure that integrity of these markets is maintained and to curb practices that result in manipulation or artificial price swings.