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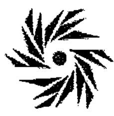

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August 21, 2006

Ms. Eileen A. Donovan
Office of the Secretariat
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, D.C. 20581

RE: Comprehensive Review of the Commitments of Traders Reporting Program (71 F.R. 119 (June 21, 2006))

Dear Ms. Donovan:

The National Grain Trade Council (NGTC) welcomes the opportunity to respond to the Commodity Futures Trading Commission's (CFTC or Commission) request for comments on the Commission's review of the Commitments of Traders (COT) Reporting Program.

NGTC is an association whose membership brings together commodity futures exchanges and boards of trade with their grain industry counterparts including agricultural merchandisers, processors, and refiners; futures commission merchants; food and beverage manufacturers; railroads; and banks. The businesses of all of our member firms depend on the effective functioning of the risk management instruments traded on the US exchanges and overseen by the CFTC.

Our comments specifically apply to grain futures markets and derive from the risk management experience and expertise of NGTC's member firms as well as non-member firms – some of whom signed our letter on the COT issue delivered to the Commission on March 10, 2006.

The current COT report structure captures traditional grain hedgers and non-traditional financial hedgers in the same Commercial category. As discussed below, these two groups have wholly different considerations motivating their behavior.

NGTC members recognize the legitimacy of financial hedging and welcome these participants in the grain and oilseed futures markets.

It is critical to recognize, however, the enormity of their influence and presence. It is our understanding that investment in commodity indices has grown from virtually nothing in the late 1990s to approximately $100 billion today. The bulk of this investment is held by financial hedgers, and perhaps $10 billion of this total is indexed into grain futures markets (corn, three wheat contracts, soybeans and soybean oil). There may well be even more invested that we are not aware of through more narrowly-based indices, new ETFs, and debt instruments tied to specific commodity price moves to name a few.

Portfolio research supporting these money flows demonstrates favorable multi-year performance characteristics of commodity-based baskets relative to stocks, bonds, and other investments. The research does not concern itself with day-to-day, month-to-month, or even yearly price performance of the baskets themselves; instead, it focuses on trends over years and even decades. Also, commodity baskets provide a desirable risk and price performance offset (i.e. inverse correlation) relative to stock and bond returns. As a result of these factors, many sophisticated entities in the investment community believe that long-term favorable investment returns, both outright and relative to more traditional instruments like stocks and bonds, can be obtained from commodity price baskets primarily composed of futures or futures-based instruments. These instruments avoid the costs and complications of owning stocks of the physical commodities. While these money flows into our futures markets may diminish from time to time, experience leads us to expect continued net growth.

The traditional grain hedgers are farmers, merchandising firms, storage elevators, livestock producers and feeders, crushers, processors, importers, and exporters from around the world. Market price fluctuations result from a myriad of influences like weather, crop production, currency fluctuations, and supply and demand developments in the underlying commodity. Such price changes elicit immediate responses from this community of users, triggering corresponding cash-related activity in futures markets on a daily, minute-to-minute, penny-to-penny basis.

The financial hedger who uses futures markets to create a commodity price-exposure portfolio has completely different considerations. For example, this user typically buys the most current or nearby futures contract and rolls its positions forward prior to expiration. A decline in price in a given futures contract does not cause the position to be sold out. Similarly, an increase in price does not encourage a sale. There is little transactional aspect to the positions and therefore less responsiveness to price moves in the underlying futures contract. For most entities within this group of hedgers, the futures contracts incorporated in their portfolios have effectively changed character and become investment securities.

Moreover, many of these financial hedgers have no first-hand control over the futures positions they hold. Instead, the commodity baskets have been repackaged as securities and sold to institutions, sophisticated investors, and/or the general public. Decisions to buy or sell rest with third parties whose investment considerations have no specific relation to or concern with price movements in a single small component like corn, wheat, or soybeans within a larger basket including many commodities. Index and other commodity investment hedges have the characteristics of securities,

not commodity futures. These futures positions are held for investment, not for trading or resale. In effect, a component of futures market open interest has been "securitized" as investment securities.

This new and critical distinction is missed entirely in the current COT reporting format, diminishing its historic value as an indicator of grain producer and consumer response to market prices.

While the Commission and the various exchanges have specific data, the information available to us suggests that index hedges now constitute a significant share of open interest in some grain futures markets. The Chicago Board of Trade (CBOT) Wheat contract is thought to be one such contract. The primary deliverable commodity in this contract is US Soft Red Winter wheat, with Hard Red Winter, Dark Northern Spring, and Northern Spring specified as other deliverable grades. This year's soft red winter wheat crop size is expected to equal approximately 75,000 contracts; the entire US wheat production for the 2006 crop year is estimated to be about 360,000 contracts. Current CBOT Wheat open interest is over six times the production of soft red winter wheat and 1.3 times the production of all classes of wheat in the US. By comparison, CBOT Wheat open interest at the end of July from 1995-2000 averaged approximately 113,000 contracts – 1.2 times the production of soft red winter wheat and one-quarter (0.25) the production of all classes of wheat over the same time period.

We hope the above reinforces to the Commission the reason for the legitimate concern of the traditional hedging community in the grain industry. The buying power and holding power of index hedgers is large and can be a dominant market factor. In some cases, it has the potential to exceed the influence of the traditional hedging community, perhaps even to create an unintended but real shortage - not of the physical commodity, but of futures contracts. This can happen if the "supply" of natural sellers is exhausted but the financial buyers' demand continues. Depending on the size of positions held by financial hedgers relative to the total open interest, the non-responsive nature of their positions has clear potential to make the relationship of some futures contracts to the underlying cash markets less predictable, more volatile, and in extreme cases, irrelevant. Hedgers, including farmers, of physical grain who have relied on historical basis relationships to guarantee effectiveness of their hedging operations may have a significant new risk, a risk that can only be illuminated by providing the data that distinguishes between grain hedgers and financial hedgers in a revised COT report. Without new data, there is simply no way to know if this hedging risk, different from any ever experienced in the history of our industry, resides in markets used extensively and daily for generations for commercial management of price risks in the underlying physical commodities.

We believe the CFTC has a responsibility to make available to the broad futures trading community the most accurate and comprehensive data on market composition. NGTC does not believe that creating a separate category in the COT report for non-traditional commercials would put any position holder at a competitive disadvantage. To the contrary, NGTC believes that good data improves market transparency, assists markets in their task of fair and efficient price discovery, and

comprises policy that is beneficial to the public interest. With a single step, the CFTC can help restore full confidence of the grain industry in its hedging mechanism.

In recognition of this fundamental change in our industry, we ask the Commission once again to create either a separate reporting category, or a subcategory of the existing COT Commercial category, to capture open interest data for non-traditional financial hedges, thereby distinguishing this new and important component of open interest from the open interest held by traditional grain hedgers.

It is from this perspective that NGTC offers its response to some of the questions posed by the CFTC.

1. **What types of traders in the futures and option markets use the COT reports in their current form, and how are they using the COT data? More specifically: (a) how do traders use the COT information on commercial positions; (b) how do they use the COT information on non-commercial positions; and (c) In particular, with respect to information on non-commercial positions, what information or insights do traders gain from the COT reports regarding the possible impact of futures trading on the underlying cash market?**

   In the past, information on commercial positions contained in the COT reports was widely used as an indicator of producer and grain consumer response to the market signals transmitted in current futures prices. The magnitude of financial hedging, primarily index fund activity, that is now reported within the commercial category has obscured the value of this historic indicator, limiting the usefulness of the COT data as currently reported.

   Information on non-commercial positions contained in the COT reports is now, and has always been, widely used as an indicator of trend-trading and other speculative fund activity.

   The week-to-week changes in reported gross positions in all categories should provide, and historically did provide, a reasonable window into commercial and speculative activity levels and market involvement as prices move from week-to-week. As noted above, the situation has changed with the advent of large volume financial hedging in grain markets. The COT has lost significant value, but it still ought to be and easily could be an important source of information on market makeup.

   For many participants in the grain futures markets, the COT reports tie into reports of activity generated from the trading floors. As the grain futures markets transition to anonymous electronic order matching and open outcry floor activity diminishes, the flow of information generated from trading floors will disappear, making COT reports more important as the only indicators of broad patterns and trends in speculative and commercial activity within given price ranges.

3. **Do the COT reports, in their current form, provide any particular segment of traders with an unfair advantage?**

Most grain futures contracts are currently large enough, in terms of daily volume and typical open interest levels, that it is impossible to identify a single firm's position from the COT reports. Attempting speculatively to identify one firm's position would be a meaningless exercise in any case because the depth of open interest and breadth of daily activity in most contracts effectively disguises any single firm's activity. Moreover, the reported data is delayed, which renders any effort to reconstruct one firm's position useless given the passage of time and changes in price.

While we have heard concerns expressed from within the swaps community, NGTC strongly believes that the COT reports do not provide, nor have they ever provided, any segment of the industry with an unfair advantage. For example, for over 30 years – before the advent of financial hedging in the grain markets – the Commercial category included only the traditional grain hedgers. We know of no instance during that period in which any one firm's positions or activities were compromised by COT data even though futures open interest and volume were a fraction of what they are today. Similarly, we are not aware of any confidentiality or disclosure problems with the large speculative trading funds' COT position reports in the 1980s and 1990s. At that time, these participants traded and held large positions and periodically exerted a strong day-to-day influence in the grain futures markets.

Today's swaps participants in our markets are no different than the traditional commercials or the trend-trading speculative funds – there is no confidentiality risk or risk of disclosure of one firm's positions. Open interest levels and daily volumes today are far larger than in the past, and we believe that it is not possible, or useful, to attempt to "deconstruct" one firm's activity or position on the basis of COT data released days after the activity takes place. It is also important to recognize that by creating a new category the COT report will also provide greater transparency to the positions held by traditional hedgers – returning the same degree of visibility into their gross positions that the report provided before the recent rise of the financial hedgers.

In the case of smaller markets, we believe that the CFTC and the individual exchanges are best situated to determine if the volume and open interest of such markets might require a filter to disguise single firm activity. Any such perceived or actual problem today in a smaller market would have existed previously in that same market, during all these years that the COT report has existed, and the filters or other confidentiality protections would be no different than before. Regardless, if the Commission and an exchange believe that a disclosure risk exists in a small contract, NGTC is confident that the CFTC and the exchange can work together successfully, as in the past, to make sure appropriate safeguards are in place.

4. **Should the Commission continue to publish the COT reports?**

   For all the reasons explained above, we believe it is essential that the CFTC continue to publish the COT reports, although preferably with the modification we recommend. These reports are a valuable source of information for the hedging community and trading public and are consistent with the Commission's mission.

5. **If the Commission continues to publish the COT reports, should the reports be revised to include additional categories of data—for example, nontraditional commercial positions, such as those held by swap dealers?**

   Please reference our introduction and response to question 1. Since 2005, NGTC has urged the Commission to immediately begin reporting index fund activity in the grain futures markets. Specifically, we have encouraged the CFTC to report index fund activity as either a subcategory of the commercial open interest component in the COT report or as a new freestanding category.

6. **As a general matter, would creating a separate category in the COT report for "non-traditional commercials" potentially put swap dealers or other non-traditional commercials at a competitive disadvantage (since other market participants would generally know that their positions are usually long, are concentrated in a single futures month, and are typically rolled to a deferred month on a specific schedule before the spot month)?**

   Please reference our response to question 3. NGTC does not believe that creating a separate category in the COT report for "non-traditional commercials" would put swap dealers or other non-traditional commercials at a competitive disadvantage. As the CFTC notes in the question, the industry understands that these positions are almost always long and are rolled forward as the spot month approaches delivery. They are seldom, if ever, liquidated. In many cases the methodology and mathematics underlying the index fund long positions are a matter of public record because index composition, weighting, and timing of the roll are publicly disclosed.

7. **More specifically, if the data in the COT reports are made subject to further, and finer, distinctions, such as adding a category for non-traditional commercials:**
   a. **Would it increase the likelihood that persons reading the reports would be able to deduce the identity of the position holders, or other proprietary information, from the reports?**

      Please reference our response to questions 3 and 6. NGTC does not believe that adding a category in the COT report for non-traditional, or financial, hedgers would enable the identification of specific firms' positions or otherwise reveal any relevant proprietary information. As grain futures markets transition to anonymous electronic trading, daily activity will not be traceable to any firm, making it literally impossible to identify a firm's positions.

b. **Could such persons use information gleaned from the reports to gain a trading advantage over the reported position holders?**

Please reference our response to questions 6 and 7(a). NGTC does not believe that information gleaned from the reports could be used to gain a trading advantage. We took note of concerns from the swaps industry that COT reporting might lead to "frontrunning" of financial hedgers' orders. We do not believe this is a valid concern. By definition, frontrunning involves inappropriate foreknowledge of pending activity and use of that knowledge to place orders in the present marketplace immediately ahead of the affected party's orders. With release of COT data that is now delayed by three business days, frontrunning can't possibly occur. If frontrunning were to occur in any situation, it would involve inappropriate disclosure of information that has no relation to COT reporting and could occur just as easily in today's environment, under today's COT format, as in an environment with a revised COT format. We fail to see how frontrunning and COT reporting are related.

c. **In such case, in order to reduce the likelihood of publishing categories with few traders, which might provide information giving other traders a competitive advantage over the reported traders, should the Commission consider raising the threshold number of reportable traders needed to publish data for a market from 20 traders to some larger number of traders?**

Please reference our responses to questions 3 and 6. Historically, NGTC is not aware of a situation when COT information compromised a firm's confidential positions or created any disadvantage for a reporting firm. In the open outcry trading environment, publication of COT data would not provide useful information to any party trying to identify a specific firm's positions. As grain markets transition into an anonymous electronic trading environment, NGTC believes there will be no risk of compromise because there will be no information that ties price, volume or daily activity to any firm's name.

In the case of contracts with smaller volume and open interest, the CFTC and the exchanges currently gather data showing each firm's position as a percent of the total. NGTC is confident that the CFTC can continue to work effectively with the exchanges hosting these contracts to determine if a specific filter or other reporting changes are necessary to assure confidentiality. NGTC believes that it is not necessary for the CFTC to raise the threshold number of reportable traders above 20.

8. **If the data in the COT reports are made subject to further, and finer, distinctions, should the reports be revised for all commodities, or only for those physical commodity markets in which non-traditional commercials participate?**

We advocate refining the COT reports for the grain markets, particularly those with physical delivery contracts but also those with cash settlement contract design.

10. **The Commission has observed that the non-traditional commercials tend to be long only and tend not to shift their futures positions dramatically—even in the face of substantial price movements. If the data in the COT reports are made subject to further, and finer, distinctions, would issuing the additional data on a periodic basis, in the form of a quarterly or monthly supplement, be sufficient?**

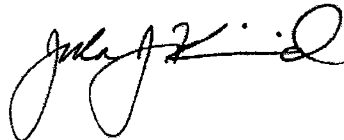
    Based on the experience of the past year, NGTC believes that a revised COT report containing data on both traditional and non-traditional hedgers should be released at least weekly. There is no advantage to be gained by withholding COT information on any major component group from the trading public. Activity of participants captured in each category can have a major impact on daily volume and open interest, and no useful purpose can be served by reporting one category, or subcategory, fully while not reporting another.

11. **Some reportable traders engage in both traditional (physical) and nontraditional (financial) commercial activity in the same commodity market. If the data in the COT reports are made subject to further, and finer, distinctions, such traders would have to break out their non-traditional commercial OTC hedging activity into a separate account. Would such a requirement represent an undue burden to those traders?**

    Based on prior discussions with CFTC staff, it is our understanding that the Commission has long tracked traditional and nontraditional commercial activity from data collected on Form 40s and has the ability to compile and report it with a high degree of accuracy – similar to the accuracy in data from other reporting categories. Additionally, to comply with generally accepted accounting principles (including Financial Accounting Statement 133) and typical internal accounting controls, firms doing both types of business already segregate traditional and non-traditional commercial activity. In light of these existing circumstances, we do not believe it is burdensome to require each firm to categorize and report separately both types of hedging activities to the CFTC.

Thank you for the opportunity to comment on these questions. Please contact me at (202) 842-0400 if you have questions or would like to discuss these comments.

Regards,



JULA J. KINNAIRD
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