ISDA®

International Swaps and Derivatives Association, Inc.
360 Madison Avenue, 16th Floor
New York, NY, 10017
United States of America
Telephone: (212) 901-6000
Facsimile: (212) 901-6001
email: isda@isda.org
website: www.isda.org

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August 21, 2006

Ms. Eileen Donovan
Acting Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, DC 20581

Re: Commitments of Traders ("COT") Reports

Dear Ms. Donovan:

This letter contains the response of the International Swaps and Derivatives Association, Inc. ("ISDA") to the request for comments issued by the Commodity Futures Trading Commission (the "Commission") regarding possible changes to the Commitments of Traders ("COT") reports. The request for comments followed background information on the COT reports and various issues and questions regarding the COT reports, all of which were published in the Federal Register on June 21, 2006 (71 Fed. Reg. No. 119 at 35627 *et seq.*) (the "Request").

ISDA, which represents participants in the privately negotiated derivatives industry, is the largest global financial trade association, by number of member firms. ISDA was chartered in 1985, and today has over 725 member institutions from 50 countries on six continents. These members include most of the world's major institutions that deal in privately negotiated derivatives, as well as many of the businesses, governmental entities and other end users that rely on over-the-counter derivatives to manage efficiently the financial market risks inherent in their core economic activities. ISDA documentation is the standard for OTC derivatives transactions globally. A current list of ISDA's members, as well as other information about ISDA and its activities, is available on our website at www.isda.org.

Background

As the Commission discussed in its Request, it has granted hedge exemptions to swap dealing firms for futures contracts entered into to hedge exposures in commodity index-related swap activities. Without hedge exemptions, these swap dealers otherwise would have exceeded the speculative position limits in certain commodities such as wheat, corn, and soybeans. The commodity indexes usually represent long-only portfolios of futures on physical commodities and are weighted according to non-discretionary and widely-known formulas based on production weighting, liquidity weighting, or some combination of the two. It is a condition of the hedge exemptions that have been historically granted that the futures positions taken by swap dealers must offset specific price exposure and must be unleveraged.

Some commenters, particularly "traditional" agricultural commercial participants, have associated index investor participation in the commodities markets with increased speculation and volatility. By design, these indexes are passive investments and are not attractive to traditional speculators seeking profit through active trading of futures positions. Rather, the indexes are intended to allow investors without the expertise or inclination of traditional speculators to invest in the commodities markets as a whole to diversify their portfolios and to hedge their exposure to inflation. Investors in commodities indexes include institutional investors such as large pension funds and individual investors who are increasingly participating in the indexes through such products as mutual funds and exchange-traded funds. Index investments are passive and predictable, and should not by themselves increase market volatility. This predictability does, however, provide other market participants that anticipate the recurring rolling of index positions with potential trading opportunities. To the extent that these market participants are provided with more direct and specific information about the position of the passive index providers, they are more likely to engage in speculative trading that increases volatility. Thus, ironically, the more disclosure that is required of "non-traditional" commercial participants the more likely it is that volatility will increase. This is a result presumably contrary to the wishes of "traditional" agricultural commercial participants.

Particular Risks to ISDA Members

The nature of the commodity indexes puts swap dealers at increased risk should proprietary information about their futures positions become publicly known. Such potential disclosure undermines one of the basic tenets of futures trading – anonymity. As discussed above, a necessary condition for both the passive nature of an index investment and of the particular hedge exemptions granted is that futures positions that the swap dealers hold in various commodities must offset the actual risk created by trades with investor counterparties, most of whom are passive index investors. Swap dealers' positions will therefore correspond to their respective commodity indexes. Because the index weightings are publicly available, knowledge of a dealer's position in a particular commodity would allow another market participant to calculate the dealer's position in all of the index commodities.

In a dispersed market, the risk of reverse engineering would be low, but the non-traditional commercial category is highly concentrated, with, we believe, the top four swap dealers composing over 70% of the category. In some of the lower-volume commodities markets, only a single swap dealer is a dominant participant, so reverse engineering its entire index position would be readily achievable. Any reasonably sophisticated person could, over time, measure the flows of passive investor capital into and out of the market through each swap dealer. Market participants, including speculators, with such information on non-traditional commercial trends, would gain a competitive advantage allowing them to trade ahead of the swap dealers. The resulting reduced returns would not be borne by the swap dealers themselves, who generally do not have unhedged positions in the markets, but by their institutional and individual investor clients. Any discussion of changes to the COT reports should consider the effects of such changes on these passive investors.

Conclusion

The public policy rationale for creating a new category of "non-traditional" commercial participants is purportedly to reduce volatility created by these same entities. As discussed above, creating a separate category which singles out one or a few swap dealers for special scrutiny would have precisely the opposite effect, by creating trading ahead opportunities for speculators. ISDA believes that public policy is best served by continuing the COT reports in their current form, as they are beneficial to all market participants and play a role in promoting the efficient operation of market forces. ISDA strongly recommends against the creation of a new, non-traditional commercial category. If the Commission decides otherwise, we recommend that any additional reporting be in a no more than two-year pilot program that we would be prepared to work with the Commission to design with a limited number of commodities. This will allow the Commission and all market participants to observe the results. Proceeding in this manner will allow the Commission to measure carefully the costs and benefits of such an approach, while limiting the potential negative consequences that might result from such enhanced disclosure.

ISDA appreciates the opportunity to provide these comments. Should you require any further information, please do not hesitate to contact the undersigned.

Sincerely,

Gregory Zerzan
Chair,
North American Regulatory
Committee
International Swaps and Derivatives
Association, Inc.