



Report

Efficient and Effective Oversight of Changes to Agricultural Futures Contracts with Open Interest

*Subcommittee to Evaluate Commission Policy with Respect to Implementation
of Amendments to Enumerated Agricultural Futures Contracts with Open
Interest (Ag-OI)*

*Agricultural Advisory Committee
US Commodity Futures Trading Commission*

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Foreward

I have long viewed the role of the Commodity Futures Trading Commission (CFTC) as a partnership with our regulated entities and market participants. The best policies emerge only after bringing all stakeholders to the table and finding a mutually beneficial path forward. All too often the federal government decides to address a problem facing an industry through top-down, prescriptive laws and regulations. However, doing so often creates new problems and challenges not foreseen by those making the decisions. Working hand-in-hand with people on the ground and active in our markets is truly the only way to create sound regulation that is effective in the real world.

This coordinated approach not only produces the best functioning regulatory environment, it also creates a culture of compliance where those involved in the markets know and understand the rationale applied to the rules because their input was considered in creating the policy. Compliance is always the goal in regulation. Compliance is best achieved through mutual respect and a common understanding. If those efforts fail, and clearly understood rules are disrespected, then enforcement, should always be the Commission's last resort in obtaining compliance.

These views on policymaking and regulatory compliance inform my robust support of the formation of the Subcommittee to Evaluate Commission Policy with Respect to Implementation of Amendments to Enumerated Agricultural Futures Contracts with Open Interest (Ag-OI) and the process through which it carried out its mandate. A team of diverse stakeholders and thought-leaders in the agricultural markets created a blueprint for how to make adjustment to agricultural contracts with open interest. This report reflects a consensus among those involved from those responsible for contract design, to intermediaries, to those using the contract to hedge their risks and even those who do not necessarily participate in the markets directly but are impacted by the prices discovered.

I am pleased at the work done to create this report and the effort made to find common ground. I want to express my sincere thanks to all participants on the AG-OI Subcommittee for their input and participation. These meetings are not easy to squeeze into already busy schedules, and I know there were members who literally stopped their tractors in the middle of their field, or pulled their work trucks to the side of the road in order to join the Subcommittee meetings over the last six months. Your commitment and sacrifices to this project have not gone unnoticed and I know I speak for those on the Agricultural Advisory Committee (AAC) when I tell you how much I appreciate your hard work.

A very special thank you goes out to Assistant Professor Joseph Janzen of the Department of Agricultural and Consumer Economics at the University of Illinois at Urbana-Champaign. Professor Janzen chaired this Subcommittee, while also being a full-time professor, a father and becoming a father once again during the process of completing this report. To say that Professor Janzen went above and beyond the call of duty is an understatement. Without Joe's leadership and guidance, this report would not exist, let alone come together with unanimous

support from the Subcommittee members. Professor Janzen – your service to the CFTC and to the agricultural sector generally is greatly appreciated and is clearly memorialized in this report.

Additionally, I want to thank Christa Lachenmayr from the CFTC's Division of Market Oversight (DMO) for lending her expertise and guidance to the Subcommittee and facilitating the subcommittee's work on this report from start to finish. I know Christa has put countless hours into assisting the Subcommittee with this product and she did so because she feels very strongly about the importance of having a consensus-based approach to managing contract changes in the agricultural markets with open interest. Christa's years of invaluable work in the ag futures markets in DMO, as well as her hard work in assuring the AAC's utility is maximized in our work at the CFTC, is a testament to her passion for agriculture and agricultural markets.

I would be remiss if I did not take this opportunity to also thank former CFTC Chairman Heath Tarbert for his leadership of the AAC. I am fortunate to follow in Heath's footsteps as a sponsor of the AAC. I know he was very committed to getting this report completed and I am thankful that we have reached that goal. I know former Chairman Tarbert is proud of the work that went into this report.

As I stated earlier, a coordinated approach where all stakeholders are viewed as partners is the best way to achieve success in any regulation. This report is a glowing example of how that success is achieved and I am honored to be a part of this success. Thank you to everyone who helped achieve this success.

*Commissioner Dawn D. Stump, Sponsor
CFTC Agricultural Advisory Committee*

Executive Summary

The Ag-OI Subcommittee was established to make recommendations to the Agricultural Advisory Committee of the Commodity Futures Trading Commission regarding evaluation of amendments to enumerated agricultural futures contracts with open interest. This report summarizes information reviewed by the Subcommittee about the rationale and process for amending agricultural commodity futures contracts when market participants have existing long and short positions. These contracts are subject to specific oversight under relevant statute and regulation not required of all futures contracts.

The Subcommittee considered the situation faced by exchanges when proposing to amend contract terms and conditions. Exchanges seek the timely implementation of contract changes intended to ensure futures contracts comply with regulation and best serve a diverse set of market participants. These goals must be balanced against the possible material impact on the value of existing positions. The report documents the growing share of open interest held in long-dated contracts which exacerbates this tradeoff.

The Subcommittee considered possible improvements to the Commission's procedures for oversight of contract amendments. The Subcommittee found that Commission oversight cannot avoid tradeoffs between timely implementation of necessary changes and material impacts on open interest. It is an unavoidable consequence of the requirement that contracts fulfill their statutorily mandated purpose. However, Commission oversight can play an important role in the amendment process by promoting awareness among market participants and ensuring the consideration of a broad swath of viewpoints.

The Subcommittee does find that the current process for amending agricultural futures contracts works well to foster compliance with core principles, align contract terms to common commercial trading practices, and weigh interests of exchanges and market participants. The Subcommittee found that the Commission may be able to improve its oversight of contract changes by facilitating information flows and maintaining channels for public engagement and open dialogue. This would fulfill the stated desire of market participants to inform and be informed about the contract amendment process. It also found that the Commission should continually improve staff policy and guidance to reflect an up-to-date understanding of contract terms and market conditions and focus its oversight on contracts, terms, and conditions which are most likely to have material impact on positions held by market participants.

Through its deliberations, the Subcommittee generated a set of six findings and recommendations. In brief, the Subcommittee recommends the Commission should:

1. Provide enhanced information to the public on which markets are subject to CFTC approval processes and on the results of past approvals.
2. Develop a robust system of public comment on submitted amendments that enables participation by all market participants when such input is needed.

3. Consider means to formalize procedures for dialogue with exchanges and market participants on contract changes before and after the formal submission of an amendment by an exchange.
4. Improve existing risk disclosures required of market participants to clearly indicate the possibility of changes to contracts with open interest.
5. Maintain a principles-based approach to market oversight that avoids prescriptive evaluation of proposed contract changes and concentrates attention on contract changes that are more likely to have a material impact on the contract's value.
6. Continually improve staff policy and guidance to reflect current market conditions and contract specifications, such as the use of self-adjusting contract terms.

Through these proposed actions, the Commission will provide additional clarity to exchanges and market participants which should enhance the benefits of futures markets in facilitating price discovery and hedging effectiveness and reduce risks to exchanges and market participants.

At a meeting on April 21, 2021, the Subcommittee voted 20-0 to adopt the report, its finding and recommendations.

Introduction

Agricultural futures markets have a history that spans more than 150 years in the United States. These markets have witnessed dramatic changes in production, consumption, and trade of agricultural commodities, advances in communication and transportation systems, and many other shifts in the global economy. To maintain relevance in such a dynamic environment, futures markets have adapted. New futures contracts have been developed and existing futures contracts have periodically been reviewed and their terms and conditions revised when appropriate.

This report of the Subcommittee to Evaluate Commission Policy with Respect to Implementation of Amendments to Enumerated Agricultural Futures Contracts with Open Interest (Ag-OI) (hereafter, referred to as Subcommittee), considers the role of the Commodity Futures Trading Commission (hereafter, the Commission or CFTC) in the process by which agricultural futures contracts are amended.

Based on input from a diverse membership, the report makes findings and recommendations to improve the efficiency and effectiveness of the Commission in its regulatory role. The report acknowledges the important and beneficial roles played by futures exchanges and market participants in this process but does not make prescriptive recommendations for these entities. Similarly, while the report draws upon historical CFTC approvals of exchange-proposed futures contract amendments, it does not review the specific details of those changes. It is forward-looking and makes findings and recommendations related to future changes.

Issue Statement

To understand what is at issue, it is important to know why futures contracts are amended and the tradeoffs inherent in making such amendments. Futures contract specifications are critical to the market's ability to discover prices and serve as a hedging instrument, objectives held in common by exchanges and the CFTC and fundamental to the Commodity Exchange Act (the Act). Exchanges seek to serve their customers, the market participants who buy and sell futures contracts, by providing a low-transaction-cost trading venue that attracts significant trading volume. The CFTC, as the exclusive regulator of futures trading, affirms these goals. The Act states that futures trading is "affected with a national public interest by providing a means for managing and assuming price risks, discovering prices, or disseminating pricing information through trading in liquid, fair and financially secure trading facilities" (7 USC § 5). That is, price discovery and risk management benefit exchanges and market participants, and the broader public as well.

To foster accurate price discovery and effective risk management, futures prices must be "representative of the value of the commodity generally so that the relationships with prices at other points of commerce are rational" (Hieronimus 1977). There must be a consistent economic relationship between futures and cash markets. Futures contract specifications determine the value represented by the futures price, the connection to a diverse set of cash

markets, and therefore the ability of the contract to discover prices and provide risk management.

These broad goals of price discovery and risk management are related, but not the same as the specific compliance objectives put forward in federal statute and regulation. This is necessary because price discovery and hedging effectiveness are not precisely defined, quantifiable objectives. Moreover, no set of contract specifications is perfectly tailored to all market conditions, so optimal price discovery and hedging effectiveness in all conditions is an unrealistic standard.

Instead, the Act and the Commission's regulations lay out a set of core principles for Designated Contract Markets (17 CFR § 38) to which exchanges must adhere.¹ Two of these principles focus on maintaining economic relationships between futures and cash markets and are closely related to the concept of price discovery. Core Principles 3 and 4 prohibit exchanges from listing contracts that are readily susceptible to manipulation and place onus on exchanges to prevent manipulation, price distortion, and disruption to the delivery or cash-settlement process. In addition, the core principles place emphasis on transparency. For example, Core Principle 7 requires contract terms and conditions and other contract-related information to be made available to market participants and to the public.

The regulations supporting Core Principle 4 also include a "good faith effort" standard used by the Commission to engage the exchanges on contract compliance issues. It requires exchanges to "when necessary, make a good-faith effort to resolve conditions that are, or threaten to be, disruptive to the market" (17 CFR § 38.251(c)). It often results in contract amendments intended to address compliance issues. The good faith effort standard infers that contract amendments may be necessary – even when those changes apply to open interest – in order to address contract performance issues such as a divergence in the cash and futures prices (convergence), the adequacy of deliverable supply, or the integrity of the delivery or cash-settlement process.

Trade-offs in Amending Futures Contracts

Exchanges develop, propose, and implement contract amendments in consultation with market participants. The role of the CFTC in this process is defined in the Act: The Commission is tasked with evaluating and approving proposed changes to futures contracts for a set of enumerated agricultural commodities². The statute requires that:

¹ Part 38 of the Commission's regulations governs the general obligations of DCMs under the core principle regime, including compliance obligations, as well as financial information and resource requirements, operational capabilities, surveillance obligations, and trading and products requirements.

² Enumerated agricultural commodities are general and reference physical commodities rather than specific futures contracts. The term applies to: "the following commodities specifically enumerated in the definition of a "commodity" found in section 1a of the Act: wheat, cotton, rice, corn, oats, barley, rye, flaxseed, grain sorghums, mill feeds, butter, eggs, *Solanum tuberosum* (Irish potatoes), wool, wool

“A designated contract market shall submit to the Commission for prior approval each rule amendment that materially changes the terms and conditions, as determined by the Commission, in any contract of sale for future delivery of a commodity specifically enumerated ... if the rule amendment applies to contracts and delivery months which have already been listed for trading and have open interest.” (7 USC § 7a–2 (c)(4)(B))

That is, the statute requires additional oversight of agricultural futures contract changes that i) are material in the sense that they affect the economic value of the contract and ii) apply to existing open interest.

Materiality is an important condition. The requirement for the CFTC to approve material changes is meant to protect market participants from changes in the value of existing positions due to contract amendments, particularly those changes predictably beneficial to either long or short open interest. It is important to note that statute and regulations do not define materiality. Within the Commission’s regulations, there is a limited set of contract amendments that are explicitly deemed non-material (17 CFR § 40.4) and can be implemented without CFTC approval, either by self-certification or notification. Exchanges may also make the case (under the terms of 17 CFR § 40.4(b)(5)) that a given change is non-material and can be self-certified by the exchange, but in practice most changes proceed through the standard approval process.

The essential objective when amending futures contract specifications is to ensure that the change achieves compliance with core principles found in the relevant statute while minimizing the adverse impact of material changes on existing position holders. The portion of the statute quoted above identifies the levers available to the exchange when amending contracts – it chooses the substance of the amendment and determines the timeline for implementation (by applying the change to specific contract months). Changes to contract months not yet listed or without open interest are likely to do no harm, because market participants have not yet made any financial or performative obligations. Once aware of new contract specifications, market participants can freely choose to trade under those terms or not.

The presence of open interest creates the possibility that the announcement and/or implementation of changes to the terms and conditions may move the price in a direction that adversely affects some existing position holders (while benefitting position holders on the other side of the market). That is, there is potential for market participants to experience profits and losses based solely on changes to contract specifications rather than any shift in underlying fundamentals.

Thus, there is a trade-off between timeliness and potential material price impacts in the optimal implementation of amendments to futures contracts with existing open interest. Near-term contract months typically have greater open interest and therefore the magnitude of any

tops, fats and oils (including lard, tallow, cottonseed oil, peanut oil, soybean oil and all other fats and oils), cottonseed meal, cottonseed, peanuts, soybeans, soybean meal, livestock, livestock products, and frozen concentrated orange juice, but not onions;” (17 CFR § 1.3).

amendments would be greater simply by the number of market participants affected. Additionally, near-term contract months are closer to the delivery period and expiration, so any amendments to contract terms such as quality or delivery specifications could change the economics of making or taking delivery, thereby disrupting convergence.

Lengthening listing cycles has complicated the process of amending contracts. Twenty years ago, when the listing cycle for most agricultural futures contracts may only have extended 12 to 24 months into the future, an exchange could apply amendments to contract months without open interest within the next crop year or two at the most. Now, implementing a contract change beyond open interest would occur much further in the future. In the case of corn, the most actively traded agricultural commodity, contracts for delivery over 48 months hence are listed at any given time. There is frequently open interest in these distant months. In such cases, contract amendments will almost always apply to existing open interest if compliance is to be achieved on a reasonable timeline.

The share of open interest in deferred contract months can be substantial. Figure 1 displays the concentration of open interest in contract months further than one year (twelve months) from delivery for enumerated agricultural futures contracts. It shows deferred open interest in major grain markets is greater than in livestock, minor grains like rice and oats, butter, or frozen concentrated orange juice. Figure 1 also shows that the share of open interest in deferred contract months varies considerably over time. In corn, the largest agricultural futures market by open interest, the median share of open interest in contracts more than 12 months to delivery is approximately 8%, but the interquartile range is 5 to 11% and the 95% percentile value is 17%. Wheat, soybean, and cotton futures have smaller but similarly substantial shares of open interest in deferred contract-months. Other enumerated commodity contracts have much smaller shares of open interest beyond one year from delivery.

Note the concentration of open interest in deferred-month contracts shown in Figure 1 considers aggregate open interest. Positions held by individual market participants may be significantly more concentrated in deferred months. Contract changes that affect only a small share of overall open interest may affect an individual trader's entire position.

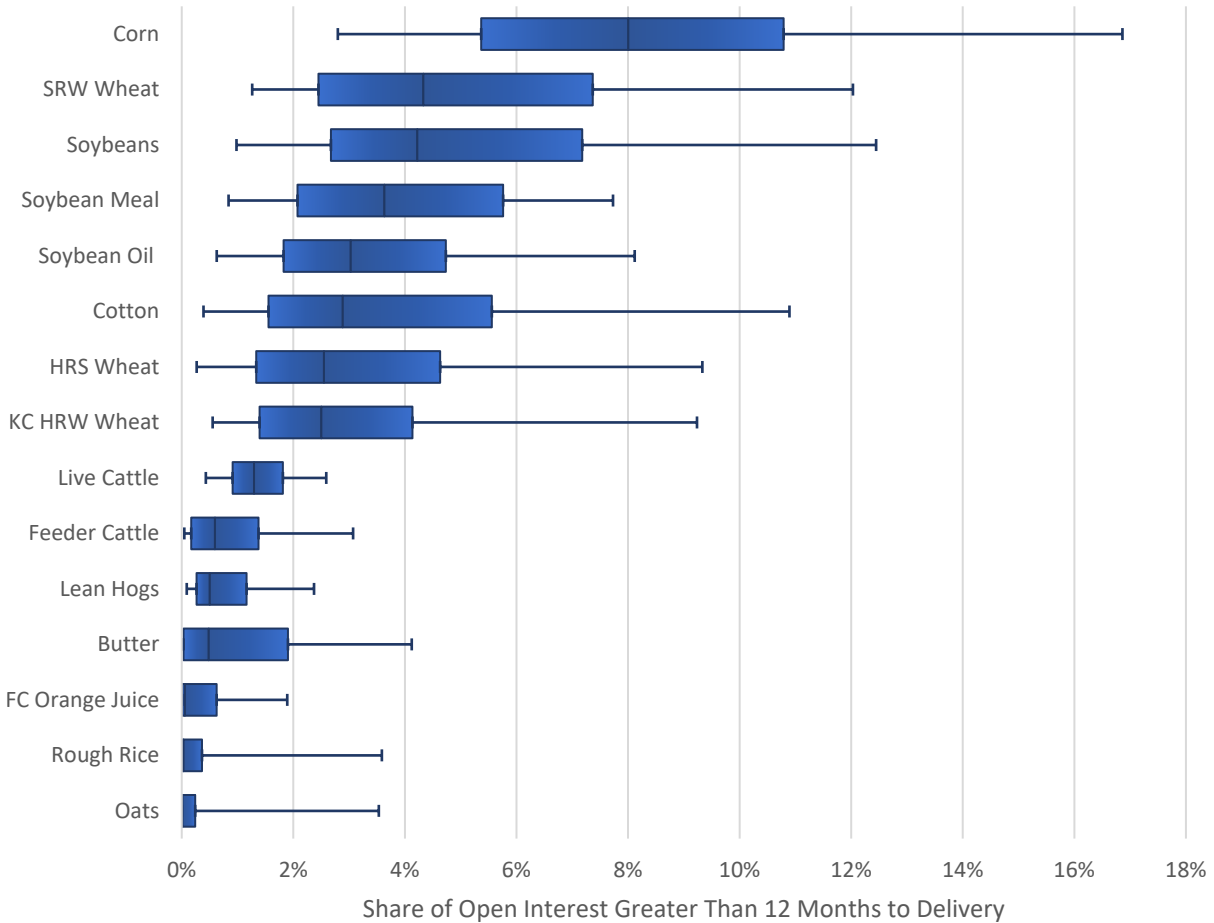


Figure 1. Boxplots describing the distribution of the share of open interest in contract-months more than 12 months from delivery by contract market, 2007-2020.

Note: Data on open interest at month-end from Bloomberg. Bars indicate median and interquartile range. Whiskers indicate 5th and 95th percentiles. Contracts are ranked by median share of deferred months open interest.

There is an additional complication inherent in amending futures contracts: the specific consequences of any change are uncertain *a priori*. Given their experience and knowledge of the underlying and futures markets, exchanges are generally able to design contract amendments that will address performance issues, but no party can observe price discovery and hedging effectiveness in a given circumstance under an alternative set of contract specifications. It is not possible to prove that manipulation or price distortion are impossible under a given set of contract specifications or that a set of proposed amendments will precisely address contract performance issues. Moreover, market participants all else equal prefer stable contract terms. Exchanges have historically been reticent to make changes when the conditions generating a disruption are thought to be temporary. The nature of the process favors incremental changes over singular, sweeping ones.

Uncertainty about the ability of a contract change to provably deter market disruption or address other regulatory compliance issues implies change is unlikely in the case of *de minimis* or temporary issues. Additionally, while the underlying agricultural markets on which futures markets are based tend to be dynamic, that evolution happens over time. As a result, contract amendments are relatively infrequent. Table I shows that the median contract for an enumerated agricultural commodity has been amended seven times since 2007, or once every two years. This period includes the volatile market conditions of 2008 which saw a relative flurry of contract amendments. Changes have been rarer since that time.

Table I. Number of Approved Amendments to Futures Contracts for Enumerated Agricultural Commodities, 2007-2020. Source: CFTC Filings and Actions Database

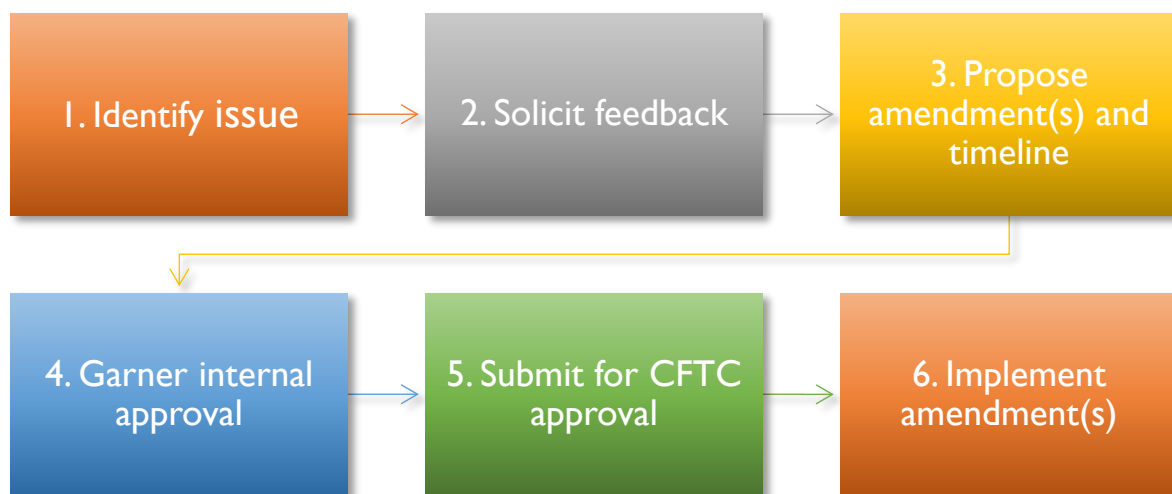
Designated Contract Market	Contract	No. of Approved Amendments
KCBT/CBOT	KC HRW Wheat	16
CME	Live Cattle	15
ICE	Cotton No. 2	14
CBOT	SRW Wheat	10
CBOT	Corn	8
MGEX	HRS Wheat	8
CME	Feeder Cattle	7
CBOT	Rough Rice	7
CBOT	Soybeans	6
CME	Lean Hogs	6
CBOT	Oats	5
CBOT	Soybean Oil	3
CBOT	Soybean Meal	3
ICE	FC Orange Juice	3
CME	Butter	1

Since contract specifications are amended infrequently, a given change should be deliberate in its design and significantly improve regulatory compliance and/or market performance. The “good faith effort” standard discussed above is intended to encourage such changes. This report explores other mechanisms available to the Commission to foster transparent, efficient, and effective contract changes to improve market performance.

The Process for Amending Futures Contracts with Open Interest

To describe how the CFTC can enhance the efficiency and effectiveness of its processes related to amending contracts, consider its role in the existing process. The role of the CFTC in amending contracts, including enumerated contracts with open interest is limited in the Act by design. The Commission ensures exchanges meet the good faith effort standard discussed above. Figure 2 outlines six general steps involved in amending a futures contract with open interest. The exchange, market participants, and the CFTC each have input at different points in the process, with the exchange involved at all points.

Figure 2. Process for Amending Futures Contracts for Enumerated Commodities with Open Interest



In the first step, the exchange, whether through a standing contract committee or staff outreach, regularly reviews contract terms and conditions and scrutinizes their compliance with the Act and adherence to common cash market practice which can change over time. Through this process, the exchange, market participants, and/or CFTC identify any issues with existing contract terms and conditions. At this point, whether through public or private communication, the exchange acknowledges the issue and considers whether it merits further internal inquiry. For the issue to rise to the level that justifies further consideration and an eventual contract amendment, there is likely some agreement among all parties even at this early stage that there is an issue that requires resolution or that there has been a fundamental change in the underlying market that needs to be reflected in the contract terms and conditions (e.g., Pirrong, Haddock, and Kormendi 1993).

Second, the exchange solicits more specific feedback from market participants. There are different venues in which this feedback may occur: focus group, survey, and/or standing contract committee. These groups maintain a diverse composition of commercial and non-commercial market participants, though the exact composition of feedback may depend on the nature of the issue. For example, issues with the delivery process for contracts with physical delivery may focus on those who participate in the physical delivery process.

Third, the exchange develops amendments to address the issue, proposes implementation timeline, and internally approves proposed amendments. The implementation timeline considers whether a proposed amendment is likely to have a material impact on contract's pricing and the trade-off between timely compliance and effects on existing open interest discussed above. At this stage, the exchange is generally in communication with the CFTC regarding a forthcoming submission for approval. Simultaneously, it is also considering internal implications of the amendment with respect to its own potential legal liability and garnering internal approvals for the proposed amendment.

Fifth, the exchange publicizes the forthcoming change coincident with its request to CFTC for approval. Upon receipt, CFTC conducts its due diligence review. The CFTC may (or may not) note objections or concerns, solicit public comment, and/or issue notice of non-approval. Amendments can be affirmatively approved by the full Commission, approved by the Director of the Division of Market Oversight in some circumstances, or approved by the passage of time at the end of the 45-day approval period in the absence of further action by the Commission.

Finally, the amendment is implemented on the contracts so designated. This may leave a period where nearer to delivery contracts trade under prior terms and deferred contracts trade on older terms. As noted earlier, the Commission's regulations do provide a fast track to implement changes to futures contracts that are not material.

Review of this process shows the importance of exchanges and market participants in self-regulation and initiating necessary change, which is consistent with the status of exchanges as self-regulatory organizations subject to a principle-based regulatory regime. It also reveals that the Commission plays an informal, consultative role at points where the Act does not describe or reserve any formal role for the Commission up to the point where an amendment is submitted to the Commission for approval. There is in practice on-going communication among exchanges, market participants, and the Commission at nearly all points in this process.

Full public transparency is not always possible throughout the process and is not required until the formal submission is made to the CFTC. Exchanges and the Commission must be judicious in signaling forthcoming changes that may affect market participants decision to enter or exit a given position. In particular, the exchange and the Commission strive to avoid communications that provide an informational advantage to any subset of market participants.

Formal public comment may be a part of the review process, but the Commission must initiate the public comment process on a case-by-case basis. The advantage of public comment is that it democratizes input and provides all interested parties with a common means to express their concerns. However, it may be superfluous or unnecessary in instances where all market participants with a significant interest can express their views through other mechanisms, particularly because the Commission may not begin collecting public comments until after a request for approval has been made.

Historical Contract Amendments

The Subcommittee reviewed the historical record of contract amendments in the 14 years from 2007 to 2020 for which there is complete documentation in CFTC's electronic records. For this report, past amendments to contract specifications were grouped into one of four general categories: delivery rules, position limits, risk controls, or other trading rules.

Delivery rules are terms and conditions related to the delivery process for physically delivered futures contracts or specification of the index to which a cash-settled contract is settled. These include but are not limited to the grade and quality specifications, delivery locations, delivery procedures, and specification of the delivery instrument including storage rates. Position limits are any restrictions on who can hold positions of a particular size, and may apply to single contract months, all months combined, or to the spot month specifically. Risk controls refer to price limits and trading halts that may be imposed as a response to market volatility. Other trading rules are any other contract specifications that do not fit into one of the above categories. In the past, such changes include daily settlement procedures, changes to the listing cycle, and changes to expiration dates.

The specifications amended and the implementation timeline are important parameters that determine the magnitude and scope of any impact to the economic value of a contract. Figure 2 describes the number and proportion of amendments by category. Note these numbers apply to submissions which may include multiple, related contracts or one or more contract amendments. For example, 2018 changes to storage rates for Corn and Soybean futures contracts were filed as a single submission. The figure shows that no single category predominates, though delivery rules changes make up about 40% of filed amendments. Changes to price limits have historically been the most filed amendment type, although subsequent changes are expected to become rarer with the adoption of adjustable price limits in most grain and livestock futures contracts by 2020. While such dynamic contract specifications are used in limited circumstances, they are designed to regularly recalibrate terms and conditions that are known to vary and could potentially cause market disruptions, thus obviating the need for future amendment approvals.

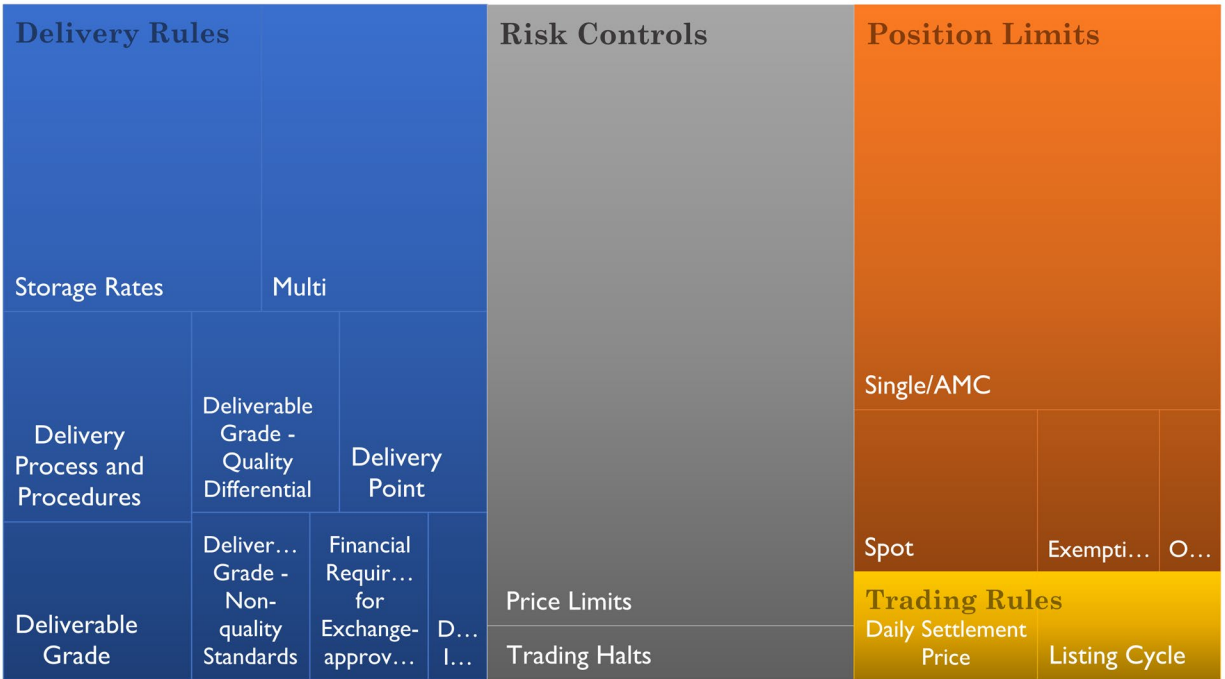


Figure 3. Contract amendments by type and sub-type, 2007-2020. Source: CFTC Filings and Actions Database

The implementation timeline is an important decision made in the process to amend a futures contract. Lengthening this timeline can reduce or eliminate the scope of the material impact of the change on open interest. Figure 3 describes the implementation timeline by amendment category for the same set of contract amendments considered in figure 2. It bins implementation timelines into three groups depending on the time from when the amendment was submitted by the DCM for approval by the CFTC to the first affected contract month. Most changes in the position limits, risk controls, and other trading rules categories are implemented on contracts for nearby delivery or relatively quickly – either immediately or within six months. Those types of amendments are typically considered to be at arms-length, i.e., increasing the position limit for a particular commodity does not necessarily mean that market participants will increase their position sizes, nor would there be an expected price impact associated with increases in position sizes so long as they meet the other criteria in the Act. Amendments to delivery specifications have the potential to impact prices more directly and are therefore typically implemented on a longer timeline, generally more than six months and often more than one year. Changes to storage rates, delivery locations, and deliverable grades are in nearly all cases implemented on contracts for delivery more than six months hence.

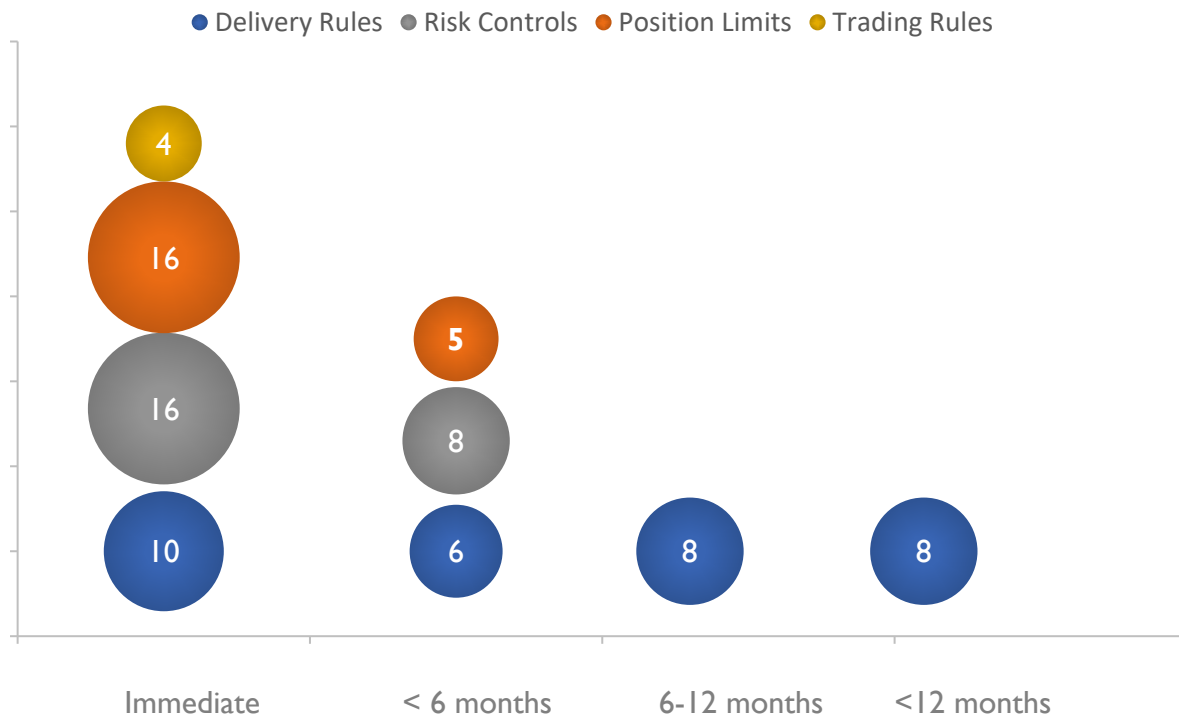


Figure 4. Contract amendments by type and implementation timeline, 2007-2020. Source: CFTC Filings and Actions Database

Notable among recent contract amendments summarized in Figure 2 and 3 are those establishing dynamic contract specifications that either continuously or periodically adjust other contract terms in response to contemporaneous or historical data, even if those contracts have existing open interest. Once initially approved by the Commission, subsequent contract changes occur without further approval or notification to the Commission. Exchange practice does currently involve notice of the changes to the marketplace.

Dynamic specifications define an adjustment mechanism based on observable data. For example, adjustable price limits common to most CBOT/CME grain, oilseed, livestock, and dairy contracts set daily price limits based on a percentage of the average price level over a recent time period. The Variable Storage Rate (VSR) for the CBOT SRW Wheat and KC HRW Wheat contracts adjusts storage rates charged to the holders of the contract's delivery instrument based on a measure of a futures calendar spread as percentage of financial full carry over the months preceding the expiration of the nearby leg of the spread. These dynamic contract specifications were approved by CFTC prior to implementation; however, the Commission has no guidance in 17 CFR 38 Appendix B or Appendix C specific to the evaluation of amendments that propose dynamic specifications.

In adopting dynamic specifications, exchanges and market participants coalesce around clear expectations for what constitute necessary future changes. Given their permanence, dynamic contract specifications pose unique design challenges. Namely, they have the potential to

create uncertainty between the contract month to which existing specifications apply and the contract month when the new specifications are implemented, all of which typically have open interest. While position holders generally prefer stable contract terms, dynamic specifications may be beneficial in reducing the implementation timeline and regulatory burden for making routine changes , therefore lessening the potential for market disruptions when specifications that are known to vary are not appropriately calibrated.

Scope and Activities of the Subcommittee

The formation of the Subcommittee was approved unanimously by the Commission on September 23, 2020, followed by a call for nominations in the Federal Register closing on October 29, 2020. The Subcommittee was composed of 22 members representing a diverse cross-section of market participants plus all three designated contract markets for enumerated agricultural commodities. (A full list of Subcommittee members is given at the end of this report.)

The Subcommittee met three times in December 2020 to receive presentations by CFTC staff and representatives from exchanges that list enumerated agricultural futures contracts (CME Group, ICE Futures US, and the Minneapolis Grain Exchange) on the contract design and approval process and to define the scope of its deliberations. A draft report was circulated on January 19, 2021 and the committee met shortly thereafter to discuss the report's proposed recommendations. The Subcommittee held two additional meetings to further refine the findings and recommendations, followed by a final meeting on April 21, 2021, at which time it voted 20-0 to adopt the report, its findings and recommendations.³

³ Subcommittee members Jim Fryer of the National Cattlemens Beef Association and Hayden Wands of the American Bakers Association were not able to be present for the vote; both subcommittee members are also members of the full Agricultural Advisory Committee.

Findings and Recommendations

The Ag-OI Subcommittee finds in this report that the current process for amending agricultural futures contracts works well to foster compliance with core principles, align contract terms to common commercial trading practices, and weigh interests of all market participants. As self-regulatory organizations, the Subcommittee recognizes that exchange-led mechanisms for soliciting and incorporating market participant feedback are the primary means for initiating amendments to agricultural futures contracts.

Additionally, the Subcommittee recognizes the Commission's unique role in the approving proposed changes and in ensuring that agricultural derivatives markets are performing their price discovery and risk management functions.

The Subcommittee further recognizes the need for consistency, transparency, and dialogue as contracts are amended. It notes that some existing processes are informal and based on working relationships between staff members at each institution. There is merit to formalizing effective practices. The Subcommittee also identifies areas where Commission processes are undefined or unclear. These findings and recommendations are intended to be forward-looking, principle-based, and adaptable to market conditions that will continue to change over time.

Per the mandate of the Subcommittee, it is important to note that these findings and recommendations relate only to the Commission's oversight role and are not intended to impose any additional requirements on the exchanges. Each recommendation calls for specific action from the Commission only.

Transparency in Market Oversight

Finding 1

The Subcommittee finds that future contracts amendments would be improved by a clearer understanding among all parties of the regulations governing the process and the standard for regulatory compliance. Market participants should understand that Commission approval is a statutory requirement when changes apply to open interest in contracts for enumerated agricultural commodities. However, exchanges generally lead and retain substantial control of the process. Core Principle I provides exchanges with reasonable discretion in how they comply with the Act and the regulatory "good faith effort" standard gives the exchange considerable flexibility in achieving compliance for specific contract terms. Historic data on contract changes confirms this point, so past approval and non-approval decisions from the Commission may serve as an important resource for all parties.

Recommendation 1a

In order for market participants and the public to understand which products are subject to differing statutory requirements, the Commission should maintain a publicly available record of listed contracts where the underlying commodity is an enumerated agricultural commodity, and therefore subject to the approval process for amending such contracts.

Recommendation 1b

Given that past materiality and approval determinations made by the CFTC can be a relevant factor in future determinations, the Commission should maintain a publicly available record of its past materiality determinations and of past approval and non-approval decisions.

Public Engagement

Finding 2

The Subcommittee affirms the usefulness of public comment as an effective means of dialogue between market participants and the Commission following submission of a contract change. Public comment may provide additional information beyond what is submitted for approval by an exchange useful to the Commission in evaluating a contract amendment. Public comment creates a durable record of existing opinion usable by all parties in the process of making subsequent changes to the same or related enumerated agricultural contracts.

Recommendation 2a

The Commission should more consistently and systematically engage with market participants. More consistent engagement would build and reinforce trusted relationships with market participants, which are necessary when the CFTC has questions about market performance. Enhanced engagement would also serve to raise CFTC's awareness of market participants' concerns and allow for more timely and informal resolution of issues.

Recommendation 2b

To improve consistency in public engagement, the CFTC should define conditions in which it will call for public comment on an exchange filing. The subcommittee notes the utility of public comments to the Commission, exchanges, and market participants when the proposed changes apply to significant contract performance issues or are particularly controversial.

Finding 3

The Subcommittee recognizes the benefit of Commission engagement with exchanges and market participants before and after the formal submission of a contract change. The actions of the Commission in the amendment process prior to formal submission are not defined in regulation or guidance. Market participants expressed a desire to be informed about how the Commission responds to concerns about market performance expressed by market participants and industry groups and about the Commission’s process for acting on any concerns. Increasing the transparency around the procedures the CFTC uses to identify and respond to market performance issues would further the objective of regulatory accountability. It would also provide clearer signals to market participants and exchanges about how the Commission is balancing regulatory compliance objectives with the need to mitigate adverse impacts on existing open interest.

Finding 4

The Subcommittee finds futures contract specifications are subject to change, even when there is open interest, because there is a statutory imperative for futures contracts to comply with core principles which supersedes the goal of minimizing the material impact of a change on any individual market participant. The Subcommittee further finds that risk disclosures play an integral part in informing the marketplace about the risks inherent in futures trading and that existing disclosures⁴ do not adequately inform market participants about the specific risks associated with changes in contract specifications that may affect the value of an existing position. The Subcommittee recognizes that contract changes may create concerns about and issues of legal liability. While the Subcommittee does not make findings or recommendations to impact legal liability, it asserts that greater transparency would increase awareness of the potential for contract amendments to be applied

Recommendation 3

To promote accountable and transparent public engagement, the CFTC should work with the exchanges and market participants to develop guidance or staff policy about dialogue regarding amendments to contracts for enumerated agricultural commodities prior to submission and seek further input as to whether public engagement prior to submission would be practical and beneficial in certain circumstances.

⁴ Current regulations contain risk disclosure language used by Futures Commission Merchants that may be relevant to the case of contract changes that affect open interest. For example, 17 CFR § 1.55 Appendix A(4) states market participants should be made aware that contract specifications may change “to reflect changes in the underlying interest.”

to open interest and therefore may mitigate the possibility of liability claims by market participants who perceive or experience harm from said changes.

Recommendation 4

The Commission should work collaboratively with exchanges and market participants to increase awareness about the possibility of contract changes in all futures contracts for enumerated commodities. Specifically, the Commission should review its requirements for risk disclosures to market participants found in regulation and update them as necessary to inform market participants about the potential for an exchange to propose and implement contract changes affecting open interest even when those changes may affect the value of a position.

Effective Evaluation of Proposed Changes

Finding 5a

The Subcommittee finds that a specific definition or methodology for determining the materiality of a contract change would be overly prescriptive and generally incompatible with a principles-based regulatory regime. The Subcommittee considered different methods for defining contract amendments as *de minimis* or nonmaterial in a way that such changes could be implemented via self-certification. While a specific definition of materiality could in theory simplify the regulatory approval process, it is difficult to formalize the complex interaction between the specific terms amended, the implementation timeline, and market-specific situational details that determine how the value of existing open interest will be impacted by a change. The Commission in its evaluation should be able to consider all these factors and how they assess an exchange's implementation plan. For example, smaller or nascent markets may have special circumstances that require the Commission re-evaluate the importance of an amendment's impact on individual market participants to preserve the viability of the market as a whole. A one-size-fits-all approach to market oversight in such situations is unlikely to promote price discovery and risk management objectives.

Finding 5b

While existing regulation and guidance treat all changes to contract terms as equivalent, the Subcommittee finds some terms tend to be more relevant to price formation and more likely to affect the economic value of existing futures positions. After reviewing historic changes, the Subcommittee finds that contract terms exist along a continuum of materiality. Amendments to delivery-related terms and conditions such as deliverable grades, quality differentials, locations, and storage rates tend to be more material. Other categories of contract changes identified above are more likely to be non-material. *The Subcommittee also finds the implementation timeline for a change is relevant to its materiality.* Changes can have a larger or smaller impact on price depending on the location of existing open interest along the forward curve, both in terms of

time to delivery and relative to the marketing year for many seasonally driven commodities. Given the considerable variability across time and markets in the location and composition of open interest, specific definitions of materiality related to the level of open interest alone are unlikely to be optimal.

Recommendation 5

Commission review of proposed amendments and the guidance pertaining to such reviews should recognize certain types of contract amendments more likely to have a material effect on futures prices. Regulatory review by the Commission should be streamlined to prioritize analysis of the change's relation to the underlying physical commodity market, particularly the delivery or cash-settlement process. Review should also incorporate information on the level of affected open interest.

Finding 6

The Subcommittee finds that existing CFTC guidance is practicable and useful but requires periodic updating to remain relevant. The Subcommittee recognizes a gap in existing Commission guidance regarding dynamic contract specifications. Current guidance does not describe how the Commission will evaluate proposed changes which include adjustable terms. The Subcommittee finds that transparency with respect to data, timeframe, adjustment mechanism and notification of changes are all important components of a dynamic contract specification. Just as with the futures price itself, the adjustment mechanism should not be subject to manipulation or frequent market disruption.

Recommendation 6

The Commission should establish guidance for its evaluation of contract changes that include dynamic contract specifications. This guidance should include criteria for evaluating the adjustment mechanism and should recognize the potential for interactions among dynamic contract specifications in one market, other contract specifications in the same market, and prices and open interest in other markets.

References

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