Statement
Of
Joseph T. Nicosia
President
American Cotton Shippers Association
On
Commodity Futures Hedge Exemptions/Speculation – Position Limits
To
Committee on Agriculture
U.S. House of Representatives
July 10, 2008

Chairman Peterson, Ranking Member Goodlatte, and members of the committee, I am Joseph T. Nicosia, of Memphis, Tennessee. I appear today in my capacity as President of the American Cotton Shippers Association (ACSA). Accompanying me today is ACSA's Executive Vice President & General Counsel, Neal P. Gillen.

I am the CEO of Allenberg Cotton Company and a member of the Executive Committee of the Louis Dreyfus Corporation. I oversee the trading of cotton and also trade grains, oilseeds, livestock, currencies, and energy.

The concerns and some of the recommendations expressed in this statement are shared by the entire U.S. cotton industry - producers, ginners, warehousemen, merchants, cooperatives, and textile mills. For the past four months ACSA has been working closely with Amcot – the association of marketing cooperatives, and the American Cotton Producers of the National Cotton Council in addressing our concerns to the IntercontientalExchange (ICE), the Commodity Futures Trading Commission (CFTC), and the Congress.

Recent Developments

We are pleased to inform you that the ICE has been responsive to our concerns, and so to has the CFTC, which has actively considered and adopted some of the recommendations we made to the Commission's April 22nd Roundtable. Further, we appreciate the scheduling of this week's hearings and the overall sense of urgency by many in the U.S. Congress to determine what can and should be done. Your involvement is another example of the concerns expressed by this Committee to effectively oversee the futures markets by addressing these important issues. Hopefully, your legislative findings and recommendations will result in full market transparency revealing the necessary data that allows the CFTC to know first-hand what is taking place in the markets so it can make sound regulatory decisions providing for the orderly trading of agricultural futures contracts.

Interest of ACSA

ACSA, founded in 1924, is composed of primary buyers, mill service agents, merchants, shippers, and exporters of raw cotton, who are members of four federated associations located in sixteen states throughout the cotton belt:

Atlantic Cotton Association (AL, FL, GA, NC, SC, & VA)
Southern Cotton Association (AR, LA, MS, MO, & TN)
Texas Cotton Association (OK & TX)
Western Cotton Shippers Association (AZ, CA, & NM)

ACSA's member firms handle over 80% of the U.S. cotton sold in domestic and export markets. In addition, our members also handle a myriad of foreign growths of cotton, which is forward priced based on the New York futures market. Because of their involvement in the purchase, storage, sale, and shipment of cotton, ACSA members, along with their producer and mill customers, are significant users of the ICE's No. 2 Upland Cotton Futures Contract. Therefore, they are vitally interested in a return to an orderly futures market reflecting market fundamentals that are not grossly distorted by speculative interests.

Current Status of Cotton Contract

In ACSA's testimony to the General Farm Commodities & Risk Management Subcommittee on May 15th, we reviewed the consequences to the price run-up in the ICE No. 2 Contract in the period from mid-February to early March and the resulting problems to the cotton industry due to an unrealistically widened basis precluding the use of the No. 2 Contract as a prudent hedging or risk management tool by producers, cooperatives, merchants, and mills.

I am pleased to report, that while the industry is still suffering from the repercussions of the disruptive market events of early March, the ICE has listened to the cotton industry and has agreed to make our recommended changes to margin the futures to futures settlements and options to option settlements. It has also agreed to the industry's proposal regarding the expansion of trading limits. These important changes should provide the necessary certainty to our financing banks, who had been reluctant to finance margin requirements under the previous system that established margins not at the closing price of the futures month, but at the "synthetic" level of the closing price of the options month, which added on additional financial exposure.

The CFTC, while focusing mostly on the monitoring of the energy markets, has launched a comprehensive investigation of the February-March trading in the cotton futures contract. We have limited knowledge of the investigation, but based on what we know, the CFTC's Enforcement Division has detailed a top-flight team to this important task. The Commission is also developing a proposal to require "more detailed reporting from index traders and swaps dealers … and to review whether classification of these types of traders can be improved for regulatory and reporting purposes." I might add that it was not possible for the Commission to effectively regulate the futures markets because it had never used its authority to request such information. The lesson is that lacking the appropriate information the markets cannot be properly monitored.

More importantly, the CFTC has also agreed to "review the trading practices for index traders … to insure that this type of trading activity is not adversely impacting the price discovery process, and to determine whether different practices should be employed."

The CFTC Agricultural Advisory Committee is scheduled to meet on July 29th. Mr. Gillen and I have served as members of that Committee. At that meeting, we expect to discuss a myriad of proposals on what can and should be done to assure that the agricultural futures markets function as Congress intended that they should.

Hedge Exemptions – Speculative Position Limits

In our earlier testimony we discussed the recent phenomena of the participation of the index funds and the over-the-counter traders, who have flooded the futures markets with record liquidity to the extent that the resulting widened basis has in fact made the markets illiquid to those for whom Congress created these markets. This has had the effect of rendering the markets, particularly the cotton contract, which has significantly different supply/demand fundamentals than the other agricultural commodities, ineffective for hedging against price risks and discovering prices. More importantly, this has adversely impacted the physical markets since merchants or cooperatives cannot offer price quotations to farmers or end users because they cannot use the contracts for hedging purposes.

Simply put, these markets, now overrun by cash, preclude the convergence of cash and futures prices, hedging, and forward contracting. The markets now lack the economic purpose that the Congress required when it originally authorized the trading of agricultural futures contracts.

Speculative Position Limits

The Congress through the CFTC has imposed speculative positions limits in the futures contracts to reduce the potential for market disruption or manipulation. But such limits are no longer effective for two reasons, first, the CFTC has granted hedge exemptions to the investment funds allowing them to exceed the limits, and second, large traders were permitted by the Congress, through the swaps exemption, to operate outside the regulatory framework through the swaps markets. The transactions in these hidden markets are permitted to take place off-exchange where each party mutually agrees to satisfy each other's credit standards and to remit margins to one another as the underlying market fluctuates. Such transactions have the characteristics of an exchange-traded futures contract, but are traded "over the counter" (OTC) and are not subject to CFTC oversight.

Such transactions pose problems when one of the parties to the swap has a "hedge exemption" that exempts his on-exchange futures trading from position-size limits. The swaps dealer would take an equal and opposite position in the futures market to the swaps trade. For example, should a pension fund desire to purchase $20 million in long exposure in cotton, it can purchase this exposure from a swaps dealer. The dealer, now short the price of cotton via the swap, enters the futures market to hedge his position by buying cotton futures. Given that he is a "hedger," CFTC allows him to trade futures in excess of the normal speculative position-size limits. This has created a situation where such large investors can trade in any contract in any size they desire without regard to position limits. They are not limited by the CFTC. Only a swaps dealer can limit such trades, and no swaps dealer is going to turn a deaf ear to any financial entity awash in cash.

These arrangements, along with the billions of dollars invested in index funds, bring so much cash into a market that the traditional speculators cannot take a short position to match the institutional longs. This leaves it up to the commercials - cooperatives, the merchants, and the processors to offset these positions. But lacking the huge margin requirements they cannot do so. That is the situation today as the funds continue to purchase futures. Unwilling to assume such margin risks in such a volatile futures market the commercials remain passive not only in the futures, but in the physical markets. The result - markets with no economic purpose for the commercials. Therefore, no business is done. Producers, lacking a price, cannot properly plan and processors must buy hand to mouth. Simply put, the investment funds have negated the real purpose of the futures markets causing severe disruptions in the agricultural marketing process.

Recommendations

While we are pleased that the CFTC has placed a moratorium on granting further hedge exemptions to the so-called "passive" investment funds, action must be taken – a balance must be struck - with those funds currently operating with a hedge exemption.

We submit that the CFTC should take immediate action to require **that an index fund with a hedge exemption restrict its position in a commodity to the dollar allocation or the percentage of funds allocated to that commodity as defined in the fund's prospectus and recorded with the CFTC. Further, any variation should be subject to speculative position limits, and that such funds should report their cash positions on a weekly basis.**

ACSA also recommends **that the CFTC monitor and oversee all swaps and OTC activity by requiring the reporting of all swap and OTC contracts by market participants, and that the CFTC determine the aggregation of positions from all sources, including the exchanges, ETF's, swaps, OTC, and other trading entities.**

We also recommend that the CFTC **require that all non-traditional hedge accounts, those not involved in the commercial enterprise of physically trading bales of cotton, be reported as a separate individual category.** It is also recommended **that only those involved in the commercial enterprise of physically trading bales of cotton, shall be eligible for hedge margin levels.**

In our view, these requirements would provide the CFTC and the trading public with the necessary information on which to make sound regulatory and market decisions. It will hopefully attenuate the current situation in which these essential markets have become investment vehicles for speculative funds who act unimpeded by market fundamentals or regulation.

Again, Mr. Chairman, thank you for providing us with the opportunity to participate in these important hearings and for your attention to our concerns.

Committee on Agriculture
U.S. House of Representatives
Information Required From Non-governmental Witnesses

House rules require n-governmental witnesses to provide their resume or biographical sketch prior to testifying. If you do not have a res ne or biographical sketch available, please complete this form.

1. Name: Joseph T. Nicosia

2. Business Address: 7255 Goodlett Farms Parkway
Cordova, TN 38016

3. Business Phone Number: (901) 383 5000

4. Organization you represent: American Cotton Shippers Association

5. Please list any occupational, employment, or work-related experience you have which add to your qualification to provide testimony before the Committee:

Chief Executive Officer, Allenberg Cotton Company
Louis Dreyfus Commodities
Director, Louis Dreyfus Corporation

6. Please list any special training, education, or professional experience you have which add to your qualifications to provide testimony before the Committee:

Member, Cotton Committee IntercontinentalExchange
Director and Founding Member of The Seam, an electronic agricultural marketplace.

7. If you are appearing on behalf of an organization, please list the capacity in which you are representing that organization, including any offices or elected positions you hold:

President, American Cotton Shippers Association
Member, Board of Directors & Executive Committee
Chairman, Committee on Futures Contracts

PLEASE ATTACH THIS FORM OR YOUR BIOGRAPHY TO EACH COPY OF TESTIMONY.

Committee on Agriculture
U.S. House of Representatives
Required Witness Disclosure Form

House Rules* require nongovernmental witnesses to disclose the amount and source of Federal grants received since October 1, 2004.

Name: Joseph Nicosia

Address: 7255 Goodlett Farms Parkway
Cordova, TN 38016

Telephone: 901-383-5000

Organization you represent (if any): American Cotton Shippers Association

1. **Please list any federal grants or contracts (including subgrants and subcontracts) <u>you</u> have received since October 1, 2004, as well as the source and the amount of each grant or contract. House Rules do <u>NOT</u> require disclosure of federal payments to individuals, such as Social Security or Medicare benefits, farm program payments, or assistance to agricultural producers:**

Source: None. I am also an employee of Allenberg Cotton Co., which may have received federal grants or contracts. **Amount:** ______

Source: ______ **Amount:** ______

2. **If you are appearing on behalf of an organization, please list any federal grants or contracts (including subgrants and subcontracts) <u>the organization</u> has received since October 1, 2004, as well as the source and the amount of each grant or contract:**

Source: None. **Amount:** ______

Source: ______ **Amount:** ______

Please check here if this form is NOT applicable to you: ______

Signature: Joseph Nicosia

* Rule XI, clause 2(g)(4) of the U.S. House of Representatives provides: *Each committee shall, to the greatest extent practicable, require witnesses who appear before it to submit in advance written statements of proposed testimony and to limit their initial presentations to the committee to brief summaries thereof. In the case of a witness appearing in a nongovernmental capacity, a written statement of proposed testimony shall include a curriculum vitae and a disclosure of the amount and source (by agency and program) of each Federal grant (or subgrant thereof) or contract (or subcontract thereof) received during the current fiscal year or either of the two previous fiscal years by the witness or by any entity represented by the witness.*

PLEASE ATTACH DISCLOSURE FORM TO EACH COPY OF TESTIMONY.