National Grain and Feed Association

1250 Eye St., N.W., Suite 1003, Washington, D.C. 20005-3922, Phone: (202) 289-0873, FAX: (202) 289-5388, Web Site: www.ngfa.org

Statement of the
National Grain and Feed Association
to the
Commodity Futures Trading Commission
April 22, 2008

The National Grain and Feed Association (NGFA) appreciates the opportunity to submit recommendations to the Commodity Futures Trading Commission (CFTC) concerning the performance of agricultural futures markets and impacts on commercial grain hedgers. We applaud the CFTC for holding this roundtable discussion to examine whether the futures markets are properly performing their risk management and price discovery roles. The NGFA's findings and recommendations are as follows:

- The NGFA strongly recommends a moratorium on all hedge exemptions for passively-managed, long-only investment capital entering agricultural futures markets. For funds already approved for hedge exemptions, the NGFA strongly recommends against expansion of hedge exemptions beyond levels already approved by the CFTC. The NGFA also recommends that all passively-managed, long-only investment capital participate in futures on a dollar-for-dollar, unleveraged basis, with all investment capital fully margined. This is consistent with rules proposed by CFTC late last year in its proposal to establish a hedge exemption for pension and index funds, and with rules governing the two funds that currently have hedge exemptions.

- The changes instituted by CFTC in its Commitments of Traders (CoT) report in early 2007 to identify "Index" participants was a very positive step, and the report has become a useful tool for market participants. The NGFA respectfully requests that CFTC analyze the report to assure that all long-only, passively-managed investment capital entering agricultural futures markets is correctly reported to the Commission and properly categorized and reported in the CoT report's "Index" category. The NGFA further requests that the Commission fully and clearly define futures market activity reported in each existing category of the report; and consider whether any additional detail/categories added to the report would provide additional clarity for market participants.

- The NGFA does not believe the pending storage rate (premium charge) changes for the CBOT corn, soybean and wheat contracts accurately reflect the real costs and value of storage capacity. The NGFA will ask the CME Group to poll the grain handling industry immediately to determine accurate commercial storage values. If warranted under current conditions, the NGFA will ask the CME

Group to implement those rates, with CFTC approval, in lieu of currently pending storage rate increases for corn and soybean contracts, and also for the wheat contract, as soon as possible to enhance cash/futures convergence.

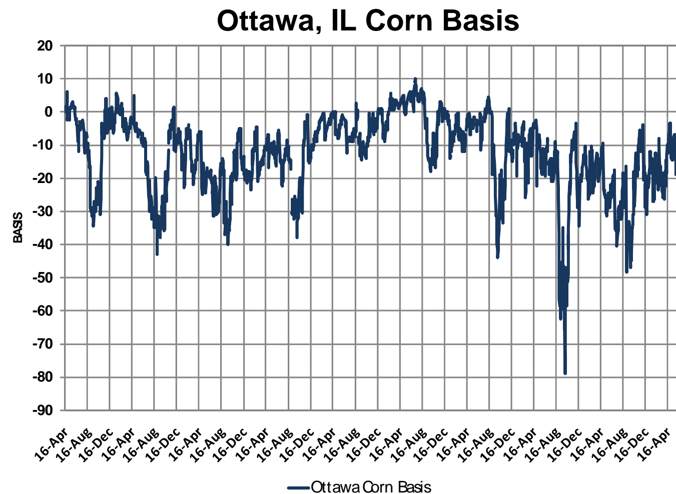
- The NGFA generally supports the concept of exchange-cleared swaps as a mechanism that creates the opportunity to spur innovation and new risk management products.

- The NGFA is supportive of repealing restrictive CFTC regulations on agricultural trade options. In their place, the NGFA supports rules allowing commercial participants (elevators, producers, processors) to engage in ATOs in the course of their businesses.

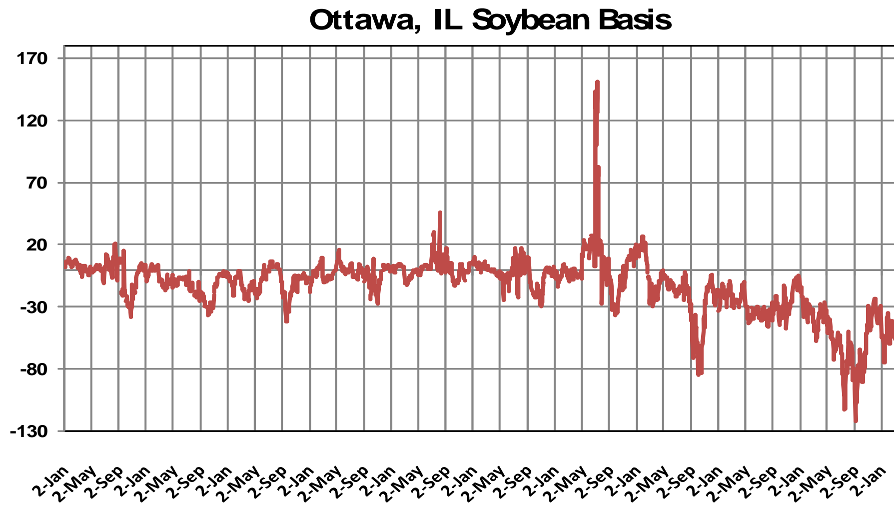
<u>Convergence and Basis Issues</u>

The NGFA's member companies are elevators and processors, many of them first-purchasers of grains and oilseeds from producers. These NGFA-member firms rely on well-functioning futures markets for price discovery and to help hedge price and inventory risk. One of the bedrock fundamentals on which hedging strategies are predicated is consistent and reliable convergence between cash and futures prices.

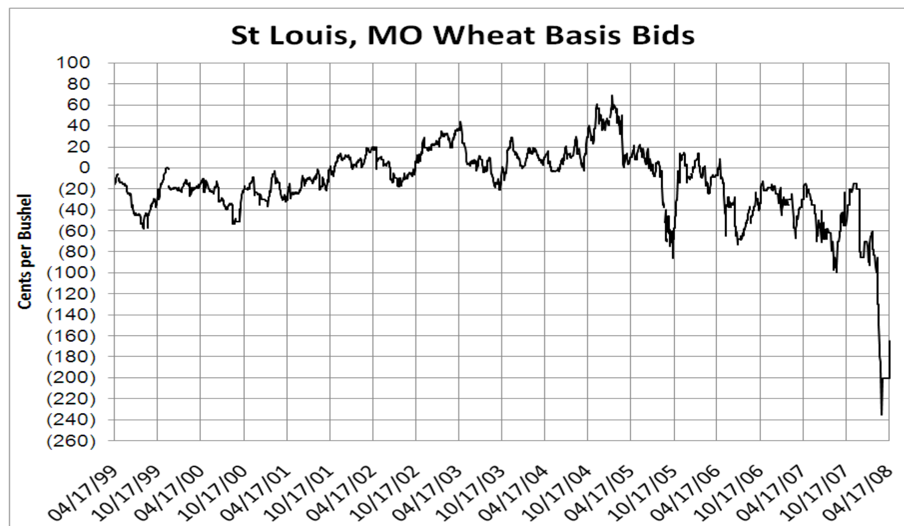
Today, that previously reliable relationship between cash and futures has deteriorated to a point where many commercial grain hedgers are questioning the effectiveness of hedging using exchange-traded futures. Genuine convergence occurs less often and only for short periods of time. The band, or range, of convergence has widened due to several factors, including: 1) higher and more volatile transportation costs; 2) demand for storage created by biofuels growth; and 3) the futures market running ahead of cash values due to passively managed, long-only investment capital. The following charts illustrate that basis has become more volatile and "weaker" than demonstrated historically – corn, to some extent, and soybeans and wheat more dramatically – thus, convergence has deteriorated:



Source: Advance Trading Inc.



Source: Advance Trading Inc.



Source: Advance Trading Inc.
Note: This chart represents river values in the St. Louis area; wheat mills in the St. Louis area are paying higher values (e.g., +5 Chicago on one recent day) for appropriate-quality wheat.

This lack of convergence – or “divergence” as some are calling it – is evident in wider basis levels between cash and futures. Cash bids to producers at any given location and time still reflect the true value of commodities, but rapid advances in futures price levels have widened basis to levels not historically expected. This wider basis can sometimes make commodity prices appear “too cheap” at the local grain elevator.

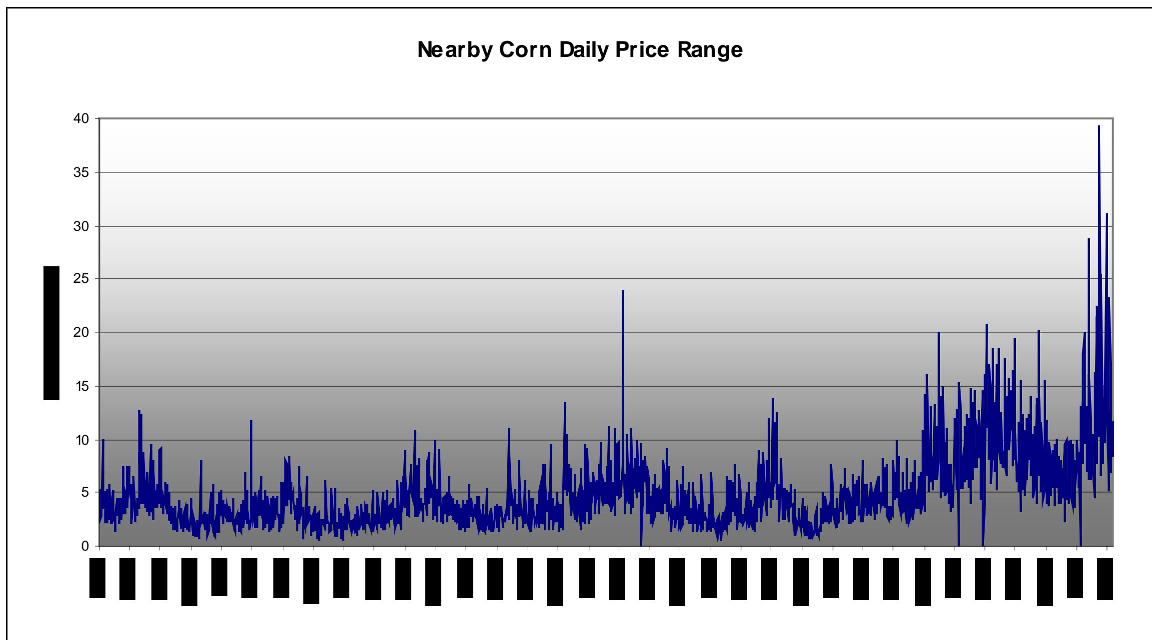
As mentioned above, many factors are at work to influence price levels and basis: transportation and fuel costs; changes in supply/demand fundamentals; carry-over inventory levels; farmer selling; storage rates; and more. Changes in any of these factors can result in significant changes to basis levels, and today we are seeing many changes occurring simultaneously. However, we believe that one new factor – the entry of large

amounts of long-only, passively-managed investment capital into agricultural futures markets – is causing a disruption in markets.

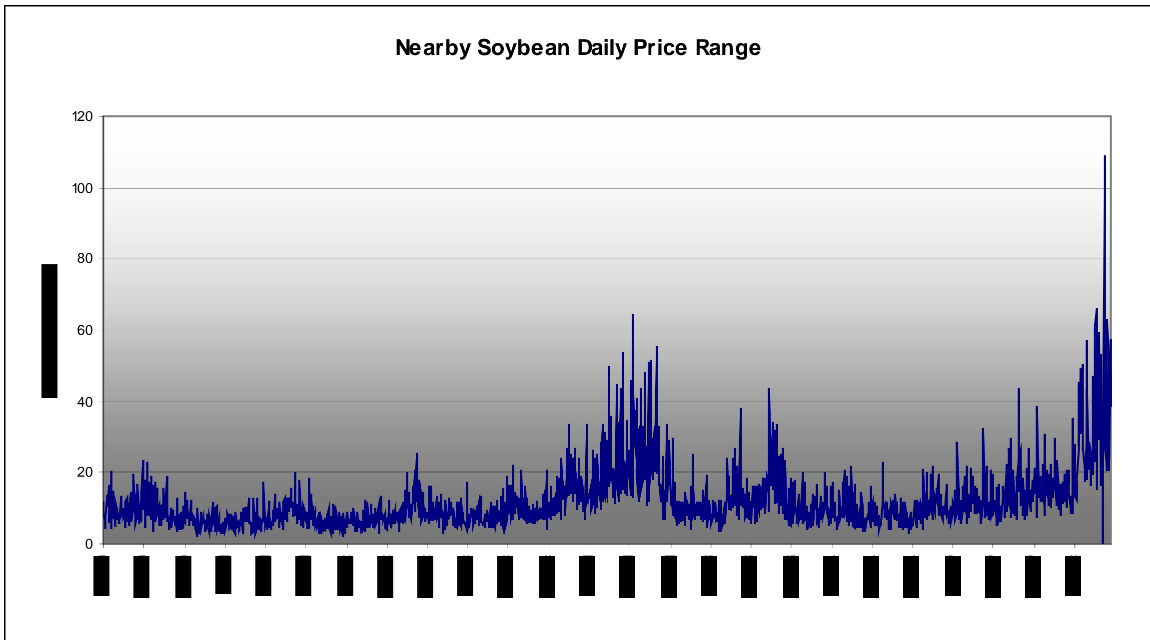
Financial Liquidity Issues

Decreased hedging efficiency due to deteriorating convergence and unpredictable basis patterns are not the only concerns for commercial grain hedgers today. As a result of significantly higher futures prices, driven in part by investment capital, elevators who purchase cash grain from farmers for deferred delivery have been hit with extremely large margin calls on their hedge accounts. Long-only investment funds account for a significant share of open interest in the CBOT grains and oilseeds contracts. These passively-managed, long-only contracts are not for sale at any price for extended periods of time, resulting in elevated prices not reflective of demand, increased speculative interest in the market, increased volatility, and pressure on banking resources to fund margins.

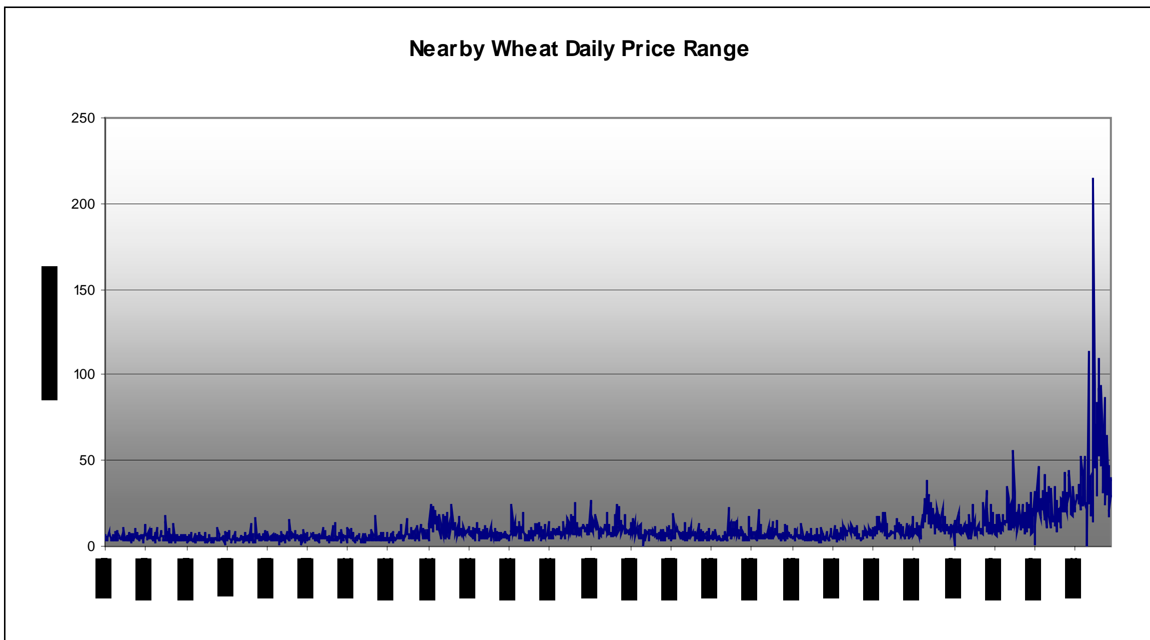
The following charts show the increased volatility for corn, soybean and wheat futures in recent months:



Source: CME Group



Source: CME Group



Source: CME Group

To finance inventory purchases and make margin calls, commercial grain hedgers' borrowing needs today are several times normal levels. Elevators have reached their borrowing limits and some lenders have reached the limit of amounts they can lend to the commercial grain sector. Additional futures price advances – due to supply/demand shocks, bad weather, or ever-larger amounts of investment capital – could lead to severe financial stress. Even today, some elevators lack the capital to finance additional hedges, so they have been forced to restrict or eliminate deferred purchase bids to producers. If

the situation continues, producers who lack access to cash forward contracts they have come to expect will increasingly be frustrated in efforts to optimize their marketing opportunities at a time when cash prices are very attractive.

Moratorium on Hedge Exemptions

For the reasons detailed above, the NGFA opposed CFTC proposals issued late last year to increase federal speculative position limits and to create a new hedge exemption for index and pension funds. Today, we believe action is urgently needed to allow agricultural markets to "take a break" and adjust before additional large amounts of investment capital find their way into agricultural futures.

We are recommending **a moratorium on all hedge exemptions for long-only, passively-managed investment capital entering agricultural futures markets.** For funds already approved for hedge exemptions, the NGFA strongly recommends against expansion of hedge exemptions beyond levels already approved by the CFTC. The NGFA recommends that long-only investment capital participate in futures on dollar-for-dollar, unleveraged basis, with all investment capital fully margined, consistent with rules suggested by the CFTC late last year in its proposal to establish a new hedge exemption for pension and index funds, and with rules for those funds already possessing hedge exemptions.

Commitments of Traders Report

Early last year, the CFTC began publication of a supplemental Commitments of Traders report with a new "Index" category to report investment capital. The NGFA's member companies were extremely pleased with that new category, believing that transparency in the marketplace is of benefit to all participants. In particular, the new "Index" category was helpful in assisting commercial grain hedgers to develop their risk management strategies based on supply/demand fundamentals, rather than on speculative investment capital.

We believe that today's market environment calls for a re-examination of the CoT report. While some suggest that investment capital's share of open interest in agricultural futures contracts has not increased in recent years, we are skeptical of that claim. We suspect that some activity that rightly belongs in the "Index" category could now be showing up in other CoT report categories. For that reason, **we respectfully request that the CFTC analyze in detail the reporting it receives from market participants to determine if all long-only investment capital is reflected in the "Index" category.** Additionally, we request that CFTC fully and clearly define futures market activity reported in each existing category of the report; and consider whether any additional detail/categories added to the report would provide additional clarity for market participants.

Storage Rates

While a number of changes to CBOT contracts have been suggested that might enhance convergence, we believe that one of the most readily available and effective tools is adjustments to storage rates (premium charges). As the result of findings of its Futures Market Performance Task Force last fall, the NGFA recommended at that time an increase in monthly storage rates for corn and soybean contracts from 4.5 cents per bushel to approximately 5 cents per bushel – the same increase already had been adopted by the CME Group for the wheat contract. The CME Group subsequently agreed with this finding and is proceeding to increase its corn and soybean storage rates, with CFTC approval just recently received.

We believe the market situation now has changed, and that additional action to increase storage rates is needed to enhance convergence. We believe that neither the current nor the pending storage rates reflect the true value of commercial space. To help remedy the situation, the NGFA would like to work cooperatively with the CME Group to determine what increased storage rate is most appropriate to ensure an efficiently functioning contract and to enhance convergence.

From time to time, the CME Group has surveyed industry for prevailing storage rates to help establish rates for the grain and oilseed contracts. The most recent such survey was conducted in early fall of 2006. Now that commodity prices have risen significantly, **the NGFA recommends that the CME Group poll the grain handling industry immediately to determine commercial storage rates.** The NGFA will ask the CME Group to implement higher storage rates if supported by the updated poll, with CFTC approval, in lieu of currently pending storage rate increases for corn and soybean contracts, and also for the wheat contract, as soon as possible to enhance cash/futures convergence.

Exchange-Cleared Swaps

The NGFA, in principle, is supportive of the concept of allowing agricultural commodity swaps to be cleared on-exchange. We believe that granting exchanges this regulatory flexibility could be a catalyst for development of new risk management products of benefit to commercial grain hedgers. In a changed market environment, innovative ideas like this may help ease the market's transition during a time of broad change and may enhance short-term market balance.

Agricultural Trade Options

In November of 1999, the CFTC published rules governing agricultural trade options. Since that time, just one entity registered as an agricultural trade options merchant, and that registrant now has withdrawn. Clearly, the net worth requirements and the burdensome reporting requirements contributed to making ATOs unworkable for potential participants.

In today's marketplace, we believe access to a workable ATO program could give producers additional marketing opportunities, spur new-product innovation and help ease financial liquidity concerns. For example, an ATO contract between a producer and a country elevator could be beneficial if the producer has weather-related production problems, or if he wants to maintain flexibility on delivery locations. ATOs also could help ease financial liquidity concerns of elevators by attracting new capital into agricultural markets without burdensome margining requirements.

We understand that CFTC staff may be considering a proposal that would rescind the burdensome regulations published in 1999 in favor of a more flexible regulatory approach under which commercial participants such as elevators, producers and processors could enter into ATOs in the course of their businesses. In today's market environment, we believe that approach makes sense. We would support the Commission moving to ease the ATO regulations.

Summary

Ultimately, the solution to recent market upheaval may simply be time. In time, the market may respond to new realities. The market likely will create new ways to deploy capital in agriculture. In time, industry may expand storage, the CME Group may implement enhancements to their contracts. Without a doubt, market participants will create new products for risk management that reflect the broad changes in the agricultural landscape – transportation, biofuels, major acreage shifts, to name a few. The NGFA will continue its work to identify additional potential responses to assist commercial grain hedgers dealing with the volatility and financial stresses of today's markets, whether they be changes to futures contracts, regulatory action or some other course.

In the shorter term, there are real disconnects and real stresses, in particular on the commercial grain hedging sector. We believe these stresses call for action along the lines outlined above that will help build a bridge to new market realities. Failing to do so could have serious consequences for all sectors of agriculture, including producers and the elevators who work with them to facilitate efficient marketing and risk management for the grain sector.