Testimony of
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On behalf of
Commodity Markets Council

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Subcommittee on Commodity Exchanges, Energy, and Credit
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Chairman Scott, Ranking Member Scott and Members of the subcommittee: thank you for holding this hearing to review the reauthorization of the Commodity Futures Trading Commission ("CFTC" or "Commission"). My name is Doug Christie, President of Cargill Cotton in Memphis, Tennessee. I am testifying today on behalf of the Commodity Markets Council ("CMC").

CMC is a trade association that brings together exchanges and their industry counterparts. Our members include commercial end-users that utilize the futures and swaps markets for agriculture, energy, metal and soft commodities. Our industry member firms include regular users and members of such designated contract markets (each, a "DCM") as the Chicago Board of Trade, Chicago Mercantile Exchange, ICE Futures US, Minneapolis Grain Exchange and the New York Mercantile Exchange. They also include users of swap execution facilities (each, a "SEF"). The businesses of all CMC members depend upon the efficient and competitive functioning of the risk management products traded on DCMs, SEFs or over-the-counter ("OTC") markets. As a result, CMC is well positioned to provide consensus views of commercial end-users of derivatives with respect to CFTC reauthorization.

Cargill provides food, agriculture, financial and industrial products and services to the world. We help people thrive by applying our insights and 150 years of experience. We have 143,000 employees in 67 countries who are committed to feeding the world in a responsible way, reducing environmental impact and improving the communities where we live and work.

As Congress seeks to once again reauthorize the CFTC, we would like to emphasize several points starting with this: the CFTC's multi-year effort to implement new swap regulatory rules has now morphed into an effort to rewrite many long-standing futures market regulations that Congress, via Dodd-Frank, never contemplated. These regulations are being proposed without consideration of the real costs on commodity producers or consumers. The additional regulatory costs that the CFTC would force upon end-users and commercial participants will ultimately be passed on to producers and consumers as the costs work their way through the supply chain. There will also be an impact on market liquidity, which will further raise the costs of risk management and ultimately the cost of finished agricultural and energy goods.

CMC would like to commend the House Agriculture Committee for the CFTC reauthorization bill that was passed by this Committee and by the House of Representatives in a bipartisan fashion during the last session of Congress. CMC believes that this Committee's straight-forward approach remains the best way to address several issues end-users still face.

Since the passage of Dodd-Frank, CMC has provided a great deal of information to the CFTC in an effort to help regulators understand how our members use derivatives markets to reduce our operational risks. We have been very appreciative of Chairman Massad's consistent and appropriate emphasis on end-user issues and we have been quite pleased with the Commission's efforts to reconstitute several advisory committees which had not met in several years. The uptick in the number of public Roundtable discussions on a variety of important topics has been greatly appreciated by CMC members. With three still relatively new Commissioners, we have appreciated the Commission's willingness to listen. We appreciate the Chairman's interest in considering end-user concerns and the steps he and the Commission have taken to positively address rules such as the residual interest rule-making. CMC believes there are additional issues that warrant Congress' attention in the context of CFTC reauthorization.

End-User Concerns

CMC recognized the need for and supported reform in the over-the-counter (OTC) swaps market and believes that Dodd-Frank provided a foundation for an effective overhaul of this important risk-management market. However, there are various issues that have arisen as part of the implementation process which we believe the Committee should revisit going forward.

1. Rule 1.35

CMC recognizes the Commission's actions to amend CFTC Regulation 1.35 ("Rule 1.35") and applauds its efforts. However, CMC members still believe that the costs and burdens associated with Rule 1.35 as currently written vastly outweigh any benefits. CMC members remain concerned about the scope of Rule 1.35's requirement to retain written communications made via "digital or electronic media" that "lead to the execution of transactions in a commodity interest and related cash or forward transactions" ("pre-trade communications"). Although unregistered members of a DCM or SEF are now exempted from the requirement to retain text messages, unregistered and registered CMC members are still troubled by the requirement to retain written and electronic records of pre-trade communications.

CMC members believe the proposed changes do not go far enough in providing relief and that the rule will force members to either withdraw from or forego membership in DCMs and SEFs, or, out of an abundance of caution, spend significant amounts of time and resources in a commercially impracticable attempt to capture all required records. Further, CMC members would like additional clarification regarding what constitutes a "text message" under the proposed amendments. CMC believes that the Commission should encourage membership in DCMs and SEFs in order to further promote transparency in the marketplace and to reduce costs for consumers of commodities. If further relief and clarification is not provided, Rule 1.35 will discourage membership in DCMs and SEFs, which will in effect reduce transparency in the marketplace, limit the ability of commercial firms to utilize modern and efficient means of communication, and lead to legal and regulatory uncertainty for end-users and customers.

2. Deliverable Supply Estimates

CMC requests that the Commission make a determination about the deliverable supply estimates for each of the twenty-eight physical commodities covered by the CFTC's proposed rule that will serve as the baseline for spot month position limits. Until a proper deliverable supply baseline is established, it will be impossible to assess the appropriate long or short spot month limits that may be set for individual contract markets.

The Commission has received updated deliverable supply data from affected contract markets which CMC believes are conservative estimates. CMC urges the Commission to make an objective economic study of the relevant physical commodities that could be delivered upon expiry.

Additionally, CMC encourages the Commission to analyze physical markets in an objective fashion that is appropriate for each commodity asset class. The Commission should consider domestic storage capacity, real time production levels and historic import activity for asset classes such as oil and gas. In addition, the Commission should consider refinery capacity when considering deliverable supply for gasoline or other refined products. For grains and soft commodities, storage capacities and flows of the relevant commodity in areas that are in and tributary to the specified delivery points should provide a realistic estimate of deliverable supply.

With an objective economic study made (and an opportunity for public comments), the Commission will be in a better position to deliberate and decide, if necessary, on the appropriate federal spot month position limit levels for each of the relevant commodity asset classes. Upon establishment of federal limits based on updated deliverable supply estimates, the applicable designated contract markets also will be able to continue to use their discretion in setting exchange specific limits below the federal limits as necessary and appropriate to reduce the potential threat of market manipulation or congestion.

3. Bona Fide Hedging

Commercial and end-user firms accept and manage several different types of risks in the supply chain that impact producer and consumer prices. Examples of risks are below:

- Absolute contract price risk with the counterparty (or flat price)
- Relative price risk (basis and calendar spread risk) - unfixed
- Time, location and quality risk
- Execution / logistics risk
- Credit / counterparty default risk
- Weather risk
- Sovereign / government policy risk

All of the above risks directly impact the commercial operations of a merchant and ultimately affect the value of the merchant's commercial enterprise (including the price the merchant pays and receives for a product). In each and every transaction, the above identified risks, including potentially others, are not the same and the relationship between them is constantly in flux. As a result the merchant must make a decision how to not only price the risk in the commercial transaction, but more importantly, how to actively hedge and manage the risks. For instance, in negotiating a forward contract with a potential counterparty, the merchant must take into consideration all of these and will make the most appropriate decision on if/when/how to utilize exchange traded futures contracts to hedge the multiple risks that are present. All of these risks affect price. In other words, the hedging of all of these risks is directly hedging price risk.

The fundamental principle is this: price risk is far more complex than just fixed-price risk, but may include volatility and similar non-linear risks associated with prices, and a transaction to hedge any of these risks in connection with a commercial business should receive bona fide hedging treatment. Regulators should not condition bona fide hedging treatment as available only when risk crystalizes by virtue of a firm holding a physical position or by entering into a contract. Commercial market practices would be severely impacted if hedging transactions were not deemed bona fide hedges. We ask this oversight Committee to help ensure that CFTC regulation empowers commercial and end-user firms to manage risk to the fullest extent possible.

Unfortunately, the CFTC is taking a different course by seeking to adopt a narrow view of risk. Within the CFTC's proposed position limits rule, the Commission has chosen to focus solely on the absolute price risk of a transaction with a counterparty, and is not considering the multitude of risks in the commercial operations of enterprises.

By narrowly defining bona fide hedging, the traditional hedger will be compromised and thus will not be able to effectively manage its risks. If this happens, risk premiums are going to rise throughout the business, which will be passed along the supply chain. Bid/offer spreads will widen and liquidity will be substantially reduced. This narrow view of hedging, if adopted, will mean that producer prices will decline and the cost to the consumer will increase.

Commercial producers, merchants and end-users have provided numerous examples to the Commission in the last three comment letter periods and have explained how detrimental it would be to constrain the market participants that are bona fide hedgers. A summary of several areas of concern related to hedging in the CFTC's proposed position limits rule follow below.

- *Anticipatory Hedging, Merchandising, & Processing*

Within Title VII of Dodd-Frank and in the Commodity Exchange Act ("CEA"), Congress explicitly referred to anticipatory and merchandising hedging as bona fide hedging methods because they are crucial to the risk management functions of commercial and end-user firms. Anticipatory hedging allows commercial firms to mitigate commercial risk that can reasonably be ascertained to occur in the future as part of normal risk management practices. Merchandising activity enables producers to place commodities into the value or supply chains and ultimately brings those commodities to consumers with minimal price volatility.

In addition, merchandising activity promotes market convergence – a crucial aspect of the price discovery function commodity markets serve. A reduction in the efficiency of convergence increases risk, reduces liquidity, and ultimately may lead to both higher consumer prices and lower producer prices. Allowing the full scope of hedging activity promotes more efficient, effective and transparent markets – exactly the public policy goals of the Commission.

Also of concern is the issue of the anticipatory processing hedge. While the Commission's proposed rule states that such hedges are bona fide, the proposed rule simultaneously extinguishes the utility of the exemption by stating that anticipatory processing positions will only be recognized as bona fide if all legs of the processing hedge are entered into equally and contemporaneously. Hedging is based on human assessment of risk at any given time. Sometimes it is best to hedge just one leg of processing exposure. The proposed parameters around the processing hedge exemption not only fail to recognize market dynamics; worse, they put the Commission in the position of defining risk and mandating how that risk must be hedged in the market.

- *Economically Appropriate Risk Management Activities*

CMC would also like to express concern to this Committee with language in the CFTC's proposed position limits rule which suggests that a bona fide hedge only exists when the net price risk in some defined set is reduced. This is inconsistent with the manner in which a commercial firm evaluates risk – which is not limited to price risk, as mentioned above. The most appropriate way to deem a derivatives transaction as "economically appropriate" is whether a commercial firm has a risk abated by the transaction, and such risk arose in its commercial business.

Linking the ability to engage in bona fide hedging to a net reduction in risks across an entire enterprise, corporate family, or separately-managed lines of business is not consistent with how commercial firms commonly address risk. Moreover, individual firms identify which risks they want to accept. A transaction that may be risk reducing on one side of a business, but leave an opposite risk unhedged in another part of the business might serve legitimate business purposes. Thus, to impose a “net price risk” formula across a corporate group for purposes of bona fide hedging effectively replaces a commercial firm’s business judgment with regulatory prescription.

- *Non-Enumerated Hedges*

Non-enumerated bona fide hedges are important to commercial market participants, as they allow additional flexibility for firms to hedge risk in ways that are unforeseen. However, the ability to utilize these non-enumerated hedges is often dependent upon utilizing the hedging strategy in real time in response to fluid market conditions. Specifically, merchandisers and other intermediaries (physical, financial and risk, among others) play a vital role in helping end-users understand and ultimately reduce their risks. To the extent that these merchandisers and other intermediaries are unable to get exemptions for the hedges they require to provide these services, risk mitigation will be reduced and overall systemic risk will increase.

CMC supports allowing market participants to engage in non-enumerated hedging activity subject to a reasonable review period similar to that contained within current CFTC Regulation 1.47. In addition, we would like to emphasize that the expertise of the exchanges should continue to be drawn upon by the Commission to allow a timely review of these petitions in the most efficient manner for the Commission.

- *Cross-Hedging*

Cross-hedging is another important hedging tool for commercial participants, and is particularly important for commodities which may be processed or transformed into products which may not be traded commodities. CMC believes that commercial firms should be granted the discretion to determine what relationships between two positions are correlated sufficiently to be considered “substantially related.” The CFTC has advanced a notion of a bright-line test with respect to the regulation of cross hedges. The decision to use a cross-hedge is multi-factored, and commercial businesses have a natural profit incentive to achieve as great a correlation as possible. However, a fixed correlation is not always achievable, and sometimes risk managers are limited in their selection to what products are available. CMC members believe that a position limits regime where risk managers can freely select their cross-hedges, report them as such, and stand ready to explain them to the Commission if necessary is the proper regulatory design.

CMC has urged that the Commission not impose an arbitrary deadline upon which market participants engaged in cross hedging must exit their hedges in the spot month, near month, or in the last five trading days. DCMs should be permitted to set restrictions on a contract-by-contract basis, recognizing the unique characteristics of each individual commodity and contract, and the need (or lack thereof) for commercial end-users to continue to utilize cross-commodity hedges in a specific market during the spot month, near month, or in the last five trading days.

- *Gross and Net Hedging*

CMC continues to request that the Commission allow end-users to utilize both "gross hedging" and "net hedging" concepts when managing risk. The Commission uses concepts of both "gross hedging" and "net hedging" in its discussion of the economically appropriate requirement, but these terms are not separately defined and the context in which they appear does not fully inform their meaning. CMC understands gross hedging to be the practice of separately hedging each of two or more related positions. Net hedging happens when that firm nets its cash purchase and sale contracts to a net long or short position and then offsets that risk by entering into short or long derivatives transactions, respectively. It is crucial that the Commission affirm that each of these methods entail derivatives that would be eligible for bona fide hedging treatment. Additionally, when utilizing gross hedging, firms should have the flexibility to hedge either the gross long or the gross short when this is the most economically appropriate risk management position.

- *Wheat Equivalence Determinations*

It is critical to maintain equality among the three U.S. Wheat markets: Chicago, Kansas City and Minneapolis. Currently, each market has the same spot month limit and the same single-month and all-months-combined limit. Regardless of the level at which these limits are set, parity should be maintained among these three markets. Different limits for the same type (but not necessarily variety) of commodity could dramatically impact the growth or potential for risk mitigating strategies between the contract markets. In the case of wheat, this is particularly critical given the nature of the three differing varieties. Having three varieties provides not only additional opportunities for market participants to reduce risk through spread trades, but also provides opportunity for hedging and risk management by commercial participants between markets in response to domestic or global economic factors.

4. Trade Options

CMC is urging the Commission not to categorize trade options as referenced contracts subject to position limits. These physical options, including physical forward transactions with embedded volumetric optionality, are an important tool in physical commodity markets. Trade options may be used to manage, among other things, supply chain risk, price risk or both. Subjecting these products to federal position limits could severely harm the efficient operation of physical commodity markets and increase costs for end-users.

Trade options do not trade like physical futures and cannot simply be traded out of or unwound prior to the spot month. In the spot month, a trade option that does not qualify as a "bona fide hedging position" could only be offset with another physical position to bring the net position within the applicable position limit. Taking on a physical position in order to offset a trade option for position limit purposes could introduce new risks to the market participant and would undermine the entire purpose the market participant entered into a trade option in the first place. Such a result would be extremely disruptive to the physical markets.

The burden on market participants associated with speculative position limits on trade options would be substantial. Market participants would be required, for the first time, to track trade options separately from spot and forward contracts, develop systems to calculate the futures contract equivalents for these physical-delivery agreements, and, ultimately, monitor trade option positions for compliance with applicable limits.

5. Aggregation

CMC is recommending that the CFTC not pursue aggregation of positions only based upon affiliation or ownership. Instead, the Commission should require aggregation of positions where an entity controls the day-to-day trading of a portfolio of speculative positions. In the past, Commission staff highlighted the possibility of using the independent account controller safe harbor as a model for not requiring aggregation among related companies where there is ownership but not control. CMC applauds this approach and believes it may provide a useful framework for capturing the purposes of position limits while not unduly burdening otherwise separate trading activities.

Towards that end, CMC recommends the Commission adopt an exemption from the requirement that persons under common control ("excluded affiliates") aggregate their positions under certain circumstances described below.

Accounts of entities under common ownership need not be aggregated where the entities are excluded affiliates. An excluded affiliate should be defined as a separately organized legal entity:

> (1) That is specifically authorized by a parent entity to control trading decisions on its own behalf, without the day-to-day direction of the parent entity or any other affiliate;
>
> (2) Over whose trading the parent entity maintains only such minimum control as is consistent with its fiduciary responsibilities to fulfill its duty to supervise diligently the trading of the excluded affiliate or as is consistent with such other legal rights or obligations which may be incumbent upon the parent entity to fulfill (including policies and procedures to manage enterprise wide risk);
>
> (3) That trades independently of the parent entity and of any other affiliate; and
>
> (4) That has no knowledge of trading decisions of the parent or any other affiliate.

CMC appreciates the Committee's consideration of our views regarding the regulation of bona fide hedging.

6. The Swap Dealer De Minimis Level

As the Committee is aware, the swap dealer de minimis level, currently set at $8 billion, is slated to drop to $3 billion by the end of 2017. CMC members are concerned that a lower swap dealer de minimis level will cause companies to exit the swap business because the extra costs of swap dealer registration are not sustainable for most non-financial companies. This in turn would lead to fewer counterparties available to offer end users risk management solutions.

A lower swap dealer de minimis level would lead to further consolidation of the swap business toward only a hand-full of registered swap dealers, mostly Wall Street banks. This threat is not purely hypothetical: when the CFTC initially proposed a lower dealing threshold for counterparties of municipal utilities, those utilities found that liquidity rapidly disappeared and the number of available counterparties diminished. Eventually the CFTC was forced to retreat and increase the de minimis level for energy swaps with municipal utilities to $8 billion dollars.

It is likely that a lower de minimis level would have the same effect, not only for utilities but all companies that use swaps to manage risk. We respectfully urge the Committee to adopt a provision similar to that contained in last year's reauthorization bill which would prevent the de minimis level from dropping without a new rulemaking by the CFTC.

CMC believes the self-executing provision in this rule as well as the provision that was recently reversed by the CFTC involving its residual interest rule are fundamentally flawed. We applaud the Commission for their reversal on residual interest and urge this Committee to encourage the Commission to do the same regarding the swap dealer de minimis level.

In addition to these specific regulatory topics, CMC encourages Congress and the CFTC to continue to seek resolution to international regulatory issues. Two in particular are US-EU equivalence and the Basel III Leverage Ration. With regard to the US-EU equivalence issue, the lack of an equivalence determination has significant impacts to end-users that operate globally and depend on access to US exchanges and clearinghouse for risk management. For example, right now U.S. futures contracts count as "OTC derivatives" under the European Market Infrastructure Regulation (EMIR) because US futures exchanges have not yet been "recognized" by European regulators. This creates a disincentive for commercial end-users (Non-financial counterparties, or NFCs under the EMIR construct) that prefer not to be subject to the EMIR OTC thresholds and registration requirements as an NFC+. We are encouraged by recent progress on the broader equivalence debate and hope to see this resolved soon.

With respect to the Basel III Leverage Ratio issue, CMC members are deeply concerned that the leverage ratio will significantly increase the cost of hedging for end-users. CMC was very encouraged by Chairman Conaway and Ranking Member Peterson's letter to the Federal Reserve and also by Chairman Massad's public comments on this issue. We appreciate your engagement on this issue and hope to move the international regulatory community in the right direction.

Conclusion

Commodity derivatives markets continue to grow and prosper. They have become deeper and more liquid, thereby narrowing bid/ask spreads, and improving hedging effectiveness and price discovery. All of these developments benefit much more than just those who trade commodities. Efficient derivatives markets offer providers of food and energy the ability to reduce the multitude of risks they must manage. Consumers are the ultimate beneficiary of these efficiencies.

The swaps market reforms in Dodd-Frank were not required because of problems in physical commodity markets. Commercial end-users of agricultural and energy futures had no role in creating the financial crisis. In fact, the regulated futures market fared well throughout the financial crisis. CMC members recognize the need for the Dodd-Frank Act and support its goals, yet these regulations should be efficient and reasonable rather than overly prescriptive and complex.

We believe that as Congress considers how the CFTC is to regulate in the future, it should use the core principles on which the CFTC was founded as its guide. A balance must be maintained between regulatory zeal and consideration as to how regulatory changes could result in negative consequences to not just CMC members in the middle of the food and energy chain, but also to the producers and consumers on each side of the chain. Undue regulatory interference with the hedging mechanism introduces risk that must be priced into the chain, negatively affecting both ends and everything in between. Given this, we strongly believe that the CFTC's post Dodd-Frank trend toward very prescriptive changes to futures market regulation will hinder rather than improve our economy's ability to manage commodity market risks.

While the independent regulatory agency that this Committee has oversight responsibilities over must continue to evolve in order to adequately regulate increasingly complex derivatives markets, many of these pending changes also introduce the potential for regulators to *create* risk and increase costs by going beyond their purview. Doing so, without consideration of the consequences, is dangerous and goes against both the "do no harm" principle of regulation as well as the CFTC's core principle regulatory heritage.

Compliance costs for end-users have skyrocketed in the past year. Today, agriculture and energy end-users are faced with thousands of pages of new CFTC rules that no one person can comprehend followed by a multitude of letters issued by the Commission to clarify rule language, extend compliance dates, or provide temporary no-action relief.

But the problem isn't only that this complexity and regulatory uncertainty adds unnecessary costs. It is also that, uncertainty, via additional regulation of the risk management tools that commodity market participants utilize, *actually creates risk* where it didn't previously exist.

CMC members mitigate risks by hedging. The fact that future regulation may determine that the risk management methods we have described here today may no longer be considered hedging is of enormous concern and is an example of where risk could be created.

When regulatory initiatives lack clarity or evolve to be at cross-purposes with the core principles on which the Commission was founded, CMC members are compelled to reach out to this Committee for help. We believe last year's CFTC reauthorization bill provided significant clarity to the marketplace and we hope to be a resource to the Committee once again as it pursues CFTC reauthorization this year.

Thank you for this opportunity to testify. We look forward to continuing to work with this Committee to strike the right balance.

I look forward to your questions.