

**Statement
of
The National Cotton Council
American Cotton Shippers Association
AMCOT
Submitted
to
The House Committee on Agriculture
on
The 2009 Derivatives Markets Transparency and Accountability Act
February 4, 2009**

Chairman Peterson, Ranking Member Lucas, and members of the Committee, I am Gary Taylor, CEO of Cargill Cotton Company in Cordova, Tennessee. Cargill Cotton is a division of Cargill, Incorporated, an international provider of food, agricultural and risk management products and services. We service growers, ginners, buyers and textile mills worldwide through our network of buying, selling and shipping offices and our cotton gins and warehouses. I appear today representing the members of the National Cotton Council, the American Cotton Shippers Association, and AMCOT, a trade association of marketing cooperatives.

We appreciate your scheduling this week's hearing and the outstanding leadership you have provided this past year on this subject critical to farmers, marketers, processors and consumers of agricultural and energy products. The involvement of the Committee this past year exemplifies its interest and its willingness to effectively oversee the commodity futures markets and to address issues vitally important to the functioning of the U.S. economy.

Impact of Futures Markets on Cotton Industry

The sound and effective regulation of a transparent futures market would provide significant benefits to the cotton industry, which is concentrated in 17 cotton-producing states, stretching from Virginia to California with the downstream manufacturers of cotton apparel and home furnishings located in virtually every state. The industry and its suppliers, together with the cotton product manufacturers, account for more than 230,000 jobs in the U.S. The annual economic activity generated by cotton and its products in the U.S. is estimated to be in excess of \$100 billion.

In the past year, the cotton industry has undergone severe financial strain due to the uncertainty and unpredictable risk caused by a dysfunctional futures market. Coming to light is the damage of the March 2008 debacle in the ICE No. 2 Upland Cotton Contract as a number of first handlers have been forced into bankruptcy, several have announced orderly closures, and most have seen their assets dwindle to a critical level. Traditional merchandising relationships between growers and buyers have ceased because price risks are too great for short hedging purposes. Growers continue to be concerned about the financial viability of marketing entities with whom they have previously contracted crop sales. The inability of merchandisers to hedge their risks translates into a weaker basis and lower prices offered to

the cotton producer. Each penny reduction in the price of cotton means that U.S. cotton farmers lose \$85 million in revenue. Therefore, to insure the survival of our marketing structure, the cotton futures market must be returned to its historical function of price discovery and risk management relative to real market conditions.

The Lesson Learned

As the cotton industry and the agricultural complex informed this Committee in 2008, investment funds and Over-the-Counter (OTC) operatives flooded the futures markets with record amounts of cash, throwing the trading fundamentals out of balance, resulting in a widened basis, and thereby making these markets illiquid for those for whom Congress created these markets. The presence of large speculative funds and index funds in the energy and agricultural futures contracts distorted the futures and the physical or cash markets of these commodities. The abundance of unregulated cash allowed these funds to overwhelm these markets negating their primary purposes.

Long before others in the Congress or the regulatory agencies recognized the problem or began to take action, the House Agriculture Committee had hearings underway and appropriate legislation before the Congress. Now, the leaders of the developed and developing world are calling for the U.S. to effectively regulate the commodity markets. We commend the Committee for that bipartisan foresight and believe that the legislation before the Committee, *The Derivatives Markets Transparency & Accountability Act of 2009*, would address the concerns raised by the cotton industry and the agricultural sector and restore the confidence of the commercial trade and the lending institutions. Above all, it will facilitate market fundamentals, not speculative activity, resulting in accurate price discovery in the futures markets.

The Importance of Market Liquidity

The cotton industry acknowledges the importance of market liquidity and the essential function the speculative interests perform in the commodity markets. We welcome that participation and do not wish to discourage it. In our view, the legislation before the Committee by requiring full transparency and accountability of speculative trades would not discourage speculative participation in the commodity contracts. Market liquidity is essential, but it must be tempered and monitored – it should not dictate the direction of the market.

Speculative Position Limits & the Swaps Exemption

In the current regulatory structure of the futures markets, 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 three reasons:

1. The CFTC has granted Hedge Exemptions to the investment funds allowing them to exceed the limits;
2. Large traders were permitted by Congress, through the Swaps Exemption, to operate outside the regulatory framework altogether; and
3. Non-traditional traders speculative limits are only imposed as contracts go into convergence.

The other significant area of concern is the exempt status afforded Swaps transactions that are executed off-exchange with each party mutually agreeing to satisfy each other's credit standards and to remit margins to one another as the underlying market fluctuates. Such transactions, however, pose problems when one of the parties to the Swap has a "Hedge Exemption" that exempts his or her on-exchange futures trading from position-size limits.¹

These arrangements, along with the billions of dollars invested in index funds, brought so much cash into the market that the traditional speculators could not take a short position to match the institutional longs. This left it up to the commercials to offset these positions. But lacking the necessary capital to meet the huge margin requirements, they could not do so.

That has been the situation this past year as the funds continued to purchase futures. Unwilling to assume such margin risks in such a volatile futures market, the commercial traders were forced to remain passive not only in the futures, but in the physical markets as well. The result: markets with no economic purpose for the commercials. Therefore, no business was done. Producers, lacking a price, could not properly plan and processors had to buy hand to mouth. Simply put, the investment funds have negated the real purpose of the futures markets, causing severe disruptions in the marketing process.

Cotton Industry Recommendations

In order to restore the integrity of the futures and derivatives markets and to ensure that such markets function properly by providing price discovery and hedging thereby allowing producers and manufacturers to lock in prices and merchants and cooperatives to offer forward prices to producers and manufacturers, the U.S. cotton industry has developed a number of recommendations that are incorporated in *The Derivatives Markets Transparency & Accountability Act of 2009*. Congress should:

- Establish trading limits to prevent excessive speculation,
- Subject all contract and over-the-counter market participants to speculative position limits,
- Subject speculative entities to the same weekly reporting requirements as the trade, and
- Limit hedge exemptions and limit eligibility for hedge margin levels to those actually involved in the physical handling of the agricultural commodity.

The cotton industry also believes that the lack of transparency and disparate reporting requirements by market participants is appropriately addressed by the legislation by requiring the CFTC to:

¹ In such situations, 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 a commodity, it can purchase this exposure from a Swaps dealer. The dealer, now short the price of that commodity via the Swap, enters the futures market to hedge his position by buying futures in that commodity. Given that he is a "hedger," the 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 it is unlikely that a Swaps dealer would turn a deaf ear to a financial entity awash in cash.

- Disaggregate index funds and publish the number of positions and total value of the index funds and other passive, long-only and short-only investors, and data on speculative positions relative to their bona fide physical hedges, and
- Establish reporting requirements for index traders and swap dealers in designated contract markets (exchanges), derivative transaction execution facilities and all other trading areas.

In addition to these necessary changes, the cotton industry feels strongly that the CFTC should require the Intercontinental Exchange and its clearing house members to adhere to the practice of margining futures to futures settlements and options to options settlements.

Also, the cotton industry has an important caveat for both the Committee and the CFTC. We submit that no action should be taken to discourage over-the-counter transactions with legitimate commercial purposes – transactions that are transparent and have proven to be beneficial risk management tools utilized by producers, merchants, and manufacturers. It is essential that we encourage commercial innovation for those producing, merchandising, manufacturing, or using the physical commodity traded in the futures markets.

In closing, I would like to stress that restoring confidence in the futures market is of the utmost importance to our industry. Thank you for considering our views and recommendations during the development and consideration of this vitally important legislation.