November 26, 2010

Mr. David A. Stawick
Secretary
Commodity Futures Trading Commission
Three Lafayette Center
1155 21st Street, NW
Washington, DC 20581

Re: Agricultural Commodity Definition (CFTC RIN 3038-AD23)

Dear Mr. Stawick:

Better Markets, Inc.[1] appreciates the opportunity to comment on the above-captioned proposed rules (the "Proposed Rules") of the Commodity Futures Trading Commission ("CFTC"), the purpose of which are to define "a swap in an agricultural commodity" as required by provisions of the Dodd-Frank Financial Services Reform Act (the "Dodd-Frank Act"). As noted in the Notice of Proposed Rulemaking, "[n]either Congress nor the CFTC has previously promulgated a definition of that term for purposes of the [Commodity Exchange Act] or CFTC regulation."[2]

Introduction

We proposed alternative definitional language that focuses on the realities of the marketplace and better aligns the regulatory structure with what actually happens (and will happen post-rule) in the marketplace. This market-based approach will avoid the very real concerns raised by the Proposed Rules of market participants gaming the regulatory

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1 Better Markets, Inc. is a nonprofit organization that promotes the public interest in the capital and commodity markets, including in particular the rulemaking process associated with the Dodd-Frank Act.

2 Notice of Proposed Rulemaking, 17 CFR Part 1, page 65586.

system to avoid application of what might appear to be clear rules, but which leave open gaps that can – and will -- be exploited.

While the definition in the Proposed Rules encompasses four categories,[3] this comment focuses on the fourth category:

> Commodity-based contracts based wholly or principally on a single underlying agricultural commodity.[4]

The practical significance of the fourth category of the Proposed Rules is substantially limited to a narrow focus: whether commodity based contracts having composite index reference prices will be subject, in whole or in part, to future regulations specific to agricultural commodities and to the potential for imposition of position limits.

The Supplementary Information section of the Proposed Rules expands on the meaning of commodity-based contracts described in the Proposed Rules. It states, in relevant part:

> Such contracts do not necessarily involve the potential for physical delivery of the underlying agricultural commodity… [and] would also include an index based wholly or principally on a single underlying agricultural commodity.
>
> Also, any index made up of ***more than*** 50% of any single agricultural commodity would be considered a commodity-based contract.... [5] (Emphasis added)

Thus, the Proposed Rules assert that a swap based on an index composed of two prices of agricultural commodities, each weighted equally, would *not* constitute a commodity-based contract. Only an index that had a single agricultural commodity that exceeded 50.1% would be subject to the Proposed Rules.

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3 Proposed Rules Section II.
4 Id.
5 Notice of Proposed Rulemaking, 17 CFR Part 1, page 65590.

The Proposed Rules then consider the definition of "excluded commodity" in the CEA and note that it could be read to include *any* index of agricultural commodities. That definition provides, in part, that "excluded commodity" means

> any economic or commercial index based on prices, rates, values, or levels that are not within the control of any party to the relevant contract, agreement, or transaction.[6]

The Commission wisely rejects that reading. It correctly reasons that to accept that reading would "frustrate the requirement in Dodd-Frank that swaps in agricultural commodities be permitted only pursuant to a Section 4(c) order of the" Commission.[7] Importantly, the Proposed Rules observes that

> [a]pplying a mechanical interpretation of the definition of excluded commodity could permit "gaming" by allowing an index based principally, or even overwhelmingly, on one agricultural commodity to avoid the limitations on trading agricultural swaps that are found in the Dodd-Frank Act.[8]

The rationale set forth in the Proposed Rules is extraordinarily persuasive. Indeed, the concerns about "gaming" are fully justified by the history and practices of the commodities markets. However, such concerns are not limited to the narrow instance identified in the Proposed Rules.

That is why the basic approach of the Proposed Rules to the concept of commodity-based contract needs to be refined to take into account how the marketplace functions *and* how it will respond to any rulemaking in this area. Unfortunately, as proposed, the rules will almost certainly encourage the very type of gaming that is cited as a concern by the Commission in its analysis of the "excluded swap" definition.

The Proposed Rule is based on answering the question "What is an agricultural commodity index?" But, it may be more helpful to ask and answer the following, slightly different question: "What is a swap, the reference price of which is a composite of prices, including an agriculture commodity price?"

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6 CEA, Section 1 a(19)(iii) [as renumbered by the Dodd-Frank Act].

7 Notice of Proposed Rulemaking, 17 CFR Part 1, page 65591.

8 Id.

We proposed this as the more appropriate question because it focuses on the realities of the marketplace and better aligns the regulatory structure with what actually happens (and will happen post-rule) in the marketplace. Equally important, it also avoids the very real concerns raised by the Proposed Rules of market participants gaming the regulatory system to avoid application of what might appear to be clear rules, but which leave open gaps that can – and will -- be exploited.

A Market-Based Approach to Index Swaps

This section focuses primarily on swaps based on indices that are composites of reference prices, at least one of which is the price of an agricultural commodity. This category of swaps will be referred to as "Composite Index Swaps."

As defined in the Proposed Rules, a market participant holding a long Composite Index Swap may or may not be holding a commodity-based swap. If it is assumed that the swaps index is calculated as 30% corn, 30% wheat and 40% soybeans, then the swap has no effect on the market participant's position in soybeans (or anything else) for position limit purposes.

Assume that another market participant holds three long swap positions, having an aggregate notional quantity value equal to the implied notional quantity value of the Composite Index Swap described above. Thus, the aggregate notional quantity value of the three swap positions is distributed: 30%, corn, 30% wheat and 40% soybeans. However, each of these swap positions will increase the long position in the relevant product for regulatory position limit purposes.

In reality, the economic effects of the two examples cited above are the same. The results under regulations should also be the same.

Market practices reinforce the view that the formal differences between the two examples should not be the basis for a different result. In both cases, if the market participant wished to hedge the soybean risk only, it would enter into a conventional reversing soybean future or swap.

The regulatory difference, which would occur under the Proposed Rules, between the results for the two market participants (and the marketplace) is not rational and would encourage the very behavior the rules seek to avoid. Market participants will easily game the differences between the two transactions above to avoid the imposition of the rules as currently proposed.

Thus, if the second market participant's long wheat position is large enough to threaten the breach of a position limit, the only sensible market move for that participant would be to enter into a transaction with a bank to convert his three swap positions into a Composite Index Swap. Thereby, the position limits are avoided merely through the form of the transaction notwithstanding the identical substantive financial similarity between the two.

No one can doubt that will become a new line of business for banks. And, they will market and sell what they will call an "innovation" as a legal and permissible way to avoid the imposition of position limits.

The new business line suggested in the prior paragraph is a real potential result. Indeed, it takes almost no imagination to foresee the creation of an electronic product that scrubs a portfolio to minimize regulatory position amounts. For every structure in a portfolio that falls within the Proposed Rules and is, thereby, potentially subject to position limits, the program would automatically propose an alternative form that would not fall within the Proposed Rules and would not trigger position limits. Form triumphs over substance and the regulatory intent are defeated by avoidance, as is the purpose of the law in this area.

However, the primary purpose of adopting a market-based approach is not merely to avoid market participants gaming the rules and avoiding the regulations. The gaming possibility simply highlights the conclusion that a market-based regulatory approach, as proposed herein, is more practical and consistent with the market realities than a focus on characterizing the index.

For example, in analyzing Composite Index Swaps, the Proposed Rules focus heavily on the nature of the index. This leads to difficult and arbitrary line-drawing. For instance, the substantive difference between an index which is 50% based on a single commodity and one which is 50.1% based on such commodity is difficult to discern and even more difficult to justify.

The proposed market-based analysis focuses on the structure of the Composite Index Swap. Each composite element of the index actually represents a separate swap. Viewed this way, the results rationally reflect market reality. And, importantly, the rule cannot be gamed. Calling a Composite Index Swap a single swap, as the Proposed Rules do, and documenting it accordingly does not make it so.

Aligning the Proposed Rules to the Realities of the Marketplace

We proposed changing paragraph numbered 4 in Part II A of the Proposed Rules in the following way:

> (4) Commodity-based contracts based on a single underlying agricultural commodity; *provided that* contracts based on composite prices in the form of an index, which composite prices include one or more agricultural commodities, shall be considered to be one or more commodity-based contracts pro-rata based on the relevant weighting of each such single agricultural commodity in the index.

This language is focused on the substance of the transactions that occur in the marketplace and will be form-neutral. It also achieves the goals of the Proposed Rules and the Dodd-Frank Act.

Conclusion

Because it reflects the realities of the marketplace and is informed by the long history of market participants' practice of gaming and avoiding rules, we respectfully suggest that the Commission adopt the market-based approach to the definition of Agricultural Commodities proposed here.

We hope these comments are helpful in your consideration of the Proposed Rules.

Sincerely,

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By wct

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