ACSA

American Cotton Shippers Association
88 Union Avenue, Suite 1204
Memphis, TN 38103
United States

P +1 901 525-2272
F +1 901 527-8303
www.acsa-cotton.org

Senate Banking Committee Hearing

June 9, 2021

Provided by:

DeltaStrategy Group

OVERVIEW

For questions on the note below, please contact Daniel Austin or Edmund Perry at 202-547-3035.

Today, the U.S. Commodity Futures Trading Commission (CFTC or Commission) held a meeting of its Agricultural Advisory Committee (AAC or Committee). The Committee received a report from the Subcommittee to Evaluate Commission Policy with Respect to Implementation of Amendments to Enumerated Agricultural Futures Contracts with Open Interest (Subcommittee). The meeting also included a discussion on global ag commodity derivatives contracts and other agricultural risk management issues.

Key Takeaways

• David Rossen, Global Hedging Manager – Cotton, Louis Dreyfus, said that the pandemic caused the textiles industry to halt activities, leading to the market falling far short of USDA estimates for cotton bale usage and impacted every level of the supply chain. Rossen said the pandemic also led to concerns that counterparties would delay or default on cotton futures contracts but that the CFTC was able to handle these risks and provide market stability.

• Rossen said that cotton markets will take time to normalize, but they demonstrated their ability to withstand even the most extreme market events. He said that futures markets performed relatively well through the pandemic, maintaining their role as positive risk management tools. Rossen noted that the ability to use anticipatory merchandising as a hedge was an important tool for the industry.

• Dhamu Thamodaran, retired chief commodity hedging officer for Smithfield Foods, said that the primary impact of U.S. tariffs on China were on American producers and that the U.S. should remove these tariffs. He said that the increase in Chinese demand for

American livestock was due more to pandemic-related shortages than the trade deal. Rossen said that the trade war with China caused it to shift away from America being its preferred source of cotton, and the primary burden of carrying excess inventory fell on American producers.

• Owain Johnson, CME Group, said that there has been a recent series of successful ag futures cash settlements that have led to an increase in interest in cash settlements. Johnson said that cash settlements have several advantages, including needing less liquidity. He said that the Commission should work to determine which Price Reporting Agencies (PRA) are sufficiently reputable and reliable for the ag industry but added that cash settlement will never fully replace physical settlement for ag products.

• FIA's Will Acworth said that China now has a very large ag futures market and no other jurisdiction outside of the U.S. is close to as large. He explained that ag futures trading is fragmented by geography but is concentrated in terms of liquidity. Acworth recommended measures to lower costs for market access, saying it would lead to more liquidity and improved price discovery.

SUMMARY

Opening Statements

Commissioner Dawn Stump (AAC Sponsor)

There are similarities between the topics this Committee considers and those discussed by the Global Markets Advisory Committee. One issue we share is growing market access for those with hedging needs.

Acting Chairman Rostin Behnam

Ag products and futures contracts are the origins of the futures markets. The use of futures contracts to determine prices and hedging risk is critical to American families' daily lives.

Subcommittee Presentation

Joseph Janzen, Subcommittee Chair, University of Illinois

The current process for evaluating changes to ag futures contracts with open interest works well, but there are some current practices that could be improved. Exchanges and market participants want timely implementation of changes to achieve regulatory compliance, while also avoiding material impacts on existing positions.

Exchanges and market participants typically identify necessary changes and report them to the Commission. One challenge is lengthening the listing cycle with significant open interest in deferred months. It is important to not define materiality, because this would be overly prescriptive and incompatible with principles-based regulation.

Commission engagement before and after change submissions is beneficial. The Commission should provide information on enumerated contracts and past determinations; systematically engage with market participants and define conditions for soliciting public comments; and more.

Q & A

Buddy Allen, American Cotton Shippers Assoc.: Thank you to the Subcommittee for its service generating these recommendations.

Global Markets for Ag Derivatives: Products & Trends

Owain Johnson, Global Head of Research and Product Development, CME Group

PRAs assess fair prices of commodities and report to a wider audience that uses them for the basis of physical or financial transactions; we have come to see their use increasingly in ag. The ag industry was slow to adopt the PRA model due to the fact that physical delivery futures already worked well, and there has typically been sufficient data available from governments.

Ag trade is also of lower value on a per-ton basis compared to markets like energy, so ag firms are less willing to pay PRA subscription rates. PRAs are being used more because the ag market is becoming more global, as well as the evolution of energy products to make the ag sector more intertwined with energy PRAs. There has also been growing interest from ag firms in more granular risk management to manage quality or location risks.

Cash settlements in the ag market have been successful in recent years, leading to an increase in their usage. The key to determining settlement method is participant confidence in delivery infrastructure and cash index data. It is important to have adequate, minimum CFTC requirements on cash settlements.

Because of the lack of delivery risks, cash settlement does not require continuous liquidity and allows participants to trade sooner. The CFTC should determine reputable and reliable PRAs for the ag market.

Will Acworth, Senior VP, Publications, Data and Research, FIA

Chinese exchanges accounted for 79 percent of the number of ag futures and options contracts traded last year; however, annual volume and open interest are not directly related. The U.S. accounted for 49 percent of the total number of contracts outstanding at the end of 2020, compared to China’s 40 percent.

The 12 most heavily-traded contracts based on volume are traded on Chinese exchanges, but based on open interest, CBOT is ranked higher because of options contracts for corn, soybeans, and sugar. Oil and oilseed contracts account for the largest amount of trading outside of the U.S. Chinese exchanges drive trends in trading volume, but U.S.

exchanges hold a large share of open interest. Both trading volume and open interest of grains contracts hit record levels in the second half of last year.

China's DCE has developed a large market for futures on soybeans meal. Trading activity in soy contracts picked up in the second half of last year but did not reach the peak set in 2016. ICE and Euronext account for less than 10 percent of trading volume in canola contracts but more than half of all open interest. Open interest of palm oil contracts reached record levels in the second half of last year.

The volume of Chinese cotton contracts is larger after adjustments than the volume of U.S. contracts. China's CZCE has become an important center for price discovery and risk management in cotton contracts.

Q & A

Stump: What is the significance of the large cotton contracts trading on Chinese exchanges? Rossen: China uses much more cotton than the U.S., but they produce significantly less; Acworth: Chinese markets are much younger than U.S. markets, but there is significant interest in increasing market infrastructure to recruit international participants.

Commissioner Dan Berkovitz: Why have some markets chosen not to move to cash settlement? Fred Seamon, CME Group: There are fewer negotiated trades in cash markets than in the past. Markets like the live cattle market have been performing well but have continued to use physical settlement. If the underlying cash market provides better data than the physical market, changing it will be considered.

Joe Barker, Natl. Council of Farmer Cooperatives: The CFTC should continue its work to improve market access, bring new futures products to market to create more opportunities to hedge risks, and increase transparency in futures markets.

John Owen, USARice Federation: Why is there not an active futures market for rice in China? Acworth: There is an active futures market for rice in China, but it is not in the top 15 in terms of market volume.

Perspectives on the Pandemic, Recovery, and the Importance of Ag Risk Management Part I: Ag Processors and Merchants

Moderator: Christa Lachenmayr, CFTC

Panelists: David Rossen, Global Hedging Manager – Cotton, Louis Dreyfus; **Christian Edmiston**, Director of Sourcing and Risk Management, Land O'Lakes; **Dhamu Thamodaran** (Retired) Executive VP, Chief Strategy Officer & Chief Commodity Hedging Officer, Smithfield Foods

Lachenmayr: What was your firm's experience during the pandemic? Edmiston: From our perspective, the pandemic increased market volatility drastically due to demand provided by government programs. We had not considered our ability to adjust risk management practices quickly prior to the pandemic, which led to system risks.

Lachenmayr: What was the impact of the pandemic on the cotton sector? Rossen: As governments issued stay-at-home orders, the textile industry came to a halt. USDA's estimate for bale use was 210 million bales, but the market fell significantly short. Given the time of year that the lockdowns began, the merchant community had assumed a large amount of price risk. The viability of people's hedges was called into question. Certain counterparties attempted to delay or default on contracts, but the Commission stepped up and contributed to market stability. The cotton market will take some time before normalizing, but it demonstrated its ability to withstand even the most extreme events.

Lachenmayr: What was the impact of the pandemic on livestock markets? Thamodaran: Risk management has never been more important. Pork production dropped 30 percent, but demand is now increasing sharply, creating massive supply chain problems. There have been hedging problems because we could not match our hedges with delivery, and restaurants were unable to take products. Now that plants are running again, we are facing a labor shortage. On the futures side, volatility is incredibly high, and we do not have the margin capacity to handle some hedging positions.

Lachenmayr: What has been the impact of the U.S.-China trade deal? Rossen: As the trade war began, China shifted away from choosing the U.S. as its preferred cotton supplier; U.S. export values were impacted. The burden of carrying inventory fell on American producers. The trade deal has shifted those burdens off of the U.S., and we have seen trade flow and prices evolve. There has been a significant increase in Chinese demand for ag products; Thamodaran: U.S. producers carry the burden of our tariffs. Prior to the pandemic, China produced half of the world's pork, but they now need a lot more. This demand is due more to the pandemic, not the trade deal. We need to eliminate U.S. tariffs on Chinese goods; Edmiston: China is the largest global importer of dairy products, and they are important to U.S. markets. The trade war contributed to what were already low prices. Recently, China has been a significant driver of exporter demand.

Lachenmayr: What should the Commission consider to enhance regulatory flexibility? Rossen: The futures markets behaved correctly during the pandemic. The ability to use anticipatory merchandising as a hedge was very important; Thamodaran: Regulatory change is not necessary. Position limits are the issue. We are always close to the limits, leading us to deny hedging requests; Edmiston: I would echo the comments that David Rossen made. Liquidity is a challenge in the butter market. We have been moving from futures to options because they provide more barriers to liquidity problems.

Q & A

Barker: How did industry coordinate during the government intervention? Edmiston: Government support programs happened rapidly, and coordination was challenging but unavoidable; volatility has since declined. There is now more room for more deliberate planning and communication; Thamodaran: The pandemic has led to hundreds of millions of dollars in losses to the food service industry.