



CFTC's Bart Chilton sees 'massive passives' as one factor in cotton's '08 price spike

By Jon H. Harsch

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Washington, Jan. 7 – Commenting on Tuesday's Commodities Futures Trading Commission (CFTC) "Staff Report on Cotton Futures and Option Market Activity During the Week of March 3, 2008," CFTC Commissioner Bart Chilton says the report shows that "There is no smoking gun, nor a single manipulator who will go to jail." Instead, he says, "there was a collection of potential culprits. Multiple factors converged in an atypical manner."

Chilton concludes that one key factor in cotton price volatility in 2008 may have been "new speculators" he characterizes as "massive passives." He writes that:

- "Since its inception, the cotton market has been a comparatively stable market, comprised for the most part by commercial traders. Speculators certainly existed, as they do in all markets. Without speculators, it would be impossible to have orderly functioning markets. That said, there are new speculators who in recent years have shifted their focus to commodity markets, including the cotton market, seeking to diversify their investment portfolios.
- "These new speculators have the possibility to financially overwhelm the market compared to typical hedgers and have a distinctive passive long-only trading strategy. These massive passives have come to represent a significant portion of some markets. In fact, they accounted for approximately 38% to 41% of the open interest in the May 2008 cotton futures contract.
- "The massive passives certainly did not single-handedly drive a price spike and contemporaneous volatility, nor is there any indication that they should have been prohibited from trading. Their trading positions as a percentage of the market were not materially different from the positions held by this investor class in comparable periods. However, it remains possible that they, among other variables, contributed to the volatility because of their trading strategy.
- "Specifically, while they contributed a significant amount of volume on the long side, they do not add working liquidity to the market because they characteristically do not alter their trading strategy on a daily or weekly basis as new market information becomes available.

- “During that week of March 3rd, 2008, the massive passives did not, as is their modus operandi, materially alter their futures or option positions. Therefore, they did not act as a liquidity source of potential counter parties – a function that traditional speculators in these markets have performed over the decades.
- “By not responding to the price fluctuations, and that was certainly their prerogative, the massive passives maintained a concentrated pool of ‘dead liquidity.’ While not per se disruptive, the massive passives were a factor that may have contributed to the volatility and drove the natural shorts, the cotton merchants, looking to reduce their exposure in the futures market into the option market.”

Chilton calls on the CFTC to be “especially vigilant” in dealing with new market conditions, writing that:

- “In my view, when dealing with a market like cotton with historically low volatility and few market participants, the Commission should be especially vigilant as to how we address the massive passives. Some have argued that we need to limit appropriately the participation in the market by these traders as a class so that they do not become excessively concentrated. That is certainly a legitimate question.”

Chilton says that he is “pleased that we are currently working on a proposed rule that would, I hope, establish a system that implements mandatory hard cap position limits on traders. Such a system could ensure that no single trader has too much concentration in a given market.” He adds that in the case of position limit exemptions, “Exemptions should be approved by the Commission, not the exchanges, and be targeted, verifiable and transparent.”

To read the Commodities Futures Trading Commission (CFTC) 27-page “Staff Report on Cotton Futures and Option Market Activity During the Week of March 3, 2008,” go to: <http://cftc.gov/ucm/groups/public/@newsroom/documents/file/cottonfuturesmarketreport0110.pdf>

For more on CFTC’s agenda in 2010, listen to Commissioner Bart Chilton on Open Mic at www.agri-pulse.com.

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