CFTC Meetings on Position Limit Proposals and the ICE Futures U.S. Softs Contracts

February 25, 2015

Key Issues for the Soft Contracts:

The proposed position limit rules pose a threat to the price discovery function of the Sugar No. 11, Coffee "C" and Cocoa contracts. The proposed rules threaten the general utility of the contracts as hedging vehicles for commercial participants.

The proposed position limit rules are built primarily on experience with domestic agricultural markets such as the grain markets; the Sugar, Coffee and Cocoa markets have several key differentiators from the grains that should be taken into account in the design and implementation of any new regime.

Sugar No. 11, Coffee "C" and Cocoa are markets that work - for commercial participants and for Exchange regulators – and the current regulatory regime for these products, which is overseen by the CFTC and incorporates rules subject to CFTC approval, should remain in effect.

Overview of Key Sugar No. 11 Contract Terms

- **Sugar No. 11 is the international benchmark for raw sugar trading:**
  - Prices delivery of raw cane sugar, free-on-board the receiver's vessel in the country of origin for the sugar--30 deliverable growths and well more than 30 delivery points;
  - Four contract months per year, trading out 3 calendar years;
  - Single notice day after last trading day;
  - Delivery period extends over 2.5 months due to the fob contract terms.

Most recent expiry (October 2014 delivery) saw over 520,000 MT/10,405 contracts delivered by 6 different deliverers at 12 different ports in Brazil, Central and South America and Asia, with 1 receiver.

Receiver only learned the delivery points and delivery volumes in each on October 1, and had to charter appropriate vessels for each port to arrive and pick up sugar by December 15.

Overview of Key Coffee "C" and Cocoa Contract Terms

- **Coffee "C" and Cocoa are <u>the</u> international benchmarks for arabica coffee and cocoa trading. While they price in-store delivery, there are also key differentiators vs. grains:**
  - Both contracts cover internationally grown commodities that have no material US production volumes;
  - Both contracts are characterized by many different quality standards, including Origin, age and location;
  - Production of both comes from plants with a multi-year life cycle;
  - Coffee "C" permits delivery of 20 different Origins in warehouses in 4 US and 3 European ports;
  - Cocoa permits delivery of over 20 different Origins in warehouses in 5 US ports.

Proposed Regulations Conflict with Commercial Market Practices in the Softs Markets

- **We believe the proposed Rules' failure to fully recognize unfixed price commitments as bona fide hedging transactions will interfere with existing Sugar, Coffee and Cocoa commercial market practices in which commercial market participants routinely commit to purchase/sell the physical commodity at an agreed differential with the final price to be set later on a date chosen by the commercial contract counterparty.**

Regarding these types of unfixed price commitments, the Exchange and commercial participants do not have a good understanding of the reason the Commission does not view them as bona fide hedges except in very limited circumstances (offsetting obligations in different delivery months and not during the last three or five days of trading, depending on product).

Proposed Regulations Conflict with Commercial Market Practices - Sugar Risk Management Example

- Commercial contract terms agreed in March 2015—merchant sells 100,000 MT raw sugar to refinery in India, to be priced against July 2015 contract minus 65 pts FOB basis, shipment May 1-July15
- Physical product timeline:
- July 1- 15 loading slot at origin
- July 10-25 loading completed at origin
- August 15-30 arrive at destination
- Complete discharging by Sep 30
- Sold by refinery as refined sugar in Q4

Refinery has price risk throughout timeline and may not want to fix the price until months after July contract expires.

Merchant typically accommodates refinery by permitting the pricing to be rolled to later futures contracts, and in this case Merchant needs to continue to manage risk by carrying futures position against the commercial contract until the price is fixed by the refinery.

Proposed Regulations Conflict with Commercial Market Practices

- **Restrictions on anticipatory hedges**

  - Unfilled anticipated requirements and unsold anticipated production are limited in the proposed Rules to 12 months, while commercial entities typically hedge larger quantities—the fact that futures contracts have a listing cycle of 24 months or more reflects this need.

    - *Sugar cane plants have a three-to-six year life cycle; Cocoa and Coffee take 3 to 5 years to mature and can produce for years after reaching maturity.*
    - *Producers <u>and</u> end users need to manage their risk beyond 12 months of production and processing needs.*

    We do not understand the reasons for the 12 month limitation, and we believe that enforcement of this time limitation will force changes in current commercial practice.

  - The proposal does not recognize anticipated merchandising, a critical function in commercial markets underlying Exchange contracts. We believe that the non-recognition of legitimate anticipated merchandising will force changes in commercial practices that have been beneficial to market participants and have not created issues or problems in practice.

Proposed Regulations Conflict with Sugar Commercial Market Practices

Proposed restrictions on the bona fide hedging definition during the last three or five trading days would further and significantly impede risk management programs that rely on the Sugar No. 11 contract.

- Unlike the other delivery contracts at the Exchange, trading in Sugar No. 11 is active through last trading day. *Average daily trading volume in the expiring contract for the last 3 trading days was 27,665 lots in 2013, and 17,849 lots in 2014.*

- Given this experience over many years, many commercial contracts in sugar permit the price to remain unfixed as late as last trading day for the contract and many entities wait until close to last trading day to price to minimize flat price risk exposure for the 2.5 month delivery period.

Proposed Regulations Conflict with Coffee and Cocoa Commercial Market Practices

The Proposal eliminates the spot month cash and carry exemption that is currently recognized by the Exchange for Coffee "C", Cocoa and FCOJ. In appropriate market conditions and subject to proper conditions set by the Exchange, the availability of cash and carry exemptions serves an economic purpose by helping to maintain an appropriate economic relationship between the nearby and next futures contract.

The economic function of the cash and carry spread exemption in the case of Coffee and Cocoa is explained by the lack of uniformity in the physical product. The different quality and origin factors mean that commercial hedgers rarely meet the Exchange's requirements for long spot month hedge exemptions in these contracts as they cannot be sure that the Exchange product they receive will meet their commercial contract specifications. This can create an imbalance in the expiring contract as holders of Exchange stocks are eligible for short hedge exemptions but few traders may otherwise qualify for long hedge exemptions – and this imbalance can be ameliorated by the proper use of cash and carry exemptions in appropriate market conditions.

Proposed Regulations Conflict with Coffee and Cocoa Commercial Market Practices – a Coffee example

- Notice Period Spot Month Limit is 500 lots; two weeks prior to FND for the March 15 contract the Mar 15 is trading at 171.50 and the May 15 at 175.00 (or 3.50 c/lb. over the March
- A merchant's cost of carry for Exchange coffee is 1.70 c/lb per month, so the spread between the March and May futures is greater than its cost of carry:
- After reviewing the merchant's data the Exchange grants an exemption for 2,000 lots with the following stipulations:
  - Long March position must be established via spread transactions in which the May trades at least 3.40 c/lb over March;
  - Merchant agrees to reduce its long March position to specified maximum levels set by the Exchange by the time the March/May spread narrows to Exchange-prescribed levels; and
  - Merchant agrees to liquidate the entire long March position before the March price rises to a premium over the May price.

The ability to grant a Cash and Carry exemption in this example helps to establish an orderly liquidation in the March contract as the merchant is providing liquidity so that traders that carry short positions into the notice period without the ability to deliver may exit their positions in an orderly manner.

Proposed Regulations – Aggregation

Aggregation should continue to be based on Ownership *and* Control, not solely on Ownership. In addition we support a facts and circumstances approach rather than a fixed Ownership percentage that triggers aggregation.

The Aggregation proposal creates significant operational issues for multinational companies with affiliates operating independently around the world. The accounting and risk management systems they have developed under the current regime may not have the capability to track and aggregate positions of all affiliates at all times.

Summing Up

The proposed position limit rules pose a threat to the price discovery function of the Softs contracts – and thereby threaten the general utility of the contracts as hedging vehicles for commercial participants.

Sugar No. 11 , Coffee “C” and Cocoa are markets that work—for commercial participants and for Exchange regulators – and the current regulatory regime for these products, which is overseen by the CFTC and incorporates rules subject to CFTC approval, should remain in effect.

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