National Grain
and Feed Association
www.ngfa.org

1250 Eye Street, N.W., Suite 1003
Washington, DC 20005-3922
P: (202) 289-0873
F: (202) 289-5388

February 10, 2014

Ms. Melissa Jurgens
Secretary
Commodity Futures Trading Commission
Three Lafayette Centre, 1155 21st Street NW
Washington, DC 20581

Re: Position Limits for Derivatives, RIN 3038–AD99

Dear Ms. Jurgens:

The National Grain and Feed Association (NGFA) appreciates the opportunity to provide input to the Commodity Futures Trading Commission (CFTC) on this very important proposed rule. For the NGFA's member firms – bona fide hedgers who are hedging physical commodity risk and who depend on futures markets for price discovery and risk management – the outcome of this rulemaking is critically important.

The NGFA is the national nonprofit trade association representing more than 1,000 companies that operate an estimated 7,000 facilities nationwide in the grain, feed and processing industry. Member firms range from quite small to very large; privately owned, publicly traded and cooperative; and handle or process well in excess of 70% of all U.S. grains and oilseeds annually. Companies include grain elevators, feed mills, flour mills, oilseed processors, biofuels producers/co-product merchandisers, futures commission merchants and brokers, and many other related commercial businesses.

A common thread – and a bedrock, fundamentally important concept – is that NGFA-member firms rely on convergence of cash and futures in enumerated agricultural futures markets to facilitate their own risk management and risk management strategies on behalf of U.S. agricultural producers. It is important to note that these strategies are not structured as an investment or as a speculative tool; rather, the NGFA's member firms use futures markets to manage business risk. As such, they rely on a consistent and predictable approach to bona fide hedging and position limit policy decisions made by the CFTC.

The NGFA's expertise resides in enumerated agricultural commodities, and we will limit our comments to those contracts. In that context, our primary points will be:

1) For many years, the Commission's definition of bona fide hedging has worked well. Hundreds of the NGFA's member firms have developed business strategies and made capital investment decisions based on a consistent approach. To redefine bona fide hedging now in ways that may re-classify certain transactions long considered bona fide

hedges by both the industry and the Commission – as the proposed rule seems to suggest – would have far-reaching consequences for agribusiness hedgers and for U.S. agricultural producers. The Commission will need to take great care in how it proceeds to a final rule.

2) A well-crafted position limit regime, relying on the expertise of traditional market participants and exchanges, is of paramount importance to proper functioning of enumerated agricultural commodity futures contracts. Much time has been spent developing contract terms that will ensure convergence. If changes in the final rule compromise predictable convergence, the utility of these contracts for risk management purposes will be threatened. For that reason, the NGFA strongly supports maintaining current "legacy" limits in the spot month and establishing limits in the deferred months that will facilitate an orderly transition to spot-month limits.

3) The reporting requirements imposed on bona fide hedgers and the process by which they apply for hedge exemptions needs to be simple and straightforward. There is no need for more onerous procedures for bona fide hedgers.

Bona Fide Hedging

The current definition of bona fide hedging and the Commission's interpretation of that definition have worked well for many years. Fundamentally, we see no need to rewrite the definition. Changes in the definition itself and changes in the way it is interpreted by the CFTC would have far-reaching consequences for bona fide hedgers in agriculture and agribusiness. As noted at the outset of this letter, long-standing business practices and capital investment decisions have been made under current bona fide hedging rules. The NGFA urges the Commission not to constrict what has been the industry's and the CFTC's historical understanding of what constitutes bona fide hedging.

However, it appears that the proposed rule would do just that. At the least, it creates a significant lack of clarity about the Commission's intentions toward U.S. agriculture. At worst, it could invalidate as bona fide hedges a number of very common types of agricultural hedging transactions. In turn, such action likely would lead to a markedly reduced ability for grain elevators, feed manufacturers, processors and other businesses to hedge their physical commodity risk and force grain and oilseed purchasers to lower bids to farmers, reduce liquidity, and restrict use of tools widely used by farmers and ranchers to manage their risk.

Under the proposed rule, we fear that a number of common hedging transactions used for business risk management in the grain, feed and processing sector, but not enumerated in the proposal, could be put at risk under the proposed rule are listed here. Among these transactions would be:

- Locking in futures spreads;
- hedging basis contracts;
- hedging delayed-price commitments;
- cross-hedging;
- anticipatory hedging of commercial transactions; and
- anticipatory hedging of processing capacity.

We have attached a number of much more specific examples as an appendix to this comment letter, and we look forward to continuing the dialogue about the importance of these and other transactions as bona fide hedges and about the need for clarity.

Perhaps the most troubling element of this rulemaking is that it re-opens issues that we believe were resolved two years ago during the Commission's previous rulemaking on position limits. In essence, following much discussion between our industry and the CFTC, assurances were provided that the grain, feed and processing industry could continue to rely on the Commission's consistent, historical interpretation of bona fide hedging rules. Now, it appears that the Commission for some unexplained reason is proposing to roll back – or at least force a rehashing – of Commission statements that were relied on two years ago. Notwithstanding the fact that the previous final rule has been vacated, the NGFA now respectfully suggests that the Commission should stand by its previous assurances. We believe strongly that the intent of Congress in passing Dodd-Frank was to preserve the use of derivatives for end users to hedge price risks associated with their businesses.

Anticipatory Hedging

A comment specific to anticipatory hedging is merited; and, again, this re-visits issues that were resolved during discussions between the CFTC and our industry during the previous position limit rulemaking.

Grain merchandisers serve the critical function of providing liquidity for producers and end users of grain. Merchandisers provide a market when producers want to move grain, including during harvest or when prices are favorable, and end users are not interested in buying. They have stored supplies when end users need grain and producers are not interested in selling. The role of the merchandiser allows for the management of price risk at both ends of the supply chain. The current proposal would harm participants it claims to protect by preventing grain merchandisers from hedging "anticipated" transactions.

Anticipatory hedging is a specific exemption allowed by the Commodity Exchange Act as amended by Dodd-Frank. Anticipated merchandising hedges, futures hedges for legitimate commercial users to hedge unfilled storage, and flat-price long futures positions ahead of anticipated processing requirements need to be fully recognized as bona fide hedges in the final rule. We request that CFTC remove from a final rule comments indicating that legitimate cash

bids and offers are no longer eligible for an "anticipatory merchandising" exemption and to remove the enumerated example indicating that "anticipatory processing" requires all legs of the transaction to be in place for the long futures leg to be exempt. We request that the Commission maintain and convey an understanding in its final rulemaking that legitimate merchandising and processing activities of the kind described are acceptable for an exemption and will not require a special exemption or the burden of additional reporting. This merely would affirm the Commission's recognition of anticipated hedging as bona fide hedging, consistent with CFTC and industry interpretation for many years.

Bona Fide Hedging – Conclusion

The proposed rule errs in attempting to define bona fide hedging for all entities – across widely disparate markets, participants and contracts – by enumerating specific types of transactions and excluding others. In effect, the proposal draws lines around certain risk management practices and supposes that transactions "outside the box" must not be bona fide hedges. This treatment is unnecessarily rigid and narrowly drawn. If adopted, it would preclude from bona fide hedging status many common transactions in the grain, feed and processing industry that have been utilized with the Commission's blessing for many years. In a final rule, the Commission must allow for flexibility for market participants and for common sense based on years of consistent interpretation and business practices.

Speculative Position Limits

Federal speculative position limits have been in place for the enumerated agricultural commodities for many years. They are a very important element of properly functioning contracts for wheat, corn, soybeans and other enumerated commodities.

The NGFA is appreciative of the difficult task facing the Commission as it seeks to establish reasonable position limits for a wide range of diverse commodities and markets. We believe strongly that a "one size fits all" approach is unlikely to provide the right solution for commodities as diverse as energy, metals, financial products and agricultural commodities. Even within the agricultural commodities, grain and oilseed markets display characteristics different from other agricultural commodities. We urge the Commission to recognize these unique characteristics – functionally and in terms of market size and participants.

Spot-Month Limits

The NGFA believes strongly that maintaining the current "legacy" position limits is the correct first step for the Commission, particularly in the spot month. There is no appreciable support within our industry or, as far as we know, from the relevant exchanges to move beyond current levels. To the contrary, much time has been spent in recent years on revisions to contract terms – especially the CBOT and KCBT wheat contracts – to help ensure that convergence occurs consistently. We believe that changing current limits now would be a mistake that could endanger convergence and compromise contract performance. The DCMs have done extensive

research and have history on the delicate balance between longs and shorts in each particular delivery market. That localized history is essential to make sure these markets converge properly to the benefit of the hedging customers. Applying non-tested, arbitrary limits to spot-month futures would have unknown consequences on the most fundamental function of the contracts – convergence with cash in delivery.

The Commission proposes to move at some juncture to a methodology under which federal speculative position limits in the spot month would be determined by formula as 25% of estimated deliverable supply. While the NGFA is not necessarily opposed to an update of estimated deliverable supply, we are not convinced that deliverable supply is the best metric on which to base position limits, nor do we believe the formula approach is appropriate for determining spot-month position limits in our markets. For instance, what happens if drought or some other supply shock reduces deliverable supplies to zero or near zero? Similar conditions have occurred in the recent past.

Even a cursory glance at the huge potential increases under this methodology – in some cases, nearly ten times current spot-month limits – shows this approach would be impractical and harmful. The NGFA recommends that the final rule must provide sufficient flexibility to designated contract markets (DCMs) to establish spot-month limits at lower levels, as appropriate to specific futures contracts. It is our expectation that the DCMs' intention would be to keep spot-month limits where they are today.

All-Months-Combined Limits

The NGFA is concerned that proposed all-months-combined limits for enumerated agricultural commodities based on open interest levels could lead to contract performance issues if not properly considered. We believe that nontraditional participants (i.e., investment capital) that have entered agricultural futures markets in recent years contributed to contract performance problems and lack of convergence that necessitated contract changes. The truly appropriate question for CFTC and stakeholders to address: Are we sure, at any given level of position limits, that futures markets are performing their price discovery and risk management roles adequately for traditional market participants, the bona fide commercial hedgers?

With that test in mind, the NGFA is concerned that too-large position limits in the non-spot months could lead to a repeat of convergence problems experienced by certain contracts. A review of proposed all-months limits in the CFTC proposal again reveals some very large increases – as much as a 79% increase in soybeans and 62% in corn. Will those all-months-combined limits "telescope" down to spot-month levels in an orderly fashion to facilitate convergence, or will increased position limits create convergence problems for additional commodities to the extent they, like the CBOT and KCBT wheat contracts, will be forced to adopt variable storage rates and other contract changes to facilitate convergence? That is the analysis that the NGFA urges the Commission to conduct prior to finalizing the rule. As with

spot-month limits, we urge that DCMs be given flexibility to adjust non-spot month limits downward when appropriate to specific commodities and futures contracts.

Wheat Contract Equivalence

The proposed rule breaks with longstanding CFTC policy of establishing the same limits for the three wheat futures contracts: CBOT soft red winter (SRW), KCBT hard red winter (HRW), and MGEX hard red spring (HRS). In fact, the proposal would reduce the KCBT and MGEX non-spot month limits to 6,500 and 3,300 contracts, respectively, from their current 12,000 contract limit – while increasing the CBOT limit to 16,200 contracts. Decreasing limits for HRW and HRS could negatively impact commercials' ability to manage risk associated with these varieties since HRW is the largest class of wheat produced in the U.S., and HRS production at times exceeds SRW production.

The NGFA and the DCMs historically have united in supporting equivalent position limits for the three contracts. Varying limits could have unintended and undesirable effects in terms of competition among the contracts for growth and liquidity. In addition, different limits would reduce liquidity available for spreading transactions between the three wheat classes that help discover price differentials for different protein levels and milling characteristics. The NGFA urges the Commission to remain consistent with historical practice in maintaining position limit equivalence across the three contracts.

Conditional Position Limits

The NGFA is opposed to conditional position limits at 5X those for physically-settled contracts. We fear that a 5X limit **in the spot month** has the potential to skew price discovery in physically-settled contracts by artificially pushing liquidity out of physically-settled futures contracts. Worse yet, we fear that such a large conditional limit could create the opportunity for mischief and deleterious impacts on spot-month convergence if participants were allowed to hold cash-settled futures or swaps positions as large as 125% of a commodity's deliverable supply in the final trading days of the physically-settled contract.

To our knowledge, only one contract currently utilizes the 5X position limit in the natural gas sector. There is no comparable contract feature for any of the enumerated agricultural commodities. There is no history to guide us, no data to analyze, no track record at all in our markets. Based on this lack of information, we believe a 5X limit would be imprudent given the potential negative consequences and no discernible benefits.

Finally, it is unclear to us why cash-settled contracts should enjoy a material, government-sanctioned advantage over the physically-settled contracts that are critically important to traditional hedgers.

Reporting Requirements

The NGFA acknowledges and appreciates the Commission's changes from the vacated position limit rule to not require daily reporting of physical positions – an appropriate step since the CFTC lacks regulatory authority over cash markets. However, the proposed rule imposes other unnecessary and onerous reporting requirements on bona fide hedgers.

Requiring users of commodities to submit a written form ten days in advance of the need for potential market positions that will be anticipatory hedges is burdensome and ultimately unworkable. Market conditions can change rapidly and dramatically, especially in an environment where high-frequency trading and fund activity have become so dominant. USDA crop reports frequently trigger sharp price swings, and shifts in summer weather can turn markets just as quickly. Markets don't wait for CFTC forms to be filed. Forcing this business – or any other business – to stand by because a form wasn't filed, or hasn't been approved by the CFTC, while market prices move against them flies in the face of prudent risk management practices.

Consider a corn sweetener operation. The operation uses in excess of 300,000 bushels of corn every day at their plant. The firm's commodity risk manager has been watching corn prices trade sideways to slightly higher in recent months and forecasts that sharply higher corn prices would cut the firm's revenues significantly, anticipating that product prices would not rise in lockstep with input costs. Then a monthly USDA Crop Report is released with shocking changes in the balance sheet, cutting U.S. corn ending stocks far below trade expectations. Futures open limit higher in corn but can still be bought synthetically using options. The commodity risk manager wants to immediately act to fix the corn raw material costs for the next four months through a combination of futures and options strategies, to eliminate the risk of even higher corn prices in the weeks ahead. The Commission must recognize that risk management decisions need to be market-driven and business-driven, not centered on satisfying a government filing requirement that may not be timely or appropriate.

In addition, the process of filing for a hedge exemption appears to lead to a lengthy and unwieldy review by the Commission of any practice not enumerated in the proposed rule, whether or not it is commonly used as a risk management practice and previously has been recognized as a bona fide hedging activity. Waiting for permission to hedge agricultural commodities is impractical and, in many cases, imprudent as a business decision.

Finally, the NGFA is concerned about the potential liability of a company, or an individual employee of a company, that could derive from the proposal to require that submitted data be certified as "true and correct." This is especially true with respect to information that may be collected from an entity or counterparty that is not accountable to the person or company submitting the report. The Commodity Exchange Act already prohibits the submission of false

and misleading information, and we are unaware of problems related to information submitted related to physical markets that would justify this new requirement.

Conclusion

The NGFA appreciates the opportunity to provide input on the proposed rule and improvements that should be made to the final rule. We would be happy to respond to any questions. We request the opportunity for additional dialogue with the Commission prior to publication of a final rule in order to discuss alternative solutions in the event there is still lack of agreement between industry and the Commission on these critically important matters.

Sincerely,

Diana Klemme, Chair
Risk Management Committee

APPENDIX: EXAMPLES OF BONA FIDE HEDGING TRANSACTIONS

The following examples represent a non-exclusive list of common hedging transactions entered into by commercial firms in agricultural commodity markets. The National Grain and Feed Association respectfully requests that the CFTC ensure the transaction types represented by these examples and other transactions historically considered bona fide hedges are included within the definition of bona fide hedging in the context of any federal position limits regime.

"ANTICIPATED" TRANSACTIONS.

The following examples demonstrate the potential need to hedge risk based on anticipated commercial transactions. End-users and commercial participants in the agricultural sector utilize derivatives to hedge anticipated production, purchases, sales, and other transactions. As noted in the attached letter, hedges of "anticipated ownership" and "anticipated merchandising" transactions are *bona fide* hedges under the language in the Dodd-Frank Act. The clear intent of these anticipatory hedging transactions is to establish a *bona fide* hedging position to mitigate commercial risk.

Example 1: *In February of 2013, prior to spring wheat planting, Elevator X, which has storage capacity that is currently sitting completely empty, locks in a spread of $1.40 on a portion of its expected throughput for the crop year by buying July 2013 Wheat futures and selling July 2014 Wheat futures. Regardless of whether Elevator X actually buys wheat in 2013, this transaction represents a hedge by Elevator X of its capacity (i.e., the value of its grain storage assets). If there is a crop failure during the 2013 harvest resulting in little to no wheat deliveries at Elevator X, the spread position hedge will perform by providing Elevator X the economic value of the position hedging against such an event. Alternatively if Elevator X (as expected) buys wheat, it will hedge these specific price risks by taking appropriate futures positions and reducing the July/July Wheat spread.*

Meat industry operations face a number of variables that can increase margin risk. The cattle and pork sectors have futures markets that allow them to hedge the livestock in forward futures months and use grain and soymeal futures to manage feed costs, and in combination the operations can better manage and reduce overall operating margin risk. There are no poultry futures, so hedging grain input costs is one of the most common hedge uses of futures for such operations.

Example 2: *A restaurant franchise chain that buys chicken wants to set the (chicken) price for (one or more) franchiser(s) for the year. They contact the poultry operation supplier and request a fixed forward (chicken) price. Given that corn is roughly 65% of the feed cost and soybean meal is 30%, the poultry operation can estimate how much corn and meal they will need during a given time period and when the final meat product can be delivered to the stores. One option to allow the poultry operation to set a fixed forward price on the chicken product is to buy corn and soybean meal futures in the months the poultry operation would be feeding and use those prices to establish the price for the meat. This will eliminate most of the grain price risk and can protect the margin established for the meat product. The franchise chain now receives a fixed*

price from the poultry operation, and the restaurant chain can in turn set prices for the franchisees so each can set their menu price for a fixed time. In this example all three parties (poultry processo , restaurant franchiser, and the restaurant franchisee) have had the benefit and reduced risk from the poultry operation's use of grain and oilseed futures.

Example 3: *Firms in the meat production business, including poultry, are constantly making decisions on how much product they need and when they need it. In turn, meat and poultry producers have end-market customers with various pricing needs. The producer/suppliers often have supply commitments but do not set the product price until a later date. Due to the amount of time it takes from the egg sets to hatching and through grow-out, many decisions must be made well in advance. Once a supplier estimates (meat/poultry) production over a period of time, that supplier can estimate the corresponding feed requirements as well. The meat producer/suppliers are at risk of adverse market movements in both meat prices and grain prices. If they can't price the meat, they can at least price the grain, which reduces but doesn't eliminate market risk. The producer buys corn and meal futures for some percentage of the business to reduce overall market exposure.*

Example 4: *A cattle feeder is buying calves that he will feed for 150 days to finishing . He knows how much corn he will need during that time. He also has a date that the cattle should be ready for market. If the producer wants to be completely hedged, the business would sell cattle futures at a forward date when cattle will be ready to market and would buy the corn (and or soymeal) futures for the feeding period . This would reduce the feedlot's risk and protect a feeding margin, reducing the overall exposure of the business to potentially volatile and adverse price changes.*

Example 5: *A processor buys soybeans from farmers and sells the soybean oil and soybean meal to customers after the beans have been crushed in a soybean plant. The CFTC's proposed rule requires that all legs of the "soybean crush" be covered, either in the cash or futures market for the transaction to be bona fide for hedge exemption purposes. In reality, there are many factors that go into managing the risk and margin of a crushing plant beyond simply board crush because the economic drivers are not the same for beans, meal and oil. For example, soybean prices may be impacted by weather, prices of substitute planting options for farmers before harvest such as corn, import and export policies, macroeconomic factors in other soybean growing countries and competition for all modes of transportation. Soybean meal is largely driven by domestic and international demand for animal protein products such as meat, milk and eggs. Meanwhile, soybean oil is largely driven by demand for food and fuel uses. Disciplined business and risk management takes all of these disparate issues into account when evaluating the soy complex. It is not always prudent to go long beans and short meal and oil in the same transaction. The CFTC requirement as proposed may actually increase risk to commercial participants and end users if the market participant were forced to place all legs of a trade when the risk factors are suggesting otherwise. The CFTC should not require a broad standard for anticipatory processing hedges and should instead recognize that risk managers are in a position to evaluate these risks when managing a commercial processing enterprise.*

Example 6: *A typical midwestern ethanol plant is capable of grinding 3.8 million bushels of corn in a month. They can convert this to ethanol at a rate of 2.8 gallons of ethanol per bushel of corn, or about 10.6 million gallons of ethanol. One day an*

opportunity arises to "crunch corn" for 50% of the next month's ethanol production. That is, the plant can sell 50% of the next month's ethanol production and, given the price of corn on that day, lock in a positive processing margin for the ethanol plant. At the time of this transaction the plant does not have physical corn bought to process. Further, on this day the plant is not able to buy the required amount of physical corn (1.9 million bushels) to cover the other side of the ethanol sale. In anticipation of buying physical corn, the plant chooses to buy corn futures to mitigate the risk associated with corn price movements. This futures hedge allows the plant to confidently sell the physical ethanol and lock in a processing margin. As physical corn is bought, the corn futures are sold to unwind the hedge which completes the "crunch."

HEDGES OF "SPREAD" OR "ARBITRAGE" POSITIONS.

The following examples demonstrate the potential need to hedge risk based on spread or arbitrage positions. End-users and commercial participants frequently utilize spread or arbitrage trading as a part of their business strategy, and utilize hedging to protect against downside risks of normal business strategy. Hedges on the value of spread or arbitrage positions would be *bona fide* hedges under the language in the Dodd-Frank Act. The clear intent of these derivatives transactions by end-users or commercial participants is to establish a *bona fide* hedging position for spread or arbitrage positions entered into in the normal course of business.

Example 1: *A country grain elevator with 5 million bushels of licensed warehouse space typically buys at harvest around 4 million bushels of corn and 2 million bushels of soybeans in addition to wheat already in the facility and corn and soybeans received at harvest to store on behalf of farmers. The firm ships about as much as they are able to during harvest. In mid-summer before harvest, the manager sees the December 13/July14 corn futures spread at 31¢ carry, and knows that Financial Full Carry on corn is about 40¢ for that spread, so the current value returns nearly 78% of the theoretical maximum. The manager wants to protect the 31¢ futures carry to assure the ability to buy corn inventory during harvest and hold it through the winter as the elevator does not have the logistical capacity to buy the 4 million bushels of corn at harvest and ship 100% of it during the fall. The manager decides to set the spread (buy Dec/sell July futures) on 2 million bushels of corn. As the manager buys corn from farmers, the elevator will sell the long December futures which leaves the short hedges forward into July 2014 futures. The elevator will watch for basis opportunities to sell the harvest corn ownership into forward time slots (winter/spring/summer). Pre-setting this futures carry by buying December futures and selling July 14 futures meets any reasonable definition of a bona fide hedge for this operation:*

- *This firm is in the business of buying grain, holding it, and shipping as basis and logistics allow.*
- *This spread strategy is to reduce risk, not to increase risk.*
- *The volume (2M bushels) is only 50% of the operation's typical harvest purchases which meets a reasonableness standard.*
- *Waiting and doing nothing exposes the firm to risk that the spread narrows; at 78% of theoretical "full carry" there is little left for this firm to potentially gain in any circumstances.*

- *The bigger risk is that the futures carry narrows and the business could stand to lose revenue needed to pay the holding costs of the inventory until it can be shipped out after harvest.*

Example 2: *A country grain elevator owns a large quantity of soybeans on Delayed Price(DP). DP inventory is where title passes to the elevator upon delivery of the soybeans by the farmer, but neither price nor basis is fixed at time of delivery. In all aspects except for title, DP functions for a farmer similar to storage. In the spring and summer of 2013, the July13/November13 soybean futures spread soared to a record high inverse (July over November). Basis values at processing plants were extremely high and the elevator decided to sell 60% of the DP soybean inventory at a basis of +125July and took long July soybean futures (in an EFP transaction) to price the sale.*

- *The elevator is now short soybean basis at +125July and is long July futures.*
- *The remaining 40% of the DP soybean inventory remains in the facility, with the elevator holding title.*
- *Many of the farmers whose soybeans were delivered to this elevator are in the habit of not pricing their soybeans until late summer.*
- *When the July/Nov futures inverse reached $2 the elevator manager decided to move the long July futures forward to November futures.*
- *The net short basis is now at $3.25Nov (+125Basis over July plus the $2 futures inverse).*
- *The elevator now waits (while earning interest from the revenue from selling the soybeans) for the farmer to decide to price.*
- *With a $2 futures inverse, the market signals are for owners of inventory to move it to market, which the elevator followed on 60% of the DP. For the elevator to continue to hold 100% of the DP soybeans in an extremely tight supply situation in the summer of 2013 in the face of a $2/bushel futures inverse would have made no economic sense.*
- *Holding onto 40% made this a conservative strategy: The elevator had those soybeans still on hand – unsold – in case some farmers might have opted to price their soybeans while basis was still high. The elevator in that case would have sold more soybeans to the crush plant as the farmer priced the soybeans.*
- *This strategy of going short basis on DP inventory meets a reasonableness test for a bona fide hedge strategy.*
- *First, the quantity is reasonable: The elevator only sold 60% of the available DP inventory.*
- *This strategy meets a 'know your customer' criterion – this elevator's farmers typically price some of their inventory late in the summer or early fall.*
- *This strategy reduces the elevator's risk: Holding 100% of the soybeans until the farmers priced would have added the risk that the elevator would not have been able to sell and ship all the soybeans in a narrow window of time just before harvest – a period when basis values are often quoted for just a few days of shipment rather than weeks and when basis values can fall rapidly and dramatically. Spreading the logistics over more weeks or months avoids that exposure.*
- *This strategy also helps ensure that the export and processing sectors can secure sufficient soybeans to continue operations on a steady schedule.*

Example 3: *A fixed price contract definition in terms of the grain trade should include basis contracts where grain is bought or sold for a defined shipment window, for a defined shipment or delivery location, at a defined fixed price in relation to the underlying futures contract. What this example doesn't show is the entire position each entity in this transaction is managing. In the grain trade the buyers and sellers have positions all relating to their basis position for example long Mar, short April shipment windows. These windows often require futures spreads to hedge price risk, or lock in margins on the trades.*

Seller A sells Buyer B 400,000 bushels of corn for April 1-15 shipment delivered CIF New Orleans at +$.35 over the May CBOT futures contract.

Mar CBOT Futures = $4.35

May CBOT Futures = $4.40

Mar-May = -$.05 carry/contango

- *In the export market a buyer buys barges shipping off the Illinois river for Mar 1-15 shipment. These barges could take 15-18 days from time of loading to travel to New Orleans to be ready for offloading to a vessel for export. The buyer of these barges delivered New Orleans has a vessel loading on April 8.*
- *The exporter bought the barges at $.30 over CBOT March futures, and sold the grain on the vessel @ $.35 over CBOT May futures, for a gross margin of $.10 at a Mar-May spread of 5c contango.*
- *The March-May futures spread at the time of the transaction was trading at a 5c carry/contango.*
- *If the Mar-May futures spread narrows to even money, the exporter is at risk*
- *The exporter buys March futures and sells May futures to lock in the gross margin on this transaction. If the spread narrows to an even money value (Mar=May futures value), the exporters hedge of buying Mar selling May futures offsets his loss on his basis position. If the spread were to widen to further contango of 7c, the exporter will lose money on the spread trade, but has knowingly locked in a 10c gross margin.*

Expanding on the example above, these transactions occur in very large quantities in the U.S. grain export market. The need for futures hedging exemptions to manage the very large bushel positions it takes to run an effective export program relies heavily on managing the spread relationships of the CBOT futures market. To take this exemption away by not clearly defining a basis contract as a fixed price contract adds inherently more risk and reduces businesses' ability to control their pricing and margin structure greatly, thereby contradicting the CFTC's stated goals in the proposed rule changes.

Example 4: *It is a common practice for country elevators to purchase and sell physical commodities on firm unpriced contracts plus or minus a fixed differential to a referenced contract. There are any number of transactions where a party enters into a firm unpriced physical contract to buy or sell because they can lock in the origination, favorable transportation, or other favorable factors. When these opportunities arise, even though the*

purchase or sale is unpriced , the party will buy and sell derivatives to lock in the differential between the time they expect to buy and sell the physical commodity. In this example the country elevator would buy the CME December corn futures and sell the CME July corn futures of the following year, to protect against the risk that the December futures will increase in price relative to the July futures (a calendar spread). Often, the purchase will take place before the sale, but the risk mitigation principals are the same.

On July 1 of a specific crop production year, an end user livestock feeder ("Buyer") likes the price of corn for the subsequent January through July delivery as it relates to their value of meat sale contracts to their own customers. Buyer bids for and contracts to buy from a country elevator originator ("Seller") 7 million bushels of corn for January through July delivery of the year following the harvest at a basis price equal to 1 cent under the July futures price at the time of physical delivery. The two firms will exchange futures positions at time of physical delivery to establish the final price for the corn. Seller now has an unpriced sale of 7 million bushels of corn. The Seller will purchase the corn to fill the sale in the upcoming November harvest. The purchases will be priced versus the December futures month. The bushels sold are only a fraction of its typical harvest purchases. The sale Seller made to Buyer is versus the July futures month. Any spread changes between the December and July futures months has a direct correlation to the value of the sale contract Seller made with Buyer. The December/July corn spread at the time of sale was $0.28 per bushel premium the July futures, or a 28 cent carry. Seller wants to protect the sale value of the contract versus July futures so it initiates a bull spread buying 7 million December corn futures and selling 7 million July futures at a 28 cent carry. This is a commercially acceptable risk management procedure for Seller. The widest the spread can economically reach is full carry (5 cents per month plus commercial interest cost usually equal to Libor) or 36 cents per bushel. If the spread widens more than the original 28 cents subsequent to Seller bull spreading the Dec/Jul, Seller is giving up an opportunity cost, since the spread has locked in a favorable margin. The Seller is simply collecting less per month on its return to capital. However, if the bull spread narrows, Seller is preventing a real loss, as the gain in its bull spread position will offset the loss the Seller will incur resulting from the December futures increasing in price relative to the July futures. Importantly, there is a limit (full carry) to how wide the spread can economically go, but there is ***no limit*** *to how narrow or even worse inverted (December higher than July) the spread can go.*

Following are four examples of what the sale would look like to Seller adjusted for the potential Dec/July spread activity. The assumption made in all four examples is that Seller's purchase cost of the corn is equal to 10 cents below the December futures price (all amounts in cents per bushel).

The first example is as if the spread never changed.

purchase basis vs dec futures		(0.10)
Dec/Jul spread		(0.28)
purchase basis vs july futures		(0.38)
sale basis vs july futures		(0.01)
Seller's return to capital w/o spread		0.37
Spread gain (loss)		-
Seller's return to capital with spread		0.37

The second example is if the spread widened from 28 cents to full carry. (36 cents max)

purchase basis vs dec futures		(0.10)
Dec/Jul spread		(0.36)
purchase basis vs july futures		(0.46)
sale basis vs july futures		(0.01)
Seller's return to capital w/o spread		0.45
Spread gain (loss)		(0.08)
Seller's return to capital with spread		0.37

The third example is if the spread narrowed from 28 cents in to 8 cents per bushel

purchase basis vs dec futures		(0.10)
Dec/Jul spread		(0.08)
purchase basis vs july futures		(0.18)
sale basis vs july futures		(0.01)
Seller's return to capital w/o spread		0.17
Spread gain (loss)		0.20
Seller's return to capital with spread		0.37

The fourth example is if the spread went from 28 cents carry to 15 cents inverted

purchase basis vs dec futures		(0.10)
Dec/Jul spread		0.15
purchase basis vs july futures		0.05
sale basis vs july futures		(0.01)
Seller's return to capital w/o spread		(0.06)
Spread gain (loss)		0.43
Seller's return to capital with spread		0.37

In the above examples, one can see that initiating a bull spread with the basis sale is a near perfect hedge protecting the asset value of the unpriced sale contract . In examples three and four, the narrowing or even inverting of the spread had a significant negative impact on the return to capital. The bull spread correlated penny for penny and offset the loss in the unpriced contract value.

Accounting Standards Codification Topic 815 Derivatives and Hedging requires a commercial enterprise to recognize all of its derivative instruments as either assets or liabilities in its balance sheet at fair value. An unpriced contract is a derivative instrument. Initiating a bull spread with the basis sale is a near perfect hedge protecting the value of the unpriced sale contract .

In summary, there is a limit to how wide the spread can go, full carry. This effectively caps the limit of spread loss potential, which again is an opportunity loss. However, there is no limit to the level of inversion of the spread. Bull spreading against unpriced sale contracts is an appropriate reduction of risk arising from potential balance sheet changes in the value of the unpriced sale contract, and meets the definition of bona fide hedging in the Commodity Exchange Act.

Example 5: *Grain Merchandiser X is in the business of buying wheat in, among other places, North Dakota, using a Minneapolis Grain Exchange (MGEX) reference price. Grain Merchandiser X is also in the business of selling wheat to Italian flour mills, using a Euronext France (MATIF) price. These prices are readily available across the price curve, more than a year in advance. As such, there are times when Grain Merchandiser X believes the differential for a particular month is favorable and it seeks to lock in the differential by selling MATIF futures (or swaps) and buying MGEX futures, even though it will ultimately buy North Dakota wheat priced in MGEX futures. This transaction allows Grain Merchandiser X to hedge the risk of the expected transactions in its business strategy.*

HEDGING IN THE SPOT MONTH.

Example: *Grain Merchandising Company (GMC) sells corn FOB U.S. Center Gulf for January 5-25 Delivery, basis +.75 the March corn futures contract. On the pricing date, GMC will take*

long March futures contracts from the buyer (via an EFP) to price the cash corn. Terms include Letter of Credit (LC) payment; no futures pricing until the LC is open to limit flat price exposure with the customer; and the LC is to be opened 15 days prior to delivery period (Dec 20). The cash corn market is a premium versus taking delivery of corn on the December futures contract. To cover its sales commitment at the cheapest price, GMC buys December futures and sells March futures. If purchasing corn in the cash market is still more expensive than taking delivery on its long futures contract position as the market enters into the delivery cycle, GMC takes delivery during the December delivery cycle (actual delivery against the futures contract is determined by the entity that is short futures and makes delivery). The corn delivered via the December futures contract position will be loaded out and will arrive by barge in the Gulf between December 25 - January 10. The end user prices futures on the basis contract on January 10. When the customer prices futures on the basis contract, GMC offsets its short March futures position with the long March futures position it receives via the EFP. GMC is contractually obligated to perform on the basis contract.

HEDGING IN THE LAST FIVE DAYS OF TRADING AN EXPIRING CONTRACT.

The following examples demonstrate the potential need for commercial participants to hedge risk in the last five days of trading in a specific derivatives contract. The uneconomic consequences of prohibiting a *bona fide* hedge position from being held in the last five days of trading are also demonstrated. The clear intent of holding these derivatives in the last five days of trading by commercial participants is to maintain a *bona fide* hedging position.

A. ACTUAL CONTRACTED REQUIREMENTS

Example: *Commercial entity C operates a corn processing plant. Commercial entity C has sales obligations of corn products to customers larger than its ownership of corn to satisfy those obligations. It has purchased futures contracts in the exchange-traded market to offset the price risk of the sales obligations beyond its ownership of physical corn. Assume the sales of entity C represent 4 weeks of production, and current ownership represents 2 weeks of production. Commercial entity C has purchased futures representing the other 2 weeks of production, protecting its price risk on that amount. It is economically correct for the entity to purchase corn at the lowest cost available. A restriction on bona fide hedge positions in the last five days of the contract period would prevent the market from behaving economically and converging to where the costs are equivalent. If holding positions in the last five days of trading were prohibited, the cost to the enterprise of taking delivery of physical corn through the exchange-regulated process may be more (or less) cost effective than corn that is offered for sale in the cash market. The cost to entity C should be the same, whether taking corn through the exchange delivery process or purchasing the offers in the cash marketing channels, given the same quality and logistical parameters.*

B. CROSS-COMMODITY HEDGES

Example 1: *AgriCorp, a grain warehouse, grain merchandiser and feed ingredient wholesaler, buys wheat from farmers. At the same time, Agricorp enters into a fixed price agreement with a feedyard to supply feed (the exact components of which could be satisfied using wheat, corn, DDGs, or other ingredients). In order to hedge its risk, AgriCorp enters into a swap, hedging the risk that the price of wheat will decline relative to the price of corn (the corn futures price better correlates to feed prices, thereby providing a more effective hedge). Since the two prices are referencing different commodities, this hedge would not constitute a bona fide hedge in the proposed rule if held in the last five days of trading.*

Example 2: *In the feed business, many of the flat price commodities are only offered seasonally or a month or two in advance of production. Many of these commodities have limited availability on the spot market so timely purchases are a necessity to secure sufficient supplies for the business. Since sales can vary significantly from spot sales to longer term sales, the business can see significant exposures throughout the year. To hedge this exposure, feed manufacturers look at hedgable commodities or mixes of commodities to lessen the exposure and continue to monitor the proper mixes to manage the position.*

Example 3: *Producers and traders of Dried Distillers Grain (DDG) will often choose to hedge them in corn futures. DDG has a similar energy value to corn and are viewed as similar feed stocks to many livestock producers and as such, their prices are highly correlated. The corn contract offers not only liquidity, but an effective price hedge.*

Example 4: *Wheat can be used as a substitute for corn when feeding livestock. They share similar (though not identical) feed profiles such that wheat can substitute for corn if the price is right. Therefore, it is not uncommon to hedge purchases of wheat with short corn futures if the likely destination is a feedlot. The feedlots generally set their bid for grain against corn price.*

For example, assume that the wheat produced in a particular crop year or region is a quality that cannot be milled for human consumption. The next best buyer for that wheat may be a livestock producer. It would make sense for the buyer of that lower quality wheat to hedge it in corn. He does this because he knows that when he sells it he will be competing against the corn price and not against wheat.

At harvest time the cash corn price in a region is $4.50 with corn futures at $4.50 and wheat futures at $5.00. Wheat quality in this region is of a non-milling quality. The buyer of wheat therefore pays the going price for corn ($4.50) and hedges by selling a corn contract at $4.50. A few weeks later, the buyer sells the wheat. Now the cash corn price is $4.80, with corn futures at $4.60. Wheat futures are $6.00. He is able to sell the wheat at the cash corn price ($4.80) and then liquidates the hedge.

In this scenario the buyer gained 20c on this wheat because it was hedged against the proper commodity – in this case, corn. This is illustrated below, along with a similar example highlighting falling prices. These examples show why cross hedging provides a less volatile hedge for the buyer: the cross hedge results in a gain of 20c or 30c. The "straight" hedge or hedging the low quality wheat with wheat futures, results in a 70c loss or an 80c gain.

Hedge with Rising Wheat Prices

Corn Hedge	
Sell Futures	4.50
Buy Futures	4.60
Futures Gain/Loss	**-0.10**
Buy Physical	4.50
Sell Physical	4.80
Physical Gain/Loss	**0.30**
Total Gain/Loss	**0.20**
Wheat Hedge	
Sell Futures	5.00
Buy Futures	6.00
Futures Gain/Loss	**-1.00**
Buy Physical	4.50
Sell Physical	4.80
Physical Gain/Loss	**0.30**
Total Gain/Loss	**-0.70**

Hedge with Falling Wheat Prices

Corn Hedge	
Sell Futures	4.50
Buy Futures	4.00
Futures Gain/Loss	**0.50**
Buy Physical	4.50
Sell Physical	4.30
Physical Gain/Loss	**-0.20**
Total Gain/Loss	**0.30**
Wheat Hedge	
Sell Futures	5.00
Buy Futures	4.00
Futures Gain/Loss	**1.00**
Buy Physical	4.50
Sell Physical	4.30
Physical Gain/Loss	**-0.20**
Total Gain/Loss	**0.80**

PRE-HEDGING

The following example demonstrates the potential need to "pre-hedge" anticipated risk based on past experience of physical transactions which may be conducted outside the hours in which the derivatives exchange is open. The clear intent of establishing this derivatives position is to mitigate risk which can reasonably be anticipated to occur and thus establish a *bona fide* hedging position.

Example: *In the normal course of business it is common for Commercial grain company X to buy/sell flat price commodities outside the hours of operation for a particular futures exchange. It is not prudent to limit business activity to only those hours that the exchanges are open. This business activity creates a need for Commercial grain company X to establish a futures position in anticipation of buy/sell activity that cannot be hedged until a particular exchange opens. This futures position is established in advance of the cash transaction and is referred to as a "Pre-Hedge." The "Pre-Hedge" volume is based on the actual experience of Commercial grain company X in a particular market and is well established over time. As one might imagine, the "Pre-Hedge" for Commercial grain company X over any given weekend during peak harvest season could be quite large. The inability to "Pre-Hedge" these anticipated cash transactions would*

put Commercial grain company X at significant risk of price fluctuation that can take place outside the hours of operation of the futures exchange, especially during a weekend.