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:

Grain Service Corporation, Inc. appreciates the opportunity to provide input to the Commodity Futures Trading Commission (CFTC) on this very important proposed rule. For over thirty years, we have provided education, consulting and brokerage services to commercial hedgers in agriculture and energy. I write to offer comments on two items in the proposed rule-making.

No Proposal of Unfilled Storage Capacity as an Anticipated Merchandizing Hedge. The Commission is not re-proposing a hedge for unfilled storage capacity that was in vacated § 151.5(a)(2)(v). That exemption would have permitted a person to establish as a bona fide hedge offsetting sales and purchases of commodity derivative contracts that did not exceed in quantity the amount of the same cash commodity that was anticipated to be merchandized. That exemption was limited to the current or anticipated amount of unfilled storage capacity that the person owned or leased.

The Commission previously noted it had not recognized anticipated merchandising transactions as bona fide hedges due to its historic view that merchandizing transactions generally fail to meet the economically appropriate test.354 The Commission explained, "A merchant may anticipate that it will purchase and sell a certain amount of a commodity, but has not acquired any inventory or entered into

3340 Peachtree Road, Suite 1910
Atlanta GA 30326

fixed-price purchase or sales contracts. Although the merchant may anticipate such activity, the price risk from merchandising activity is yet to be assumed and therefore a transaction in [commodity derivative contracts] could not reduce this yet-to-be-assumed risk." In response to comments, the Commission opined that, "in some circumstances, such as when a market participant owns or leases an asset in the form of storage capacity, the market participant could establish market positions to reduce the risk associated with returns anticipated from owning or leasing that capacity. In these narrow circumstances, the transaction in question may meet the statutory definition of a bona fide hedging transaction."

With the benefit of further review, the Commission now sees a strong basis to doubt that such a position generally will meet the economically appropriate test. This is because the value fluctuations in a calendar month spread in a commodity derivative contract will likely have at best a low correlation with value fluctuations in expected returns (*e.g.,* rents) on unfilled storage capacity.

In its analysis, the Commission has not, in my opinion, correctly identified the risk being hedged in this situation. Grain elevators commonly enter into spread transactions in the futures market to manage the risk of storing company-owned grain. They are not attempting to hedge the risk of what rental they might receive on storage space allocated to storing customer-owned grain since those rates are quite stable.

In planning to store company-owned grain, an elevator in Iowa could in June, say, buy 500,000 bushels of Dec 14 corn futures and sell an equal amount of July 15 corn futures. The purchase of Dec futures is a temporary substitute for its anticipated purchase of corn at harvest, and its sale of July futures is a temporary substitute for its anticipated sale of corn in May/June 14. It will put on the spread if it finds the Dec/July spread attractive (July is usually higher than Dec) or if it believes the spread may narrow, reducing its return from the ownership of corn inventory.

Once the spread is in place, the elevator will sell Dec futures as it enters into fixed price purchase contracts for harvest delivery, thus "buying the basis," and leaving it "long the basis" with its corn inventory hedged in July futures. Eventually, the elevator will sell the corn and close its July futures position, thus "selling the basis." Having been hedged

the entire time, the inventory has no exposure to futures price changes. Rather, the gross revenue to the elevator is equal to the spread + the sell basis – the buy basis. For example, if an elevator sets the spread at +50 cents (July 50 cents above Dec), buys corn at -30 Dec and later sells corn at +25 July, the gross income is +50+25-(-30) = $1.05.

In entering the spread transaction the elevator has not attempted to hedge the rent it might charge others for storing grain, but is hedging 100% of its exposure to variability in a key component of its ultimate gross revenue, the price difference between Dec and July futures. Therefore, I submit that this is most definitely a bona-fide hedging transaction.

Request Four. Binding, Irrevocable Bids or Offers: The Working Group requests that referenced contracts used to hedge exposure to market price volatility associated with binding and irrevocable fixed-price bids or offers be treated as bona fide hedging positions.

The contemplated transactions are not consistent with the enumerated hedges in proposed paragraphs (3)(i), as a hedge of a purchase contract, or (3)(ii), as a hedge of a sales contract, because the cash transaction is tentative and, therefore, neither a sale nor a purchase agreement.

In the Commission's view, a binding bid or offer by itself is too tenuous to serve as the basis for an exemption from speculative position limits, since it is an uncompleted merchandising transaction that, historically, has not been recognized as the basis for a bona fide hedging transaction under § 1.3(z)(2).

In its discussion of entities that may hedge bids and offers that may not be accepted, the Commission implies that such situations are singular, as in a response to an RFP from a single commercial customer. Many entities submitting sizable commercial bids do so on a “subject” basis, i.e. with a price subject to change. Indeed, a fixed price bid or offer that is unconditionally open for any material length of time is in essence an option.

Grain elevators undertake to provide a ready local market for cash grain to their farmer customers every day of the week, but cannot readily hedge purchases made after the pit close on Friday afternoon and the electronic open on Sunday night. Prior to the advent of screen trading, the gap was from 1:15 pm CST Friday to 8:30 am CST Monday. During that time farmers continued to bring grain to the elevator, especially during harvest when combining begins early and can continue into darkness.

Based on local harvest progress, weather and past experience, an elevator may reasonably forecast that it will receive 100,000 bushels of soybeans during the period when the market is closed, and that it will be asked to purchase 70,000 of those bushels. If it does,

then it will be long 70,000 bushels on Monday morning, and exposed to a lower opening price. If harvest is in full swing in the entire region, then the subsequent hedging pressure may well result in a lower opening.

To reduce this risk, elevators have traditionally placed some “pre-hedge” sell orders on Friday before the close. Will their forecast be exact? Surely not, but the result will very likely still be risk-reducing. Suppose the elevator in this example sold 50,000 bushels to hedge some of its anticipated purchases of 70,000 bushels, and then bought 80,000. On Monday morning it would be long only 10,000 bushels instead of the entire 80,000; it would sell 10,000 bushels on the open. Or suppose it bought only 40,000 bushels: then it would be short 10,000 bushels and would buy 10,000 bushels on the open.. The point of the hedge is not to get it exactly right; that’s impossible. Instead, it’s to reduce the probable exposure likely to be accumulated over the weekend.

The key distinction here in this type of anticipatory hedging vs. the example offered by the Commission is that the elevator’s weekend bid is offered to all its customers, not just to one, and the outcome is not binary, i.e. zero quantity or full quantity. Here, the elevator is reasonable and prudent by forecasting that its bid will be accepted by some.

In both these examples from the grain industry, it’s not likely that classifying these transactions as speculative will cause spec limits to be exceeded. My purpose in urging their treatment as bona-fide hedges is to avoid undue record-keeping or reporting requirements if they are classed as speculative.

Sincerely,

Ashmead Pringle
President

3340 Peachtree Road, Suite 1910
Atlanta GA 30326