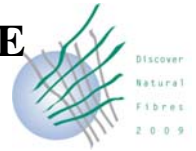




# INTERNATIONAL COTTON ADVISORY COMMITTEE

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## Memorandum 847

**To:** Delegates to the Standing Committee, Coordinating Agencies, and Members of the Private Sector Advisory Panel

**From:** Executive Director

**Subject:** Statement Regarding Regulation of Cotton Futures in the U.S.

**Date:** April 21, 2008

The Secretariat issued a report in the March/April 2008 issue of COTTON: Review of the World Situation that there has been substantial turmoil in the cotton futures contract traded in New York in recent months. Cotton futures prices showed much greater volatility than the historic norm during February and March 2008, and the spread between cash prices and futures prices for cotton widened substantially without a discernable fundamental cause. The Secretariat has noted that the increasing role of speculative activity and commodity investment funds may be affecting cotton prices in ways that are not reflected in fundamental measures of cotton supply and use. The volatility in futures prices unrelated to market fundamentals has reduced the value of the New York cotton futures contract as a tool of price discovery and hedging activity. Because the New York cotton futures contract has historically served as a tool of price discovery for cotton produced in many countries, this matter has implications for all participants in world cotton trade, not just participants located in the United States.

The Commodity Futures Trading Commission (CFTC) is holding a hearing in Washington, DC on April 22, 2008. The CFTC is the regulatory body in the U.S. with jurisdiction over trading in commodity futures. The American Cotton Shippers Association (ACSA) has prepared a statement for delivery at the hearing (see the attached document).

ACSA is a partner association on the ICAC web site, and members of ACSA are highly supportive of the ICAC. Mr. Neal Gillen, Executive Vice President of ACSA, serves as the representative of the Secretariat to the United Nations Commission on International Trade Law (UNCITRAL).

ACSA requests that its statement be distributed to ICAC member governments and members of the Private Sector Advisory Panel. ACSA suggests that supporting statements could be sent to the CFTC indicating the importance to all members of the international cotton industry of orderly trade in cotton futures so that the futures contract can be used as a tool of price discovery and as a medium for hedging cotton sales and purchases.

The CFTC will be accepting statements on the topic of speculative disruption in cotton futures contracts during a two-week period ending Monday, May 5, 2008. Statements should be addressed to Mr. Walt Lukken, Acting Chairman of the Commission, CFTC. His address is [WLukken@CFTC.gov](mailto:WLukken@CFTC.gov).

**Comments  
Of  
American Cotton Shippers Association  
To  
Commodity Futures Trading Commission  
On  
Speculative Disruption In Cotton Futures Contract  
April 22, 2008**

The American Cotton Shippers Association (ACSA) submits these comments for the record in the Commodity Futures Trading Commission's (CFTC) Round Table Forum impelled by the disruption caused in the agricultural futures contracts by excessive speculative interests. In particular, our comments pertain to the speculative disruption in the Intercontinental Exchange's (ICE) No. 2 Cotton Contract.

**Interest of ACSA**

ACSA, founded in 1924, is composed of primary buyers, mill service agents, merchants, shippers, and exporters of raw cotton, who are members of four federated associations located in sixteen states throughout the cotton belt:

Atlantic Cotton Association (AL, FL, GA, NC, SC, & VA)  
Southern Cotton Association (AR, LA, MS, MO, & TN)  
Texas Cotton Association (OK & TX)  
Western Cotton Shippers Association (AZ, CA, & NM)

ACSA's member firms handle over 80% of the U.S. cotton sold in domestic and export markets. In addition, our members also handle a myriad of foreign growths of cotton, which is forward priced based on the New York futures market. Because of their involvement in the purchase, storage, sale, and shipment of cotton, ACSA members, along with their producer and mill customers, are significant users of the ICE's No. 2 Futures Contract. Therefore, they are vitally interested in a return to an orderly futures market reflecting market fundamentals that are not grossly distorted by speculative interests. Accordingly, we urge the CFTC to restore orderly price discovery to allow the cotton contract to once again be utilized by commercial participants who physically handle cotton for price discovery and to effectively hedge their purchases and sales.

**Congress Authorized Futures Trading in Agricultural Commodities for Price Discovery & Hedging**

In 1921, the U.S. Congress authorized contract market designations in the agricultural commodities for the purposes of trading in futures contracts primarily for the purposes of:

- Hedging against price risks;
- Discovery of prices through vigorous competition; and
- Actual pricing of commercial transactions.

The Congress acknowledged that while futures contracts offer an investment opportunity, this conduct should be subordinate in importance to the commercial uses for which the agricultural contract markets were created.

In establishing the agenda for the April 22<sup>nd</sup> Roundtable Discussion, the Commission requested comments on Price Discovery in the Agriculture Futures Markets, including an overview of the market fundamentals, the role of speculators, index funds and commercial hedgers, the adequacy of transparency in the markets, and the adequacy of contract terms and conditions. In the discussion that follows we establish that the market fundamentals bear little relationship to the speculative activity in the ICE Number 2 Cotton Contract. As a result, commercial hedgers have exited this market, due to the fact the traditional cash to futures relationship has ceased to exist.

This situation is the result of a recent phenomena, the advent of index funds with an estimated aggregate value of \$1 trillion and the participation of Over-the-Counter (OTC) traders, which take a myriad of forms. While bringing record liquidity to the agricultural contracts, these entities have turned such contracts into investment contracts, thereby defeating the purposes for which said agricultural contracts were created. The result has rendered the agricultural contracts, particularly the

cotton contract, ineffective for hedging against price risks, the discovery of prices, and the actual pricing of commercial transactions. The physical markets in the agricultural commodities have been adversely impacted precluding cooperatives and merchants from offering price quotations to farmers or end users since they cannot use the contracts for hedging purposes.

**The New Speculative Activity Ignores Market Fundamentals  
Creating Severe Strain on the Cash Trade Resulting in the Lack of Price Discovery,  
the Loss of a Hedging Tool, & Higher Margin Costs**

Since January, the U.S. cotton industry and its supporting financial institutions have lacked confidence in the ICE Number 2 Cotton Contract as a vehicle to manage its price risks through hedging and to seek price discovery.

By early March, the open interest had reached record levels of just over 300,000 contracts or 30 million bales of cotton. About two thirds of this open interest was in the May and July contract periods, while the other third was in the December contract month. Since the U.S. produced only 19 million bales in 2007, the commercial trade (producers, cooperatives, merchants, and mills) represented a much smaller portion of this volume. The commercials that held the physical cotton had sold futures to lock in their basis and carry the cotton until sold and shipped.

This basis was determined when the producer, cooperative or merchant agreed to the physical sale. It is imperative that a traditional hedger be able to hedge by locking in his basis to reduce price risk, and that the market providing the hedge represent the

underlying cash market value. It is equally critical to the interest of his or her lender. Banks demand that a client's position be marked-to-market on a daily basis so that they can value the collateral held by the bank in the trader's account.

Speculative trading, at a time when not one additional bale was consumed or destroyed by weather, drove up cotton futures prices by over 50 percent in a two-week trading period in late February. On March 3<sup>rd</sup>, the price in the front month (March) reached \$1.09, when two weeks previous to that it was at 72 cents. At the same time, the physical price was in the low 60 cent range. On that day, in a short time frame, the commercial trade did not have sufficient time to adjust to this irrational event, which was unrelated to the physical or cash market – a market with half of last year's 19 million bale crop still unsold – the highest level of U.S. stocks since 1966 - a market with a 50 percent U.S. and world stocks-to-use ratio given record world yields and reduced consumption due to poor economic conditions.

The commercial trade was subject to an immediate, unwarranted, and severe financial strain – a strain never realized before in the history of the U.S. cotton industry. Credit lines and lender's perceptions of client risk were tested well beyond the norm. To meet margin calls, banks would have had to value a clients' physical stocks well beyond what the market could bear. The value of the cash commodity bore no relationship to the futures or option prices. No potential buyer of the physical commodity, either a textile mill or another merchant, would pay an amount in excess of its spot or cash market value. Therefore, to satisfy its lenders, the commercial trade had to close out futures at huge losses to generate the cash to repay its loans. Some smaller merchants, who could not withstand these losses, were forced to discontinue operations. Larger merchants with more substantial balance sheets were severely impacted as well and in some cases had to cease or greatly reduce the scope of their operations. At the end of the day, over \$1 billion would be posted in margin calls.

The current futures market situation precludes any form of price discovery because of the potentially high margin risks. Lacking the financial ability or willingness to hedge in the futures market, the result is that merchants and cooperatives cannot offer farmers forward prices. This situation also precludes individual farmers from using the futures market.

Lacking price discovery, the U.S. cotton farmer cannot adequately make production plans. The same goes for a U.S. textile mill who cannot determine what his raw fiber costs will be in future months. Further, this situation has severely impacted foreign producers, particularly in Australia and Brazil who use the ICE Contract to price forward contracts up to two years in advance of planting.

The entry of large speculative funds and index funds into the agricultural futures contracts has clearly distorted both the futures and the physical or cash markets in agricultural commodities. There is such an abundance of cash in the hands of these funds

that their impact on the agricultural markets is overwhelming and negates the primary purposes for the existence of such contract markets.

### **Re-examine Hedge Exemption for Index Funds Not Involved In Agricultural Markets**

Lacking confidence in price discovery, the U.S. cotton industry and some of the world's leading producers are now at a virtual standstill.<sup>1</sup> The U.S. cotton trade has successfully utilized the cotton futures contract as the foundation for its business model for over 135 years. Overnight, we have been stripped of a vital tool in which to conduct our business. We are now exposed to greater risk, which allows only the few highly financed or leveraged companies to function.

Unregulated speculation has severely limited our role of making a market for our producer and mill customers. In the future, how can producers maximize their price at the

farm gate or textile mills minimize their costs at the receiving dock lacking a futures market that provides accurate price discovery?

We simply cannot function in a market with unrestrained volatility unrelated to supply-demand conditions or weather events. The ICE Number 2 Contract is no longer a rational market for price discovery and hedging – its use to the commercial trade has been minimized. It is now an investment vehicle for huge speculative funds that have created havoc in the market unimpeded by fundamentals or regulation. It is a

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<sup>1</sup> In normal times of abundant supply, futures will trade at full carry from the first to the second futures month. "Full carry" in this context is for the certificated stock – cotton eligible for delivery on the futures contract as distinguished from regular cotton inventory. The difference between the two is the weight and overage penalties that accrue on certificated stock as it remains under certification for extended time periods. For cotton under certification between four and twelve months, these penalties amount to 3.5 lbs of weight per bale per month. So if, for example, a trader were to take delivery of this cotton in May and re-tender the bales on July futures, he would invoice each bale in July at seven pounds less than he paid for it in May. This seven pounds amounts to just over \$5 per bale at current prices (7 lbs @ .73 equals 5.11). This needs to be added to the cost of carry on regular inventory. Regular carry amounts to about \$5.50 per bale per month in a Memphis warehouse (Memphis is where the bulk of the current cert stock is stored). To summarize, the cost of carrying cert stock for two months from May to July amounts to about \$16.10 per bale (\$5.11 penalty + two months carry @ \$5.50). This amounts to 322 points at 500 pounds per bale.

Between May 1 and July 1 there will be 600,000 bales of certificated stock with an age of four months or older. This is roughly 60 percent of the 1 million bales in the cert stock. This means the weighted cost of carrying the entire cert stock from May to July is 290 points (600,000 bales @322 and 400,000 bales @ 243). In theory, then, 290 points is the maximum spread that May should trade under July, since that is sufficient discount to ensure a risk-less transaction, buying May and selling July. "Risk-less," that is, except for the cash flow risk of owning over one million bales hedged with short July futures for two months! In the event the cotton market should repeat its recent performance and spike say thirty cents per pound, the owner of the cert stock would need to come up with an additional \$150 million to meet margin calls before he could liquidate his seemingly "risk-free" trade. Few if any members of the cotton trade are in position to take this cash flow risk. This is proven by the 360-point spread at which May/July was trading at last week.

The additional 70 points over the cost of carrying the position for two months reflects the trade's current unwillingness (or inability) to take this cash flow risk. In normal times, merchants would trip over each other to lock in such a margin, yet the market has traded at this level. In fact, far from rushing to lock in this margin, merchants continue to add additional bales to the cert stock, presumably to get the cotton off the balance sheet along with the accompanying short futures. This implies extraordinary levels of risk aversion, and a failure of the market to provide accurate price discovery.

market overrun by cash precluding convergence of cash and futures prices, hedging, and forward contracting – a market lacking an economic purpose – a market not contemplated by the Congress when it authorized futures trading of agricultural commodities.

While speculative interests are vital to the functioning of a futures contract, a balance must be struck. In that regard, the CFTC is urged to take the necessary and immediate action to bring this about and restore the commercial trade's confidence in the futures market. Therefore, **we recommend that an index fund with a hedge exemption should restrict its position in a commodity to the dollar allocation or the percentage of funds allocated to that commodity as defined in its prospectus and recorded with the CFTC. Further, any variation should be subject to speculative position limits, and that such funds should report their cash positions on a weekly basis.**

We also submit that the role of the unregulated swaps market is contributing to this situation since there is no limit to or transparency in their trading activity. It is our recommendation **that the CFTC monitor and oversee all swaps and OTC activity by requiring the reporting of all swap and OTC contracts by market participants, and that it determine the aggregation of positions from all sources, including the exchanges, ETFs, swaps, OTC, and all other trading entities. Further, that all non-traditional hedge accounts, those not involved in the commercial enterprise of physically trading bales of cotton, be reported as a separate individual category.**

#### **Cotton Margin Requirements Are Arbitrary & Onerous**

The role of margin requirements should insure the efficient operation of a contract market by maintaining a balance of accounts between the longs and shorts and when necessary by requiring additional margin calls to effect orderly settlement in volatile markets. Most importantly, margin requirements should be fair, consistent, and facilitate the efficient functioning of a contract market. That is not the case with cotton margin requirements.

The margin requirement in the ICE Number 2 Cotton Contract is arbitrary, capricious, and unreasonable. The cotton contract does not margin futures to the close of the futures contract month, but establishes margins at the synthetic level determined by the close of the options contract in that month. While the futures month may be locked at the limit there are no limits on the option's contract, therefore, in that situation the option is likely to close at a level well above the futures close. This onerous requirement limits the ability of the commercial trade to obtain the requisite financing to use the contract market, thereby precluding the use of the contract market for price discovery and hedging.

While the margins are established by the contract markets and do not require approval of the Commission, the Commission does have emergency authority under Section 12a(9) of the Commodity Exchange Act<sup>2</sup> "to direct the contract market whenever it has reason to believe that an emergency exists, to take such action as, in the Commission's judgment, is necessary to maintain or restore orderly trading in ... any contract market." The current situation is such an emergency pursuant to the statutory definition as it constitutes a "major market disturbance which prevents the market from accurately reflecting the forces of supply and demand for such commodity."<sup>3</sup> In this case cotton. Such an emergency exists, and we urge the Commission to use its emergency authority to, inter alia, **require that the ICE and its clearing members adhere to the practice of margining futures to futures settlements and options to option settlements and that only those involved in the physical handling of the agricultural commodity (cotton) be eligible for hedge margin levels.**

We urge the Commission to promptly adopt our recommendations. These appropriate and minimal measures should help bring transparency to the cotton contract, limit excessive and disruptive speculation unrelated to market fundamentals, restore price discovery, and encourage the commercial trade to utilize the contract as a hedging mechanism thereby allowing producers and textile mills to once again have access to forward contracts as risk management tools.

In taking this necessary action we respectfully suggest that the Commission be firm in its resolve and that it ignore those who would justify this irrational imbalance in the U.S. agricultural contract markets on the grounds that the necessary oversight, reporting, and regulation of the index funds and swaps operators

<sup>2</sup> 7 USC 12a(9)

<sup>3</sup> Id.

would drive this business offshore. That is a competition issue that should be resolved in the international marketplace. It is not the role of the Commission to guarantee the exchanges record trading volumes, but to assure that the agricultural contracts provide price discovery and hedging. The CFTC's role is to protect those that Congress intended it to protect - the commercial users of the agricultural contract markets.

By taking action to restore the integrity of the agricultural contract markets the Commission will be fulfilling the legislative intent that its role as an independent regulatory agency is to prevent "excessive speculation ... to the detriment of the producer or the consumer and the persons handling commodities and the products and byproducts thereof in interstate commerce rendering regulation imperative for the protection of such commerce and the national public interest therein."<sup>4</sup>

ACSA supported the establishment of the CFTC as an independent regulatory agency in 1974. It continues to support the Commission as such and urges it to fulfill its statutory duty and resolve the current crisis in the agricultural contract markets. The Commission's failure to assume that duty would call into question its role as an independent regulatory agency.

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<sup>4</sup> 7 USC 5