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COMMENTS ON ICE'S NEW POLICY REGARDING LIMITS ON COTTON HEDGE POSITIONS DURING NOTICE PERIODS

Last week ICE announced that spot month hedge positions in cotton will be limited to 300 contracts during the notice period, unless a trader applies in advance and can demonstrate bona fide uncovered commitments due for shipment in the next two months. This policy has been presented as being only a minor change to bring cotton's delivery procedures in line with those for coffee and cocoa. While I am admittedly unfamiliar with the latter markets, it is clear to me that enacting this rule change for cotton is a profound, negative change to the ICE No. 2 futures contract.

The new policy states:

To be eligible for a notice period exemption under Exchange Rule 6.26 (Hedge Exemption), applicants must request a specific long or short position sufficient to cover the applicant's bona fide hedging requirements for the contract month's delivery month and the next succeeding calendar month. (Source: ICE Exchange Notice dated February 3, 2011)

Physical delivery via cotton futures takes place on a regular basis, and significant volumes of cotton typically change hands during notice periods. The need for this delivery capability is underscored by the large amount of warehouse space available for and devoted to certificated stock. Cotton warehouse capacity for this purpose amounts to well over 1.5 million bales, over 10% of total production in recent years.

Because of this large capacity, approved industry practice allows the warehouse a total of nine weeks to ship out its certificated stock from the time shipping orders are received. As long as the cotton is loaded out during that time, the owner has no recourse against the warehouseman for the slowness of the shipments. In situations such as we face today, where huge quantities of cotton have been sold and shipments instructed, warehouses all across the US are behind on deliveries. These delays are creating havoc overseas, where buyers of US cotton are having to reduce their yarn production due to a shortage of cotton to spin, or are having to replace their slow-arriving imported cotton with local supplies. (One spinner told me recently he is buying local cotton in Brazil at prices over $2 per pound to maintain his production rates because the US cotton he purchased earlier at much lower prices is slow to arrive. Imagine the impact on his cash flow and profitability!)

It is into this environment that ICE has introduced new restrictions on the availability of cotton through the futures market. The new rule states that a trader cannot take delivery of cotton he needs for shipment more than two months in the future. In the case of spot March 2011 futures, this means a merchant can take only cotton he owes to customers for shipment during the months of March and April 2011. **The fact is that this rule effectively stops a merchant from being able to source cotton through the futures contract at all.**

Consider the example of a merchant who has sales commitments for 500,000 bales, sold for shipment equally from March through to July, i.e. 100,000 bales per month. If this trader takes delivery of March futures, he will be able to ship out the existing 167,000 bales of certificated stock over a nine week period once he has the cotton and sends shipping instructions in early March. The nine weeks will stretch all the way into May, meaning he cannot use the cotton to meet any of his March commitments nor many of his April commitments. This reality means that few or any merchants will have significant numbers of genuinely unfilled sales for March/April by the time the notice period for March gets underway. ("Unfilled" means the merchant has sold cotton but has not yet acquired the bales he needs to ship against the sales. This is what ICE refers to as cotton needed for "bona fide hedging requirements.") As a practical matter the merchant will have already acquired the cotton for his March and April commitments because he knows any cotton he can take from the March futures contract will be available too late to be used against those sales. The merchant in this example needs to take delivery of March futures to fill his May and later obligations, which is exactly what the new rule prohibits!

Cotton acquired via March futures will be available only for shipment against May and later commitments, but ICE's new policy prohibits the trader from taking cotton for shipment that late, since those unfilled sales are due beyond the two-month window allowed in the rule. **What is apparent is that ICE fundamentally misunderstands the physical logistics of cotton shipments and the time necessary to execute those shipments.**

This new policy needs to be reversed **immediately** before it does irreparable harm to traders who rely on the futures delivery mechanisms to facilitate their physical cotton business. In its current form it renders the cotton contract ineffective as a source of supply, and as a legitimate price discovery vehicle. Putting in place rules that render the contract impotent is not in ICE's interest, and certainly is disastrous to many traders who have planned their cotton marketing for this season around using cotton acquired via futures delivery.

It is not a coincidence that the price of March futures fell from over 181 cents per pound to 165 cents in less than thirty hours from the time the rule was explained to the public. The real value of cash cotton has not changed during that time, since it is just as scarce as it was beforehand. If the futures contract cannot be used to acquire and distribute cotton, expect to see its value diverge even further from cash values. **ICE has made a rule that guarantees cash and futures prices will not converge.**

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