

Agricultural Marketing Guide >>



Commodity Futures Markets

Introduction

A commodity exchange is a place where buying and selling of commodities occurs. Exchanges perform three valuable functions.

1. exchanges set rules and regulations to promote transactions between buyers and sellers in the marketplace
2. exchanges provide the mechanism for settlement of disputes which may arise
3. exchanges display valuable price and market information to all parties interested in a particular commodity associated with the exchange

Buying and selling of commodities can be done in two ways.

1. buy or sell in the cash market or
2. buy or sell a product via a futures contract.

The cash market is where actual physical commodities are bought and sold at a price negotiated between buyer and seller. However, the futures market functions by using legally binding futures contracts, not the actual commodities themselves, which can be bought and sold. These agreements (futures contracts) provide for the delivery of or receipt of a specified amount of a particular commodity during a specified future month. Futures contracts do not involve transfer of ownership of the commodity. Instead, futures contracts involve potential receipt or potential delivery of the commodity at some future date. For this reason, one can buy and sell commodities in a futures market in the form of contracts, whether or not you grow that commodity or actually possess the physical commodity.

Organized Commodity Exchanges

Hundreds of futures contracts are traded on exchanges in the United States, Canada and around the world. Listed below are the North American exchanges with primary agricultural related futures contracts. All of these exchanges also trade options, another risk management tool provided by each exchange for a particular product.

CME Group encompasses three exchanges, the CME, CBOT and KCBOT described below.

Chicago Mercantile Exchange Group (CME) - <http://www.cmegroup.com/>

-Live cattle, feeder cattle, lean hogs, and a large number of foreign currencies including the Canadian Dollar.

Chicago Board of Trade (CBOT) - <http://www.cbot.com/>

-Corn, U.S. and South American soybeans, soybean oil, soybean meal, soft red winter wheat, oats, rough rice and ethanol. In addition, mini-size contracts (1000 bushel) of grains are offered.

Kansas City Board of Trade (KCBOT) - <http://www.kcbt.com>

-Hard red winter wheat.

Minneapolis Grain Exchange (MGEX) - <http://www.mgex.com/>

-Hard red spring wheat, grain price indexes (cash prices), apple juice concentrate.

New York Board of Trade (NYBOT) -

http://quotes.ino.com/exchanges/contracts.html?r=NYBOT_KC

-Coffee, sugar, cocoa, frozen concentrated orange juice, cotton, interest rates and major currencies.

Intercontinental Exchange (ICE) - https://www.theice.com/futures_canada.jhtml

<https://www.theice.com/index>

-ICE Futures Canada provides futures contracts for milling wheat, durum, canola, and western feed barley. ICE Futures U.S. lists contracts for cocoa, coffee, sugar, petroleum, natural gas, power, and freight as well as soybeans, soybean products, wheat, and corn in competition with the CME Group and MGEX crop contracts.

The Commodity Clearinghouse

All commodity exchanges use a clearinghouse to handle the bookkeeping of trading futures and options contracts. The clearinghouse is responsible for keeping records of trades between all buyers and sellers by acting as a third party. After each trading day has ended, all exchange members must report their transactions to the clearinghouse. The clearinghouse then ensures that financial settlement from all buyers and sellers is made. The clearinghouse guarantees all contracts by requiring that all participants maintain cash deposits (margin money) relating to their open futures positions.

With the move to electronic trading, exchanges now have extended trading hours. All still have a daily close, but may open again a few hours after the “close” using the electronic platform. Some commodity exchanges have maintained a “physical” marketplace, where buyers and sellers continue to make transactions through open outcry on the trading floor. However, these exchanges run concurrently with the electronic trading platforms.

In addition to maintaining an accounting of each trader's holdings of contracts, the clearinghouse will cancel out the trader's obligation on a contract if the trader closes out (offsets) his trade position. As soon as a contract has been traded and then processed by the clearinghouse, each party effectively has a contract with the clearinghouse instead of the actual party with whom the

trade originated. This allows either party to close out a futures market position since neither one has to find and deal with the party with whom the original trade was made. Although there must be a buyer for every seller at a common price for a futures trade to occur, the clearinghouse enables one party to close a position without requiring the other party to the original trade to be involved. For each contract sold, one is bought (zero net gain). In essence, the exchange handles the purchasing and selling of future contracts (matching buyers and sellers), offsetting one against another, regardless of who the exchange participants are.

The Futures Contract

Futures contracts are standardized, legally binding documents. Contracts are standardized to simplify trading. Futures contracts specify the commodity, quantity, grade, delivery or price reference point, delivery period, and the delivery terms. For example, the following sections highlight examples of specifications for the ICE Futures Canada Milling Wheat (ICE wheat) and Canola.

1) Delivery or Price Reference Points

Delivery or price reference points are important for the proper functioning for each futures contract. These physical locations are designated by the exchange. For example, ICE wheat contract prices physical delivery of Canada Western Red Spring (CWRS) wheat free-on-board at elevators in Eastern Saskatchewan, with additional delivery points across the Canadian prairies. This price reference point is referred to as the F.O.B. Par region. This means that all buyers and sellers of ICE wheat futures know that they are negotiating a price for milling wheat at, or within the Par region. Other discounts or premiums based on transportation costs are listed on the website. Other Prairie regions are listed here for milling wheat: https://www.theice.com/publicdocs/futures_canada/ICE_Milling_Wheat_white_paper.pdf
The Par area for canola futures is the Saskatoon area, with discounts or premiums for locations outside of that par area.

2) Currency and units

The currency of the futures contract and the units of measurement can differ between exchanges. In the case of ICE milling wheat, it is in Canadian dollars per tonne. Be aware of exchange rates when using futures listed in other currencies, such as U.S. dollars.

3) Contract months

Not every calendar month is listed in a commodity's "future". Each futures contract has only a number of contract or delivery months. For ICE wheat, the months are March, May, July, October and December.

4) Contract size

ICE wheat futures contracts are traded in 100-tonne units whereas the CBOT's wheat, soybean, corn, and oats contracts are traded in 5000-bushel lots. ICE Canola contracts are traded in 20 tonne units.

5) Contract quality

Most contracts specify one grade of the commodity. Often other specified grades are allowed to be delivered at a premium or discount to the par contract price. The "par" quality is the quality before discounts or premiums. Price differentials are established based on those usually found in the cash or "spot" market.

6) Trading hours

Trading hours state the opening (beginning) and closing (ending) times for trading of a particular futures contract. With electronic trading, many exchanges' contracts are open almost 24 hours a day while others are more limited.

7) Minimum price change

Each futures contract has a minimum price change that traders may buy or sell at. For ICE wheat and canola, traders may only bid or offer prices that are in \$0.10 cent per tonne increments.

Daily Trading Limits

Commodity exchanges set trading limits to maintain an orderly market. These limits keep prices from advancing or declining beyond a certain range from the previous day's closing price. These ranges differ for different contracts. (See "Settlement or Closing Price" below.)

For ICE wheat, the daily limit is \$20.00 per tonne (or \$2000.00 per contract). Given the daily close, the trading range can increase or decrease the next trading day by only this amount. The maximum daily trading range, therefore, is \$40/tonne or twice the trading limit. Other exchanges and contracts have different limits. Trade in a commodity futures does not stop as soon as a limit up or down is achieved. As long as there are buyers and sellers, activity can continue at the limit price. Daily limits may be expanded for trading in the day following a limit move, according to the contract specification set by the exchange. ICE has posted expansion limits of \$30/tonne and then \$40/tonne for milling wheat contracts.

Trading days

Different exchanges have specific trading days and hours. A person trading commodities on an exchange should familiarize themselves with that exchange's trading days and hours.

Settlement or Closing Price (Close)

During any trading day, the price of most futures contracts will fluctuate up and down as transactions between buyers and sellers take place. In general, most volume of trading takes place over a very narrow range of prices near the beginning and end of the trading period on a given day.

Sometimes near the close of trading, few or no actual trades occur. In the instance when there is little volume traded near the close, there may be a bid price (buyer) and ask price (seller). In this case, the Clearing House may use the end-of-day bids and asks to determine what the settlement price for the futures contracts will be. The settlement price is also known as the "closing price".

What to do with Futures Contracts

A holder of "buy" or "sell" futures contracts has several choices of how to deal with the legal obligations of a futures contract before the last trading day of the delivery month. The two most common ways of dealing with futures contracts are:

1. "offset" the contract by taking an opposite futures position in the same month of that same commodity futures, or
2. the "sell" futures position holder actually makes delivery of the physical commodity to a "buy" futures position holder and a buyer takes delivery of the commodity - called "making" and "taking" delivery.

Subject to certain rules established by the exchange, delivery of the actual commodity against a futures contract is at the seller's choosing. It is the threat of delivery that drives convergence between the futures price and the cash price in the delivery month. However, delivery seldom occurs as arrangement of delivery and process is cost prohibitive. The vast majority of futures contracts are dealt with by an offsetting trade. To offset an open futures position, the futures contract holder takes an equal but opposite position to the original trade, thus canceling the obligation. For example, the clearinghouse, which keeps track of everyone's futures contracts, sees the obligation to make delivery (the "sell" futures position) as offset by an obligation to take delivery (the "buy" futures position). The holder of the "sell" contract can offset their contract at any time up to expiry of the contract.

Important note

It is not wise to wait until a futures contract's expiry day to offset a futures position, especially if that commodity exchange contract has limited volume. Futures trading in an expiry month may be "thin", or have relatively low "liquidity". As a result, a trader may have difficulty offsetting a position as buyers or sellers of that particular month's contract are few. Expiry-month prices may move quite differently from prices of more distant futures months of the same commodity, resulting in unusual price movement and volatility.

Registered futures commission merchant responsibilities

Individuals and companies cannot buy and sell futures contracts directly through commodity exchanges. A registered broker places futures contract orders on behalf of processors, producers or buyers. However, some brokerage companies do have electronic platforms that enable clients to enter their orders via computer. Brokers are formally referred to as Registered Futures Commission Merchants (RFCMs), and are regulated and licensed by their membership through the commodity exchange.

Margin

The buyer or seller of a futures contract is required to deposit part of the total value of the specified commodity future that is bought or sold. This is known as Margin money. This deposit is required by regulations set out by each commodity exchange and must be deposited with a RFCM before a futures contract is first bought or sold. Margin money is essentially a guarantee that the trader, the customer of the RFCM, will honor the contract.

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