UNITED STATES OF AMERICA

COMMODITY FUTURES TRADING COMMISSION

AGRICULTURAL ADVISORY COMMITTEE MEETING

Washington, D.C.

Thursday, August 5, 2010

ANDERSON COURT REPORTING
706 Duke Street, Suite 100
Alexandria, VA 22314
Phone (703) 519-7180 Fax (703) 519-7190
www.andersonreporting.net

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P R O C E E D I N G S

CHAIRMAN DUNN: We've got a very long schedule today and I really appreciate everyone coming here. Let me welcome everyone to the CFTC's Agricultural Advisory Committee meeting. This is the thirty-fourth meeting of the advisory committee. The CFTC considers the four advisory committees each chaired by a separate Commissioner to be a major element in the information gathering and public outreach programs of the Commission. I want to thank all of you for attending, and a special thanks for each of the presenters and reactors in today's panels. The panels are made up of experts from CFTC staff, the United States Department of Agriculture, and knowledgeable private parties from the exchanges, the trading industry and market users community.

Each of the panelists has spent a considerable amount of time in preparing for today's program and I want to recognize the contribution of your time and expertise and offer my sincere thanks and appreciation for participating today. This meeting will revisit some of the market concerns that we have discussed in the past agricultural and other Commission meetings. The issue of cotton contracts has been the subject of both industry and CFTC studies and will be discussed again today, specifically recent developments regarding the contracts delivery points, the continuing and perplexing situation of lack of converge in the wheat market is still with us and will be revised, and the last panel will discuss livestock price reporting and livestock market fundamentals.

Our format today will be the same as in the past. First we'll hear from the presenters regarding what is going on in a specific market and what problems have been experienced, then we'll hear from a panel of reactors who will provide expertise from the perspective of the trading and market users and will be followed-up by a period of questions and answers by the Commission, the AAC and the audience. As an added item, Don Heitman of the CFTC staff will give an overview of how the recent passage of the Dodd-Frank bill specifically impacts agricultural commodities. Over the next year the CFTC will be actively writing rules to implementing the Frank-Dodd bill. The Commission values the input from the public and encourages members of the public to submit their views to the agency. To submit views on any of the 30 rule-writing areas, go to cftc.gov, click the link to OTC Derivatives Reform Law. Under the heading of Rule-Writing Process, click on See List of OTC Rule Making, find the rule-making area you're interested in and click on it. From there you will find email addresses to which you can send your comments regarding each of the rule-writing areas. If the press doesn't get anything else out of my opening statement, that last paragraph I think is of paramount importance. The Chairman and staff is working as hard as they know how and that's very hard, believe me, but we are overwhelmed with the short deadlines that we have to meet the Frank-Dodd provisions of the bill and if the

Chairman has anything to say about it we will meet those deadlines and I am confident that he is going to drive the staff and the Commission to be able to do that.

It is extremely good for the public to give us your input and we're already being inundated with folks from the industry and lobbyist groups, special interest groups, and trade associations, which is great. We've got to hear from them. But the best time I have found in getting your input into rule making is before pen goes to paper. It is extremely important for you to lock onto those rule-making areas and give the staff that is beginning the development of these rules, your input on what you think is important. Please, please do that.

I want to thank all of you for your attendance and the staff of the CFTC in making this possible, and I will ask the Chairman if he has any opening remarks.

CHAIRMAN GENSLER: Good morning. Thank you, Commissioner Dunn for chairing today's

meeting of the Agricultural Advisory Committee, for your leadership in this important area and for those remarks about the overall Dodd-Frank rule-making effort. As you say, we have a lot to do. This is a great agency, the staff is up to it, but we need the public's help. We need the public's comments. You're going to hear today about agricultural swaps and we'll hear directly from this Committee and hopefully the public will weigh in, but in all 30 years that we've put on the website I appreciate what Commissioner Dunn said because it's really important to hear from the public and their thoughts.

I want to also join Commissioner Dunn in thanking my fellow Commissioners and all of the expert panelists here today. The importance of the timing of the meeting of course is it's the first public meeting since the Dodd- Frank bill passed and that legislation for the first time will bring comprehensive regulation to the derivatives marketplace, specifically, it will subject all the dealers themselves to

comprehensive oversight, it will bring standardized derivatives to transparent trading venues and also to centralized clearing. This will greatly reduce risk in the marketplace and promote transparency for the public.

As we move forward with regard to this, I was going to focus on the areas today that I'm keenly listening to including of course the questions of wheat convergence and the ICE cotton contract, and I'm particularly interested in the views of the Committee regarding how we write rules with regard to these agricultural swaps. Don Heitman from our staff of course will give an overview later on on this important subject.

I'm interested in hearing the views of the Committee on the ICE Futures Cotton No. 2 Contract. You know so much more than I do about this subject. It's important that the exchanges periodically review contract specifications and make sure that we're keeping up with the changing market environment. It's important that exchanges review delivery points so that they best reflect the changing characteristics of the physical marketplace, and of course I look forward to your thoughts.

With regard to the convergence in wheat contracts, recently the Chicago Board of Trade went through some similar issues. They implemented changes with regard to variable storage rates on soft red winter wheat, but unfortunately now we see the significant problems down in Kansas City that you're going to help advise us on. It's really at the core of any futures contract that it converges. Without convergence, hedgers lose confidence in the marketplace whether that be farmers, millers, grain elevator operators, so I'm particularly interested in how this contract that is having problems now can be addressed for hard red winter wheat.

I look forward to hearing from the third panel on livestock price reporting. Again I want to thank Commissioner Dunn and my fellow Commissioners as well as the full Agricultural

Committee here today.

CHAIRMAN DUNN: Thank you, Mister Chairman. Commissioner Sommers?

COMMISSIONER SOMMERS: Good morning. I want to say thank you to Commissioner Dunn and to his staff for organizing the meeting today and for the excellent agenda items. I especially appreciate the forum that we have in the Agricultural Advisory Committee to discuss these issues that are on the agenda today. I think that bringing together both the exchanges and market participants and producers around the table to talk about the progress we've made on some of these issues, to talk about the specifics and differing points of view on many of these issues because a number of these issues have been on our plate almost since I've been at the Commission. I've been here for 3 years, so we've been discussing these issues for a long time and I want to say how much I appreciate this forum.

The progress, particularly on the recommendations that were in the CFTC's staff report on cotton trading during the week of March 3, 2008, and the additional changes that have been suggested for the ICE No. 2 cotton contract, I think, will be particularly interesting. I look forward to the discussion on the CBOT wheat contract performance and the changes since the VSR has been implemented, as well as discussing the Kansas City Board of Trade's hard red winter wheat basis issues. Commissioner Dunn and I had the opportunity to be in Kansas City on July 1 and I look forward to the updates since then.

Additionally, the livestock futures contracts and the pricing report are on the agenda today, and I want to say how grateful I am to USDA for being here to help us discuss those important issues.

Finally, agricultural swaps have been of interest to me, with my background, and something that we have talked about as well for almost 3 years. So I appreciate Don Heitman giving us an update on how Dodd-Frank will treat those issues. Thank you all, the members of the Committee and the panelists that are here today, for giving us an opportunity to discuss these issues.

CHAIRMAN DUNN: Thank you, Commissioner Sommers. Commissioner Chilton is going to be joining us by telephone. Commissioner Chilton, are you on the line? He has not joined us yet so I will go to Commissioner O'Malia.

COMMISSIONER O'MALIA: Thank you very much. Good morning everyone. I'd like to thank Commissioner Dunn for organizing the meeting and your leadership on these issues. Growing up on a very small family farm, these issues are very interesting to me. Growing up in Michigan, cotton was never a concern of ours, but I do have a soft spot in my heart for this red wheat contract. And I appreciate everybody's willingness to participate here today to share your views with the Commission regarding the current events in the agricultural markets and hopefully some positive solutions that can bring convergence and price discovery back to these markets if there's any concern about that.

I'm interested to hear from the cotton market participants regarding the CFTC report on the March 8 cotton market events and the Informa study regarding delivery points. As physical markets evolve it is critical that the related futures contracts with physical delivery evolve in order to ensure that the price discovery process for hedging remains intact. I'd like to know if the cotton market has evolved both in response to the changing market events of March 2008 in the contract and whether these contract changes will address those problems. Further, I am interested in receiving a report from the CME group regarding the results related to the contract modifications in the CBOT wheat contract. I believe these modifications can inform the Commission on issues related to the lack of convergence in the Kansas City hard red wheat futures market. Finally, I'm interested to hear about the current state of price reporting in the livestock market and concerns about price transparency. We must ensure that the data underlying futures contracts is the

best available data so that the contract performs it's vital price discovery function.

I'd like to thank staff who have worked many hours putting this together and everybody's participation here today. Thank you.

CHAIRMAN DUNN: Thank you very much, Commissioners. I'd like quickly to have the members of the ag advisory committee to introduce themselves. This is probably the greatest group and I really, really appreciate not only what you're doing coming to these particular meetings, but also the advice that you give me periodically through the year. Edgar Hicks will send me issues and things that he sees out in Nebraska all the time. I really appreciate getting those types of heads-up of what's going on. It keeps me in touch with what's going on in the field, but let's start with, John, if you would start off with introductions.

MR. NATZ: Kevin Katz with National Council of Farmer Cooperatives.

MR. BRUNS: Matt Bruns with the National

Grain and Feed Association.

MR. HICKS: Edgar Hicks with the National Grange.

MR. CRYAN: I'm Roger Cryan with the National Milk Producers Federation.

MR. DIERKS: I'm Neil Dierks from the National Pork Producers Council.

MR. LANGLEY: Reese Langley, USA Rice Federation.

MR. LANCLOS: Ken Lanclos, Risk Management Agency.

MR. WILLETT: Sam Willett, National Corn Growers Association.

MR. DOUD: Gregg Doud, National Cattlemen's Beef Association.

MS. PETERSON: Dana Peterson, National Association of Wheat Growers.

MR. GAINE: Jack Gaine with Managed Funds Association.

MS. COCHRAN: Christine Cochran with Commodity Markets Council.

MR. ANDERSON: John Anderson, American

Farm Bureau.

MR. WANDS: Hayden Wands with the American Bakers Association.

CHAIRMAN DUNN: Thank you all. I appreciate that. I understand we had a little technical glitch and Commissioner Chilton may be online now. Bart, are you on? The wonders of technology. We'll let him address when he gets here.

Our first panel today is going to be on the cotton contract and it's one that we've heard a lot about since March 2008 when we had a great deal of upheaval in that contract and a great upheaval in the industry itself. We're going to hear from Marshall Horn from CFTC and Tom Farley from ICE on studies that have been done by both the CFTC and ICE, and then we're going to have reactions from Jordan Lea, John Barrett and Woods Eastland who represent various sectors of the cotton industry.

Before I do that I need to read something to you. We have received an appeal from the Port of Corpus Christi that has filed an appeal with the Commission concerning certain procedures followed by the Intercontinental Exchange in dealing with the port's petition to be designed as a delivery point. The purpose of this meeting is not to address the current appeal. I therefore ask all of you not to discuss the specific procedures followed by ICE in dealing with the port's petition. Nevertheless, to avoid any possible appearance that the Commission's decision on the pending appeal could be based in part on material outside the appeal's record, I intend to ask the Commission to incorporate the pertinent parts of the record of this meeting into the record of the appeal process.

COMMISSIONER CHILTON: Mister Chairman?

CHAIRMAN DUNN: Commissioner Chilton, please.

COMMISSIONER CHILTON: Thanks, Mister Chairman. I'm sorry, like yesterday, Mike, I was on but couldn't do the audio, so I apologize for that and won't be long.

These markets have changed dramatically and I think it's a good thing that we look at it. They've changed over the years with technology and with traders. It's not like they changed overnight and took some BP magic beans, but they're changed and this is something that we need to be looking at. In particular the Chairman mentioned a couple of years. I'm particularly interested in our new authority with regard to position limits to make sure they're fair and calibrated in a real way that makes sense for markets. I'm also interested in our disruptive trading practice authority. For too long I think these markets have been subject to commodity roller coaster rides and we make sure that that's not happening, that they remain legitimate hedging tools not just for participants and not just for our economy but for consumers. So I look forward to hearing what everybody has to say and I thank you for your indulgence with the technology and thank you all for participating. Thanks, Mister Chairman.

CHAIRMAN DUNN: Thank you, Commissioner Chilton, and we'll try to make sure that we give you ample opportunity to have your input.

CHAIRMAN GENSLER: I was going to say that as Commissioner Chilton mentioned about position limit authority on agricultural position limits, this Commission is supposed to do that in 270 days which really means it's 255 days from now. So most of the rules are a year, but agricultural position limits is 270 and oil and metal are actually 180 days.

CHAIRMAN DUNN: Thank you. I would like to recognize Dawn Stump who is here from the Senate Agricultural Committee. Thank you very much for attending this. With that, Marshall, if you will lead us off with your presentation.

MR. HORN: Thank you very much, Commissioner. I'd like to do a brief overview, there will be more detail of course from other participants, to indicate what I'm going to cover, the current market situation in the cotton market at this time, a very brief discussion of the March

2008 situation in cotton, the recommendations from the CFTC staff report regarding that time period and that volatility, the issue of price limits and the very current issue, very topical issue of delivery points on the cotton contract.

Starting with the current cotton market factors and using some USDA numbers, since May, the nearby cotton future which is the 1st of July then the October ranging between about 73 cents and 84 cents per pound. The new crop statistically started August 1 looks like it could be a very large crop. More acreage was planted and growing conditions are very, very good. The USDA estimates new crop at about 18.3 million bales which is about one-and-a- half times as large as the 2009-2010 crop that we just finished of 12.2 million bales. Although we have a large crop expected, demand appears to be strong and that is keeping prices at a fairly high level. We expect usage of the crop both domestically to increase from last year, domestic consumption is going to stay about the same according to USDA, while exports which are the heart of the consumption of cotton are expected to increase to 14.3 million bales, up 2 million from last year, and season- ending stocks for next July are projected to be up to 3.5 million bales versus 2.9 this time.

Currently the October contract is trading to at a premium to the December contract and this is unusual historically. The October contract however is thinly traded. It is a new crop contract and tends to represent the earliest harvested cotton in the U.S. which is south Texas. Part of the reason for the inversion of October over December is that certificated stocks for the ICE exchange have declined tremendously. On June 2 they were about 1 million 80 thousand bales, a relatively high number historically, now the slide says 44,000, but the last number I saw was 41,000, so they've almost been decimated. A lot of that is due to the strong demand for U.S. cotton and China in particular, the largest consumer of cotton for its mills has been a very active buyer recently of U.S. Cotton and has very strong demand for its textile products. What we here from trade and from everyone really is that most of the remaining cotton stocks are already sold.

Continuing, the December contract is a true new crop contract and it's a very liquid contract, much more so than the October, and recently it's been trading at a premium to March which suggests some tightness, a premium of about 2 cents lately. We expect a big crop and the inversions do suggest that the marketplace views available cotton stocks at this time as tight, but then there will be a large crop.

The next topic is the March 2008 cotton situation. I have five points to mention. It was a time period of extreme price volatility. There were very large margin calls to cotton merchants and other traders in the market. It was a time of extreme volatility in many commodity markets and many agricultural markets including crops that compete with cotton for acreage. It was also the first time that floor trading was no longer permitted for cotton futures when it went to all electronic on the futures side and options still traded on the floor as well as electronically. At that time the futures price movements were restricted by price limits and it frequently hit the limit either up or down, whereas margins were determined based on synthetic prices derived from options which were free to move without limits and that relates back to the second point about the very large margin calls to cotton merchants and others.

The CFTC staff investigated the situation in March 2008 and published a staff report in January I believe 2010 this year. One of the main things that was looked for given the tremendous volatility was possible price manipulation. It was looked at for several possible scenarios of how there might have been manipulation and the investigation turned up no evidence of manipulation. The staff report had several recommendations even though manipulation was not a factor. First, that ICE U.S. Analyze in light of historic price volatility the expected frequency with which current price limits will restrict trading; that ICE U.S. evaluate whether in conditions of rapidly rising prices and extreme price volatility the newly expanded price limits will allow the cotton market to operate efficiently and facilitate price discovery and risk management functions. There had been an increase and a change in the rules for price limits for cotton futures but we asked that the experience with the new limits be evaluated. That ICE U.S. notify the Commission of whether it intends to implement the dormant Rule 10.09(b) and subject cotton options to price limits. If so, ICE U.S. Should provide the Commission with an update on the status of the technology upgrades that are needed to implement that dormant rule.

As a result and in reaction to the report and the recommendations, ICE Futures submitted a proposal for Commission approval for a price limit on cotton options on May 21, 2010. The Commission staff and the Division of Market

Oversight requested additional information and clarification and this proposal is being reviewed by the CFTC.

I'd like to turn to the question of delivery points and I'll point out very much that it's a very important issue and it was not part of the staff report on what happened in March 2008. Currently there are five delivery points for the cotton contract. These delivery points have remained the same for many decades. They are Galveston and Houston, Texas, New Orleans, Louisiana, Memphis, Tennessee, and Greenville/Spartanburg, South Carolina. Memphis tends to be the most active and has the most deliveries and most deliverable stock, and Galveston is often in second place, Houston and Greenville somewhat less, not having a lot of cotton sometimes and having a decent amount other times, New Orleans very occasionally. Over the years the production of cotton has shifted from one state to another so it's not what it was decades ago.

In regard to delivery points, ICE commissioned the consulting firm Informa Economics to, "Analyze the adequacy of the five existing cotton futures delivery points and determine whether there are other locations that would serve as commercially relevant delivery points." On July 16, ICE announced the recommendations of the subcommittee studying the delivery points. They did not agree with everything that Informa said. They unanimously recommended that to the cotton committee that that committee should recommend to the board of directors which is the determining body of course to add a new delivery point for cotton at Dallas/Fort Worth, Texas, and eliminate New Orleans. Just a couple of days ago the board of directors of ICE Futures adopted that recommendation and then will go to the CFTC for approval.

CHAIRMAN DUNN: Marshall, just a couple of quick things for clarification on your presentation. Stocks here of 44,000 bales. How is that historically?

MR. HORN: It's the lowest in years. I don't know how years back, but it's a very, very low level. It's 440 contracts. Actually, I think it went down to 410 or something like that the other day. It's going down every day.

CHAIRMAN DUNN: For the proposal for Commission approval on the price limit on cotton options and given the fact that we're trying to implement the Dodd-Frank bill, do you have a timeline or a timeframe on when you might see something come in to the Commission for that approval?

MR. HORN: That's really handled by other parts of the Commission of Market Oversight. I'm in surveillance and that's product review. However, it's a fairly complicated proposal in terms of how it works, and as I indicated, we did ask for clarification. I know it does have a timeframe on it and it's not anything like 200 days. It's a lot sooner than that, but I don't know the exact deadline at this point.

CHAIRMAN DUNN: The same question then

for the delivery point changes that ICE has currently made. That does have to go to the Commission for approval? First of all I wanted to make sure that's correct.

MR. HORN: Yes, sir, it is.

CHAIRMAN DUNN: Do we have an estimate or a timeline of when that might happen?

MR. HORN: I don't know. It will be studied very closely I'm sure.

CHAIRMAN DUNN: Thank you very much.

COMMISSIONER CHILTON: Mister Chairman?

CHAIRMAN DUNN: Yes?

COMMISSIONER CHILTON: I wanted to ask Marshall a question because of how he had said it. He said that they were waiting on stuff from ICE and it's my understanding that they submitted something on May 21 and that the division asked for more information and that over a month ago. So I think it's in our court and I hope we move forward like I think all of us do to get this done. I know we've got a heavy workload and this one that would be nice as Chairman Gensler said to clear the decks before we get on to the work in the Wall Street Reform Act. Is that correct, Marshall?

MR. HORN: Yes, it is. It's on a calendar to be addressed within a certain timeframe. I'm not sure of the exact timeframe. It's a fairly short timeframe.

COMMISSIONER CHILTON: Thank you.

CHAIRMAN GENSLER: I guess, Marshall, what we're all saying is we're going to put this on that list that we were working with the division directors on, the non-Dodd- Frank list, that I think it's the shared view that you're hearing from all three of us that we want to move it along.

CHAIRMAN DUNN: Just to give you some insight here or some insider information from the Commission, the Chairman has what he has called the Clean Plate Club and he is pushing the division directors to clear the plates so that we can go full steam ahead on the Frank-Dodd bill and there are things in there that I've been asking to address since the day I came on the Commission that are finally being addressed and I am very, very grateful for that Clean Plate Club.

CHAIRMAN GENSLER: Thank you, Commissioner Dunn. I'm grateful to all of my fellow Commissioners because we have not only the 30 teams set up on the 30 Dodd-Frank, but we have nearly that many, it's less than 30, on the Clean Plate List as well, and Marshall just realized he's now on it too. Thanks. I'm sure it's an honor, and thank you for your volunteerism.

CHAIRMAN DUNN: Thank you. ICE has also been very busy in this arena and we're fortunate to have Mr. Tom Farley with us. Tom, if you could walk us through some of the Informa stuff and the actions that have been taken by ICE.

MR. FARLEY: Sure. Thanks. If I may, a quick clarification on something Marshall said. It might be a distinction without a meaningful difference, but my understanding is that adding a new delivery location does not require approval as long as it's being added for a contract month that does not have any open interest. I defer to others in this room including Audrey Hirschfeld and those of you on the dais about CEA and CFMA, but that's my layman's understanding which I think is a little bit different than the way I heard it described.

CHAIRMAN DUNN: Thank you. We'll try to get that resolved and get back to you on it as soon as possible with the General Counsel's office.

MR. FARLEY: Thank you Commissioners O'Malia, Sommers and Chilton, Chairman Gensler, and thanks especially to Committee Chairman Dunn for allowing me to be here today. Thanks for your leadership, Commissioner Dunn, Chairman Dunn I should say, in putting together this public hearing on issues of importance to cotton as well as obviously wheat and other markets.

I'll say a few words about ICE's cotton no. 2 futures contract generally, specifically on delivery points, and while not in my prepared notes, I'll also add a few words about the recommendations to address Commissioner Sommers's and Commissioner O'Malia's opening remarks, and I'll add that at the end just so that you have our perspective on the implementation of those recommendations.

For almost 140 years, our exchange first as in 1870 the New York Cotton Exchange and then the New York Board of Trade and now ICE Futures U.S. has traded cotton futures and options. Over the last several decades our cotton no. 2 contract has become not just the benchmark for U.S. cotton but really the benchmark for global cotton. By way of context just briefly a few statistics, in 2009 we traded just about 5.3 million contracts which is $150 billion of value or 5 times global production of cotton of 30 billion and about 15 times world exports. During the last 25 years we've had five delivery locations and they've been static, Houston and Galveston in Texas, New Orleans, Louisiana, Greenville, South Carolina and Memphis, Tennessee. During that 25 years we've had many petitions to either expand an existing delivery location, one of those five, or do add new delivery locations and in each of those instances the answer has been no after careful consideration. Just by way of background on how those types of decisions are made at the exchange and a little bit of background on our governance, the board of directors of ICE Futures U.S. has sole governance and sole decision- making authority over all rules including cotton contract delivery locations. Just to tell you a little bit about our board, we have nine members. Our Chairman Fred Hatfield is sitting here in the audience today, a former CFTC Commissioner. Fred like five others is a public director under the CFTC guidelines. Fred and the five others would qualify as independent directors under the New York Stock Exchange public company listing requirements. The other three board members at ICE include two executive officers of ICE Inc. and me as the President and Chief Operating Officer of ICE Futures U.S. One final note, none of us are cotton market professionals and so we don't have

conflicts of interest in that regard.

At ICE we agree with something Chairman Gensler said in his remarks which is it pays to every once in a while to take a step back and look at contract terms of all your contracts and make sure you're keeping up with market conventions. I'm paraphrasing your words, Chairman Gensler. It's not exactly what you said, but that's the idea.

In 2009 the exchange commissioned Informa Economics to study our current delivery points. Informa is a leader in broad-based agricultural research and they completed their report in April of this year. It was a very thorough, very thoughtful report and included multiple sets of data on cotton, cotton production statistics, consumption statistics, market and expert statistics, and it also included a series of recommendations that Informa made about what we should do with our current slate of delivery locations, whether we should change those, modify those, add new ones, et cetera. That full report is available on our website.

After that report was published, we drew a subcommittee from our full contract committee and charged them with studying this issue. We charged them with making recommendations on any necessary changes to the current locations. Their decisions were to be based not only on the Informa report but also on their collective and individual wisdom, experience, expertise in the cotton market and any other available information including but not limited to information contained in the applications from the port of Corpus Christi and Dallas, Texas to become delivery locations on the cotton market.

If I can take a step back, our full cotton committee that I referred to comprises 21 industry professionals, producers in the form of farmer cooperatives, merchants, futures commission merchants, so it's a broad spectrum of customers domestic and international. In order to make sure the subcommittee was balanced because these are customers and they have a view and they have a

vested interest, we took a wide cross- section in constructing that subcommittee. The subcommittee included two farmer co-ops, a Texas farmer co- op, and Memphis Eastern farmer co-op, it included two domestic-based global merchants, one international-based global merchant and me as a representative of exchange management. In carrying out its mission, the subcommittee first sought to clear up what they believed to be misperceptions in the marketplace and agreed on two facts or guiding principles that they thought were important to establish. The first was that the current cotton contract terms are sufficient to ensure convergence. There is no issue with convergence in our contract. The second item was that the events of the first quarter of 2008 would not have in any way been changed by a modification to delivery points whether subtracting existing, expanding existing or adding new delivery points. It was fundamentally not a delivery point issue that arose.

Having established those two facts and

having established that a lack of convergence of the Q-1 2008 cotton episode are not reasons to make changes to delivery locations, the subcommittee then set about to say what are the circumstances under which you would change delivery points and specifically what are the criteria that you will apply to a prospective delivery location to determine whether or not it merits inclusion, and they established three criteria. The first was the trade flows in and out of that location. The second was the cost to move cotton in and out of that location. And the third was the extent to which that location is balanced between producers on the one hand and users on the other hand.

In addition, even if a prospective delivery location meets those criteria, you need to dig a level deeper and understand all the factors in the mix for that location, and let me give you an example of what I mean. It's possible that a location could meet those criteria but it could be so geographically close to an existing delivery location that it could be essentially economically comparable. For instance, committee members cited the Port of Corpus Christi as potentially one such example. It's approximately 200 miles from Houston, it's approximately 200 miles from Galveston, it's equidistant to the West Texas growing region, equidistant when compared to Houston and Galveston. Ultimately using this criteria, the subcommittee proposed adding Dallas-Fort Worth as a delivery location and subtracting New Orleans, and that was the sum total of the recommended changes.

Other potential new delivery points including Corpus Christi as I mentioned, are Lubbock, Texas, or west coast delivery locations, those were all contemplated as well and there were reasons that the subcommittee chose not to recommend them. In the case of Corpus Christi one thing I heard cited was it's not a significant center of trade flows. In the case of Lubbock, one thing I heard cited was that it may advantage producers but unduly disadvantage end users and in the west coast location it was the opposite, it could potentially advantage end users but unduly disadvantage farmers or producers who would have to pay a great deal of money to get cotton in position to deliver against a west coast delivery location.

Ultimately after considering the recommendations of the Informa report, the subcommittee, the cotton contract committee, and the applications from Dallas and the Port of Corpus Christi, the board of ICE Futures U.S. Unanimously resolved earlier this week which is the reason by the way we didn't submit a written record, this is breaking news and we've been working diligently on this write-up to the date of this hearing, that New Orleans should be deleted as a delivery location and Dallas-Fort Worth should be added. The board also determined that these changes will be implemented commencing with the December 2013 futures contract which ties back to the clarification that I mentioned at the outset of my comments.

In reaching the decision to New Orleans, the board of directors noted that New Orleans is no longer a meaningful port for cotton or storage location I should say for cotton. In determining to add Dallas-Fort Worth as a delivery point, it was noted by the board that over the last several seasons there has been a significant volume of cotton moving into and out of the location, that costs to move cotton into and out of the location whether by truck, rail or otherwise are competitive, and finally that there is a balance between the producer community, particularly that Texas producer community as well as the end user community. The board has not reached a decision on Corpus Christi. There was a little bit of bad information about that that we saw earlier this week. The board has not made a decision about Corpus Christi and we continue to study the matter.

I'll add a few comments to directly respond to Commissioners Sommers and O'Malia. As Marshall pointed out, the report that the CFTC issued about the 2008 volatility, we agreed with the conclusions of that report. There was no manipulation which was something that we believed all along and stated publicly and, further, there was no speculative buying. When I say no I mean there may have been some very de minimis speculative buying during that volatile period of February 29, March 3 and March 4, but there was essentially no speculative buying during that period and that volatility was the consequence of a tightening credit environment and heavy buying by the trade community. The recommendations that came out of that report we agreed with wholeheartedly and we've implemented all three of them. The third recommendation required that we notify the Commission of what we intended to do and we did that in May as we described. The first two recommendations had to do with studying to make sure the limits that we set were appropriate. We studied on our own, we worked with our customers and we all mutually agreed that the limits we put in place are reasonable and in fact that has been borne out in the marketplace as we have not hit limits frequently at all since we implemented those, I don't have the exact statistics, and so I did want to respond directly to the recommendations in that regard.

Thank you again for your time and attention. I'll be happy to answer any questions that you or members of the committee have.

CHAIRMAN DUNN: Thank you, Mr. Farley. Quickly, the Division of Market Oversight has sent me a note saying, If there is no open interest in the contract, there would not, I repeat, not need to be Commodity Futures Trading Commission approval for delivery location change. So your contention is correct if there is no open interest on there. Mr. Farley, there has been brought to me a lot of concern from the cotton committee and advisory committee what authorities they have within the contract. I know when ICE took over the exchange it was done with the caveat that they would retain those authorities but subsequent to that there was a governance rule by Commission.

Could you tell me the impact that that has had on that committee?

MR. FARLEY: Sure, Commissioner. The cotton committee has no governance or decision-making authority at ICE Futures U.S. That said, I do view them as a trusted adviser. I don't want to embarrass anybody. Sitting to my left is one of the members is Woods Eastland. Suffice it to say Woods a little bit more about cotton than I do. So when there's a cotton-specific issue, Woods is the type of person, and I use Woods by name again not to embarrass, him, but there are several Woods on that committee. To my right is Jordan Lea, also similarly well versed in cotton. So we go to that committee because they're a valuable source of information and again we view them as a trusted adviser, and with respect to cotton, they know more than any of us at the exchange and we make a habit out of listening to our customers. But that committee has absolutely no decision-making authority or governance at the exchange. As an artifact of the acquisition by ICE in 2007, there was some decision-making authority at that committee level but that's been eliminated and is no longer a factor.

CHAIRMAN DUNN: Thank you. Other Commissioners? If not, if we could get the reactor panel, please, and if we would start as we have you listed. Jordan Lea first.

MR. LEA: Thank you, Commissioner Dunn and members of the Commission. I'm Jordan Lea of the Eastern Trading Company in Greenville, South Carolina. I appear today in my capacity as President of the American Cotton Shippers Association known as ACSA whose members market approximately 75 percent of the cotton produced in the United States and are the primary commercial users of the ICE no. 2 upland cotton futures and option contracts.

At the outset I wish to inform the Commission that ACSA endorses the recommendations of the subcommittee of the cotton committee of the Intercontinental Change or the ICE to delete New

Orleans and to add Dallas-Fort Worth as delivery points on the ICE no, 2 upland cotton contract. I want to stress however that the adequacy of delivery points is not an issue for the commercial users of the contract. As the attached 1997 study in my remarks conducted for ACSA by Dr. Anne Peck and the 2009 memorandum prepared by Neil Galland, ACSA's former executive vice president and general counsel indicate, the ICE no. 2 contract is functioning well. There is full convergence, adequate storage capacity and most importantly, it provides accurate price discovery for producers and adequate hedging for its commercial users.

I appear today in response to the Commission's request to provide ACSA's critique of the Informa study and not the recommendations of the previously mentioned ICE subcommittee. Let me begin by stating that ACSA agrees with the recommendations of the Informa study that Memphis be maintained as a delivery point. We do though respectfully disagree with other recommendations for the reasons discussed herein.

In brief, Informa would add a new location in Texas and discontinue New Orleans, Galveston and Houston as well as consider dropping Greenville. It would consider adding Lubbock because it is a primary production area but not Dallas because it is not in a producing area and may not have sufficient warehouse capacity. We contend that the contract is functioning properly by providing convergence with the spot and the futures price and the delivery period resulting in accurate price discovery and hedging for commercials. Given that fact, one must ask the question as Professor Anne Peck did in her analysis of delivery points on the no. 2 contract, whether a contract change will have affects on the market and if so whether those effects will improve the functioning of the market. Not only did the Informa study not address this critical question, it presumes that a principal purpose of a futures contract is to provide producers with delivery points at the farm gate. Simply put, it suggests that the ICE no. 2 contract would better serve producers by being a cash or a delivery contract which is contrary to the purposes of a futures contract and is the formula for failure of this extremely useful risk-management tool.

Another assumption of the Informa study is that a change in delivery point could increase income to producers. The net price to a producer is determined not by the futures price at the delivery but by the market price. The fact is that the price received by West Texas or really any producer is the world price in the export marketplace and not the literal futures price. Therefore, to place a delivery point in the heart of the largest production area in the world as the Informa study recommends would be detrimental to both producers and to the contract in general. This suggestion also ignores the established fact that the U.S. and the international cotton industries have been well served by the location of delivery points in either consuming, export or central marketing locations for the last number of decades as previously mentioned. As Dr. Peck

said, the central purpose of a futures market insofar as it differs from other markets is to give reflection today to the value of a commodity today and at specified future dates. That is, its central purpose is price discovery and price discovery alone. Many of the features unique to futures markets such as their standardized contract terms were designed specifically to promote efficient price discovery. Peck notes, and I can tell you from personal experience, that the uniformity of contract terms rarely mirrors the actual physical transaction between commercials.

In the current pattern of expert flow, Informa's data is inaccurate in that it misstates that volume actually shifted from specific ports given that the data was not properly gathered. More importantly, Informa overlooked the evolution underway in the export patterns of shipments -- by the size of new ships coming online which are restricted to deep-water ports. The new generation of ships, the Pan Max container vessels as we call them designed to transit the widened Panama Canal starting in 2014 are already in service and currently calling on Charleston which increases the importance of Greenville as a delivery point. I would add that in discrediting Greenville's viability as a delivery point, the Informa study primarily focused on the use of the contract solely from a seller or a deliverer's bias or point of view as opposed to that of a receiver or ultimate user, and we've already heard Tom speak to the need to balance the needs of each party. When you combine the total production in the Southeast along with the total consumption of the U.S. Textile industry, a delivery point in the Southeast is more important than adding one in West Texas based on concentration and volume alone. Further, the diversion of cotton traffic from the West Coast ports will increase considerably when the co-joined ports of Houston and Galveston begin operation of their new container port in time for the opening of the widened Panama Canal. More Texas cotton will then move through the new Houston- Galveston container port because of the lower cost to move cotton to shipside and the decreased time of delivering cotton to Southeast Asia and the Far East, our primary customers.

The development will also enhance the establishment of a delivery point in Dallas-Fort Worth. Corpus Christi however in our opinion is lacking as a delivery point for a number of reasons, one of those reasons being that the container vessels mentioned, the Pan Max vessels, will not be able to transit beneath the Harbor Bridge to gain entry to the port and the Texas Department of Transportation lacks the $800 million necessary to raise the level of the Harbor Bridge to allow such vessels to enter that port. We would also concede that New Orleans' days as a cotton port have passed. Currently there are no warehouses licensed to store certificated cotton in New Orleans. Therefore we believe its deletion is justified.

Lastly, the Informa report relies

heavily on changes in crop production patterns for its delivery point recommendations. The fact of the matter is that crop patterns continually change and have changed since the high prices that impelled the switch to corn and other grains and oil seed production. The latest USDA crop report shows that this year production will increase as Marshall mentioned by 50 percent from 12.2 million bales to 18.3 million bales. Therefore, the importance of delivery points is not diminished, particularly Memphis which has always been the primary transportation and marketing center for the U.S. cotton industry.

In conclusion I'd like to stress a few following points. The events of March 2008 were -- related to the adequacy of delivery points on the ICE no. 2 contract and I would rubber stamp and agree with everything Tom said in reference to those except maybe for my knowledge about cotton. I'd like to think I know a lot. The level of trading on the ICE no. 2 contract reflects total confidence in the current configuration of delivery points. This fact alone argues for the validity of the current delivery points which both the commercials and the speculative traders deem to be an adequate balance wherein neither buyer nor seller are penalized or discouraged from using the contract. That believe by the primary users of the contract provides the essential liquidity necessary to provide cotton producers with adequate price discovery. The users of the contract require stability in its terms and conditions. Though ACSA believes that the current delivery structure is adequate, we have agreed to the deletion of New Orleans and the addition of Dallas-Fort Worth. ACSA's membership believes that the users of the ICE no. 2 contract are best served when the contract's terms are consistent. Therefore we would urge that once established, the proposed changes in the delivery structure and all other terms and conditions of the contract be maintained. Thank you.

CHAIRMAN DUNN: Thank you very much. Let's turn to someone who does have an up-close and personal relationship with cotton, Mr. Barrett?

MR. BARRETT: Thank you very much, Commissioner Dunn. Thank you for having me, Commissioners. My name is John Barrett. I live in San Patricio County which is near a place we've heard a lot about this morning called Corpus Christi, Texas. I've been a cotton and grain farmer for more than 35 years and I really appreciate the opportunity to talk to you this morning about what keeps me in business which is the cotton market and the cotton contract.

I've got four main points that I'm going to try to make in my slide presentation. They are these. The first point is that the cotton contract as worked by the New York no. 2 contract is not working for me as a farmer. In other words, it is dysfunctional for farmers. It's fine for merchants, but it doesn't work for farmers. The second point is that Corpus Christi would be a wonderful delivery point for reasons that I will get into. The third point, we just heard that

Corpus Christi had an $800 million bridge problem and we're going to show you some information about that. Then the fourth point I want to make is that if it makes sense to exchange, New Orleans for Dallas, that we think that it would make sense to exchange Galveston or Houston for Corpus Christi.

Because of the events of 2008, there is very little forward contracting in South Texas. In times past, the majority of the South Texas crop would be forward contracted at a price off of the New York contract, but that has been severely restricted because of losses incurred by the merchant community. A second important reason why the contract is dysfunction for farmers is the widened basis between the cash market and the futures market has caused the price of options to become unaffordable for a farmer and we cannot use the New York market to hedge any longer. Because of the events of 2008, farmers were unable to use the futures contract to arbitrage the wide difference between the cash price and the futures price because I could not get access to an approved delivery point warehouse. I've tried to move cotton during February 2008. I tried tenderable cotton into the Galveston warehouse facility that at that time was owned by W.B. Donovan Company and I was told that they were full of their own company cotton and they had no room for my cotton. At the same time, the warehouse that's owned by me as a farmer in Corpus Christi, Texas had plenty of space and if it would have been a delivery point, there are a number of farmers who could have certificated cotton and use that cotton to arbitrage the positions of the merchants who were trying to get out of the contract.

There has been some talk here at the table about the fact that the contract converges with the cash price at expiration and that's true. It generally does except for some transportation differences. The problems I have as a farmer and given the fact that I just mentioned that forward contracting has almost become a thing of the past is that during the year when I invest my money in the crop, the ground, the seeds, the chemicals, the fertilizer, all of the things that we have to spend a lot of money on, that there will be times when the basis between the cash price and the futures price is this wide. But when I get to the point at the end of the contract when I actually have cotton, the basis might be this wide and I've lost the opportunity at whatever point in the year that I wanted to attempt to lock in that spread, I didn't have an opportunity to do so.

This talks about my second point as to why Corpus Christi would be an excellent delivery point. Corpus Christi as opposed to the other delivery points has a large amount of warehouse storage space that is owned by producers instead of merchants. Corpus Christi has 550,000 bales of storage space by farmers. In addition, Corpus Christi is in the center of a substantial production area that stretches from the Rio Grande Valley almost to Houston. The addition of a delivery point in Corpus Christi would allow farmers to arbitrage themselves against the contract without having to rely on the merchant community. In addition, Corpus Christi is the only port on the Gulf of Mexico that has a Corps of Engineers approved 52-foot ship channel. We have an additional ship channel that goes to the La Quinta facility which I'm going to talk more about in a minute that is not only permitted by the Corps of Engineers but is currently under construction.

This slide is a list of the reasons that current shipping trends make Corpus Christi particularly attractive, and I started to say when I asked for the wrong slide that these first three reasons are very similar to the points that Mr. Lea before me just made. But the final point on here is the one that I really talk about. The La Quinta Trade Gateway is a project that the Port of Corpus Christi has been working on for several years. It's coming to fruition. I mentioned that the dredges are out there working right now. Four years ago that company that myself and my fellow farmers own, Gulf Compress, invested $13-1/2 million building a cotton warehouse at this future container port. It is going to be a hub of commerce looking into the future. The ICE contract has been looking into the situation back as it was in the 1920s and we're asking ICE to look into the future after the Panama Canal is actually widened.

I didn't want to get into a geography lesson when I came up here, but I found out I was going to have to. ACSA has said that we have a bridge problem. Up at the front of the room the Commissioner of the Port of Corpus Christi Authority, Francis Grandy is standing and he's more of an expert in this than I am, but if you look at the right-hand slide of the graphic or in the audience the one that's up on the screen you'll see the town of Port Aramsas. That is on the Gulf of Mexico and that's where the big ships come in. Then if you'll follow a blue line kind of to the southwest that's labeled Corpus Christi Ship Channel, you'll see that blue line goes to the west to Corpus Christi which is where the bridge is. Right where that blue crosses Highway 181 there's a bridge and the bridge is too short for some ships. But if you'll back up on that blue line back toward Port Aramsas you can see where it forks off kind of to the northwest and it goes to the pink location here called Project Site. That's La Quinta. That's where we want to do our cotton business and there is no bridge.

I heard something earlier today that I didn't really understand, that you couldn't have delivery points too close together because they'd be equivalent. But we've got delivery points in Houston and Galveston and as you can see they're awfully close together. Neither one of them has much warehouse capacity and they have very little nearby cotton production. Informa, ICE's consultant, recommended deleting both of them, but we don't go that far.

Our recommendation is that we make an exchange of either Houston or Galveston for Corpus Christi. Corpus Christi has more warehouse capacity than Houston and Galveston combined. Corpus Christi's capacity is readily accessible by farmers and people in my situation wouldn't face the one that I had in 2008 when there wasn't any room at the inn at Southern Compress. Then unlike Houston and Galveston, Corpus Christi has significant nearby cotton production. Gentlemen and Commissioners, I appreciate your time and I appreciate the ability to appear before you today. Thank you.

CHAIRMAN DUNN: Thank you very much, Mr. Barrett. Mr. Eastland, if you would, please.

MR. EASTLAND: Thank you, Commissioner Dunn. My name is Woods Eastland. I'm the President and Chief Executive Officer of Staple Cotton Cooperative Association which is a farmer-owned cotton marketing cooperative. We market cotton essentially that is raised east of the State of Texas. Probably the most relevant thing is our position in both the cash market and the futures market is the exact same position as a producers because we work for producers and market their cotton for them and that in the cash market we are already net long to basis and in the futures market we are always net short futures which would be the same as the aggregated position of all the cotton producers in the United States. I also recently served as chairman of the subcommittee of the cotton committee of ICE Futures that was charged with reviewing the Informa study and determining whether or not recommendations should be made as to adding and/or deleting delivery points. The Commission is aware of the recommendation that we did make. In reaching that recommendation it was the sense of the committee that six points should be noted. They're in my comments. Without detailing all six I just wanted to mention that it was unanimous among the committee members and you had there two cooperative managements from two separate cooperatives one being a large West Texas Cooperative, two merchants as Tom said, two international merchants headquartered in the U.S., one international merchant headquartered overseas.

It was unanimous that the current terms, and that was the current as they existed while we were meeting, were sufficient to ensure convergence at expiration. And second that the price volatility that we saw in March 2008 was not related in any way or caused by an insufficient number or an inappropriate distribution of delivery points.

I might want to add that as chairman the subcommittee did not issue a detailed subcommittee report to the committee which detailed our reasoning process. I think the reason for that is we all reached the same conclusion, but of the six members of the committee, I don't know if there were six different routes that were gone through to get to that conclusion, but I know there was more than one so we didn't want to read it like a U.S. Supreme Court opinion with dissents. So we just issued our recommendations and the six points that were the sense of the committee. We did have a very open and very frank discussion. We had all of the submissions, and I'm not sure from, Mr. Chairman, your opening statement what I should talk about or not talk about regarding Corpus Christi, but we did have the benefit of the Corpus Christi submission which we reviewed as well as submissions from other areas and talked about some delivery points such as the West Coast that the exchange as far as I know had not been petitioned about by outsiders, and we did reach a unanimous recommendation.

I could say from the standpoint of the reasoning process that I went through as one committee member, and if somebody on the staff has the Informa report, sometime in the future if you would look at page 30, I reached an opposite conclusion than Informa did even looking at Informa's own data. If you were to draw circles around Greenville, South Carolina, Memphis, Tennessee and the Dallas-Fort Worth area of about a 300-mile radius, that's important because of the data that Informa presented as far as freight costs are concerned. If you would draw those circles you would see that the major production regions of the United States would like within that 300-mile diameter of those three points. The major production areas of upland cotton in the United States would lie within the 300 miles of that area of any of those which would give the freight costs to deliver to a producer or somebody like a co-op representing producers relative equivalence all the way from the production areas of northeast North Carolina to the production areas of West Texas, that is if Dallas- Fort Worth were included. That's the reason why I argued for Dallas-Fort Worth and I think that going forward that concept is a very important concept for the management not just of the cotton contract but the management of all of the agricultural contracts where you have a very widely dispersed geographical production area. The idea of where the major production part of that is and where it's not I realize would always be a thorny issue, but I that it's important for the management of the exchanges as these production areas shift to realize that there is a responsibility they have incumbent to the producers to give producers in different areas to have a delivery point where their relative freight costs to get their cotton to the delivery point would be somewhat the same from production area to production area and I think that cotton has met that.

Let me go on to the second point that I'd like to cover here and that has to do with the responsibility that you have now under the new financial regulation bill. I'm probably not the only person in this room that hasn't tried to read those 2,000-and-some-odd pages or however long it is, but let me say this. I think the debacle that occurred in the cotton market in March 2008, a contributing factor to that were large speculative positions, the large positions, which entities that formerly had been defined as speculators were permitted to take because their positions became redefined as hedge positions and I'm talking specifically about index funds and I'm talking specifically about the positions of swap dealers. I think that was a contributing factor. I think it's important as you define a hedger that a hedger needs to be defined in its traditional sense. Let me digress a minute to say I've been office for 24 years. I was the CEO of Staple Cotton before the innovations of proliferation of index funds and of swaps through swap dealers occurred and we had a cotton futures market that worked perfectly well without them as far as price discovery and convergence is concerned. Since then we've had a cotton market that has worked fairly well without them. Unfortunately there are certain times in which it hasn't worked.

The point I wanted to make is this. I think the definition of hedgers should be limited to someone who in their normal course of business takes title to the physical commodity and this is when you're talking about agricultural commodities, small markets, take title to the physical commodity either as a producer, a distributor or consumer. If you follow that definition and then you look at the activities of an index fund, an index fund has a contract with its investors. That contract is a speculative vehicle. If the index fund then is allowed to take the opposite position to its contract or take a position in the contract market based on its contract and is allowed a hedge exemption in doing that, the position in the contract market is the derived position. The primary position is the contract with its investors. Yet in allowing its derived position to be considered a hedge, what you're allowing is that the derived position as a hedge and it's derived from a speculative position. That makes no sense to me. How can you say that a derived position in futures and options is a hedge when the primary position is a speculative position?

Look also at swap dealers. First of all, one of the ways in which they are used by speculators is to exceed their spec limits. When a speculator reaches his limit that he is allowed to have in options or futures, if he wants to exceed that and has enough confidence in his position, one way in which he can do it is to enter into swap contracts. When he enters into swap contracts he is expanding or extending his speculative position. However, the swap dealer then is allowed to take the opposition position in the contract market to his people with the speculator on the other side and that's treated as a hedge. That has the exact same effect on the price level of the market either futures or options as if the speculator himself had been allowed to exceed his limit in that contract market and take additional positions. Again you have the situation where the derived position which is the position that the swap dealer takes in either options or futures in a contract market is derived from a speculative position which is the contract he has with a speculator in the cash swap market. Again I would say to me just trying to think about what makes walking-around sense, it makes no sense to allow a speculative position in a cash market to be hedged and treated as a true hedge position in a contract market. So those were some things that I would hope that you and the staff would consider as you are looking at defining these definitions and setting limits going forward. Thank you very much.

CHAIRMAN GENSLER: If I could ask a question, and I like your walking-around sense actually. Congress incorporated a lot of that in saying that for the first time this Commission will be allowed to set aggregate position limits on agricultural commodities and what's called exempt commodities like oil and natural gas and metals, gold and silver. Looking at the swaps market and looking at the futures market and that's what we'll be working on, we have 270 days on the agricultural one. That's not my question but I was giving you that confidence. My question was later we'll hear from Don Heitman of our staff about agricultural swaps and explicitly in the statute it says that agricultural swaps can't be done in the same way that all the other swaps can be done unless we write a rule to allow it. So Congress set up a whole regulatory structure that at least I was very much for as you know, but on agricultural swaps they're going to defer a bit and leave it to us. So I'd be very interested in do you think that there is a role for cotton swaps specifically in the marketplace? The second question that you'll want to think about it maybe you'll think about it for weeks and let us know, if there is a role for them, should it be regulated just like all other swaps or is there something special and unique, some additional regulation that's needed. Those two separate questions I know you might not be ready for, but it would be helpful to know.

MR. EASTLAND: I think certainly there is a role for them. Somebody else may have a lot more intelligent solution or suggestion than I've got, but one possibility to consider would be that by regulation your swap dealer has got to know the counterparty's position that he's contracting with, whether he's contracting with a spec position or with a hedge position. If it's a hedge position then he should be able to lay that off in a contract market unlimited because it's a true hedge. If it's a spec position then I think it would be reasonable if he were asked to aggregate all of his spec positions he might be on the long side of some swaps and the short side of the others; aggregate some of that spec position and then the amount of that that he could take the position of in the contract market would be limited to one spec limit or I would assume in this process you would probably some sort of a special limit for swap funds. But I think the aggregate position of the swap dealer where his counterparties are specs, there should be a limit on the number of futures and options contracts that he would be allowed to participate in in the contract market.

CHAIRMAN DUNN: Thank you, Mr. Eastland. I think it really is important as I said at the onset that we get as much input as we can as we go through this frenzy of rule making and I would encourage everyone here on the early panels to please stick around for Mr. Heitman's presentation because it will give you an insight of where we're going and how we're going to get there.

What I'm going to do is ask a question and then let fellow Commissioners ask any question and then we'll open it for the Ag Advisory Committee to ask any questions. We always allow a point of personal privilege for the Chairman.

CHAIRMAN GENSLER: Thank you.

CHAIRMAN DUNN: If you could simply and succinctly tell us why it is important or not important for producers to have a delivery point close to their operation. I think that's the crux of what I had heard Mr. Barrett talk about. Then if Mr. Barrett would amplify and others would comment because I heard him say that he could not lock in the spread on his cotton and I'm a little confused. Is that you could not access the futures market or you could not lock in the spread using a delivery?

MR. BARRETT: Right, Commissioner. First of all, I'm not arguing for a delivery point close by my farm. I'm wanting one that producers that is readily accessible to producers.

CHAIRMAN DUNN: Is that storage per se

because that's what you had indicated?

MR. BARRETT: Yes. The storage is not necessarily readily accessible if it's owned by a merchant and the merchant doesn't choose to make the storage to me as a producer.

The question you asked about the margins or using the contract to hedge is basically a situation where I put out fertilizer in December and I'm selling cotton on the December contract and the December contract in terms of the roller coaster that Chairman Gensler was talking about earlier goes up and down and sometimes it goes way up. Sometimes the cash market doesn't follow it and I want to be able to lock in that price. I would have the opportunity since the merchants are not forward contracting to the degree that they used to and I can't use them to lock in a call contract, I would have the ability if I could reliably be able to deliver my cotton to go on the futures contract and sell the futures and then have my cotton to deliver against the contract at the time I chose to lock in the futures price.

CHAIRMAN DUNN: Another panelists? Mr. Eastland?

MR. EASTLAND: If I could, because like I say, I work for 4,000 cotton producers and I'm also a cotton producer myself, certainly there are times in which every cotton producer wishes that his own preferred warehouse, the one that he might own an interest in or his gin does or wherever he delivers cotton were a delivery point warehouse. Fortunately also because if it weren't this way the contract wouldn't be working properly, those instances are pretty far between I think at least in my experience in what I've seen. I do then go back and urge the approach I took on this committee which I think is a very reasonable approach about just making sure that relative freight is available; that relative freight costs are somewhat similar. There are producer-owned warehouses I know in the Memphis territory delivery point. I don't know about Houston-Galveston. I do know this, that during the period after the debacle of March 2008 when you got forward into the July contract and then into the December contract, as far as getting additional warehouses approved at the already existing delivery points, there was not any application that I know of that was turned down by the exchange because the standards they use, really all they want to sure of is that the cotton going to be safely stored and is in a facility that you can get it insured and is in a facility that is approved by USDA and those are pretty low hurdles to jump over. I know Mr. Barrett with his own crop unless he's just a huge, huge producer, it wouldn't make sense for him to go out and rent warehouse space in Houston, Galveston or Memphis for his own. I guess only the very largest producers could do that. But there has been no problem with expanding the volume of approved space and delivery points and then after 2008 we've seen it shrink back down again.

MR. LEA: My comments will be relatively brief, but I do think the risk in putting a delivery point at the farm gate, and we've seen it in other commodities, you disassociate the spot market or you actually co-join the spot market and the futures price where the contract becomes the spot market. In other words, as opposed to the ability to forward contract cotton and gain access to cotton through traditional marketing methods, merchants or even cooperatives are faced with or forced to take delivery of the contract to actually create and source inventory and that would be primary objection to adding delivery points right there at the point of production in excess or even really at all.

CHAIRMAN DUNN: Mr. Farley, what is the total delivery point storage capacity for the contract?

MR. FARLEY: I don't know the exact number, Commissioner, but it's about 2 million bales. One interesting way of looking at it is if you compare the total aggregate crop versus the total aggregate storage and then you look across markets to get a feel for how much storage is available relative to other markets, cotton far and away has the most space, far and away by a factor of I'm guessing now but maybe 5 times wheat and beans and corn for instance.

CHAIRMAN DUNN: During whatever passes for normal times I guess I could say this, what is usually the percentage of storage capacity that's being used in the contract?

MR. FARLEY: There have been very few normal times since early 2008. In early 2008 -- you might be able to help me here, but it went from in the couple hundred thousand up close to that storage capacity, I think 1.8 million bales was our high point, and we're back down now as Marshall said to 41,000. So to give you a normal time, it's difficult to do. If you look at cert stock going back prior to 2008 it's typical to have something in the 1- to 400,000 bale range.

MR. LEA: Yes, I would agree with what Tom said. After March 2008 as a response or in reaction to the volatility and to meet people's desire to deliver, we used almost 2 million bales of capacity, but at one point there was 3.3

million bales of capacity available, and in Greenville, South Carolina, my community alone, there was over a million bales of available capacity only about 70 percent of which was utilized, but to my knowledge, no individual point actually ran out of capacity. Like I've said, some were very close and were almost full. We had over 3 million bales of capacity even after 2008 and only ultimately used almost 50 percent of it.

CHAIRMAN DUNN: Mr. Barrett, but you did have trouble getting certified deliveries. Is that correct?

MR. BARRETT: Yes, sir. The warehouse I'm talking about is Southern Compress. It's located in Galveston, Texas. It used to be owned by W.B. Donovan Company and I tried to get cotton in there and the manager told me it was full. This would be in February 2008.

CHAIRMAN DUNN: Thank you all. Commissioner Sommers? Commissioner Chilton, do you have any questions?

COMMISSIONER CHILTON: I have a quick

one for Mr. Eastland and Mr. Farley. These markets up until 2008 seemed to be comparably stable and the traders were fairly consistently commercial traders. There were speculators of course as there are in any market. We need speculators. There's nothing wrong with speculators. We can't have an orderly functioning market without that. But that said, in recent years there have been these new speculators. That's what I talked about the beginning, that there are new dynamics in these markets and that they've shifted their focus to cotton and beans, et cetera, seeking to diversify their investment portfolios. These new speculators have the possibility of financially overwhelming the markets compared to the typical hedgers and they have this distinctive passive fairly insensitive long-only trading strategy. I call them massive passives. They've come to represent a significant portion of some markets. When the agency looked at the 2008 debacle, these massive passives or traders like them in index funds accounted for 38 to 41 percent of the open interest. I'm not suggesting that they singlehandedly created a price spike, I just think it's something new we have to look at, that when they are that large people want to say it's liquidity, but if they're not trading because they're price insensitive, it seems to me it's dead liquidity. My question for Mr. Eastland and Mr. Farely is with this new authority that we have in the Wall Street Reform Act are there things that we need to look at specifically with regard to this class of traders? And I don't know the answer. I'm just raising the question. Thanks, Mister Chairman.

CHAIRMAN DUNN: Thank you, Commissioner Chilton.

MR. FARLEY: Thanks, Mister Commissioner Chilton. You picked the right two guys because I think Woods and I have in the past and may today have a healthy debate about this issue so you'll get perspective from both sides.

Just a couple of points on index funds. I think in general they're a very, very good thing. Number one, they encourage inventory accumulation which can dampen price volatility in times of minimal supply or extreme demand and I think as consumers, as Americans, as global citizens, that's a very, very good thing because it's going to limit price spikes in extreme circumstances. The second thing about index funds that I think are really a great thing is that commodities markets by and large are full of people who want to go short the futures contracts because the consumers are you and me. We wear a cotton shirt and we're not going to go out and hedge that cotton shirt, and so for many, many years, over a century in this country, you had a lot of people who wanted to hedge short futures and now you add people who wanted to buy long futures and therefore you saw open interest grow and you saw more longer-dated futures hedging, it enabled farmers to risk manage more of their crops, et cetera, and so I see that as a very good thing.

The third thing I'll say on index funds

is you refer to them as massive passives which I like. It's catchy. But I'll point out we just got finished talking about our cert stock, our open interest is also down dramatically. So you tell me if there are massive passives why is it that the open interest deviates and it tends to deviate that when prices go up open interest begins decreasing. I would submit to you it's because that these massive passives aren't so passive and they are in fact price responsive.

All that said, I agree with several of the comments that Woods made about position monitoring and I think that it's great that the CFTC now has the ability to look out into OTC markets as well as futures markets and make sure that people are not using long-only index funds as a mechanism for evading position limits and that's not something that I or anyone at ICE would support certainly.

COMMISSIONER CHILTON: If I may respond quickly, remember Robert Palmer said "you're immune to the stuff"? I'm not suggesting they're immune to the stuff when it gets crazy, but when we had $147 oil, sure they changed their position then. So there is some extreme position where they change, but as a general strategy, they say this in their prospectus that they're going to go long, they're going to -- these prices. Right?

MR. FARLEY: Sorry, Commissioner Chilton. What was the question?

COMMISSIONER CHILTON: The question is the index funds and ETFs when they get into these markets, they state to their clients they're going to try to go long and mirror the long-term price of whatever the commodity is. It doesn't mean that they are totally price insensitive, they're not immune to huge price spikes, so when oil gets up to $140, yes, then they may sell because it would be crazy not to. But when you look at cotton and you look at the prices, it wasn't enough for these index traders to get back into the market. The prices weren't volatile enough for them. So they don't respond to normal market moves. Am I making myself clear?

MR. FARLEY: I understand. I'm claiming that they are price sensitive and you're saying they're not entirely price insensitive, so I think there's a spread in our views but maybe we're not as far apart as I originally though.

I'll just comment that if you're going back to Q1 cotton, that was just an entirely extraordinary circumstance. I don't know how to think about index funds during that 3-day period. They were neither buying nor selling in massive amounts and it was the only time that I know of where you had almost a short covering of an entire industry. So we tend to and I think others in the industry tend to look at the factors and circumstances during those 3 days surrounding that massive short covering.

CHAIRMAN DUNN: Mr. Eastland?

MR. EASTLAND: Commissioner Chilton, I largely agree completely with your statement. I would say this as far as index funds. As far as 2008, and of course I've read the report of ICE, I think you've got to look at it over a minimum of a

60-day period from essentially 1 February through 31 March, but we're beating a dead horse if we talk about that anymore.

As I say, I go back to my definition of who a hedger is and the reason I take this is the true hedges that are available in any of these markets is limited, a true hedge being someone taking a position in options and futures which is opposite their position in the cash market for the physical commodity. Those true hedges in an agricultural crop are limited to the supply which was the beginning stock and the size of the crop produced that year less what's been consumed. So it's just the remaining supply at any one time and historically that remaining supply especially in cotton because 95 percent of the cotton in the world is produced in the Northern Hemisphere so the supply varies very directly from the end of harvest to essentially the major harvest over in January until it bottoms out again until harvest starts again maybe in August; the supply continually gets smaller.

I think in these markets the Commission should be extremely interested in keeping some rough balance between hedges and specs as far as their open interest in futures and in options. That's the reason why I say I think in order to do that, the way to do that is to define a hedger as someone who in the normal course of their business takes title to the physical commodity as either a producer, a distributor or a consumer and they would have hedge exemptions. I don't think index funds fit that definition and I think swap dealers fit that definition only to the degree to which their counterparty is a true hedger. Therefore, there should be spec limits placed on the positions of the index funds because they are speculators in our markets and also on the position of the spec side of swap dealers.

COMMISSIONER CHILTON: Thank you.

CHAIRMAN DUNN: Thank you very much. Commissioner O'Malia?

COMMISSIONER O'MALIA: I'd like to address one of the reforms proposed as to the

March 2008 episode as Mr. Farley called it. I'd like to get the panelists' input as to whether they fully support the request to establish a trading halt on the futures options contract which I believe 2 times the market price. Can I just get everybody's input on that?

MR. LEA: I'll start. Yes, we do support that. I'm not sure how successful, they called it a cooling off period in equity markets. I'm not sure they've been enormously successful but I think they generally are and I think they would be at least a substantially positive in at least the cotton market if not all commodity markets for everybody to sort of regroup to see if cooler heads might prevail if we can get a grasp on what market condition might be creating the volatility. I think if we'd had something like that in March 2008, possibly some of that might have been avoided so I do think it's a step in the right direction. Of course if it's not appropriate and if it doesn't work as well as we think, I think you don't have to scrap all of it but try something like a similar effort. But I think it's definitely a step in the right direction from my personal opinion.

MR. FARLEY: I agree with Jordan.

MR. BARRETT: I believe that the synthetic closes circumvented the normal daily limits and I believe that's what made a lot of people go broke in March 2008 and I think it needs to be fixed.

MR. EASTLAND: I agree with the proposal.

CHAIRMAN DUNN: Mister Chairman, did you have another follow-up?

CHAIRMAN GENSLER: There are five of you I guess on the panel. You could even just raise hands if it would be more efficient. Who thinks that there should be a delivery point in Dallas? That's three. And who doesn't?

CHAIRMAN DUNN: Marshall?

CHAIRMAN GENSLER: Sorry, Marshall. I think it's Mr. Lea, you said something in your comments about it's not good to have the futures contract be the spot market. I didn't quite follow that and I'm thinking about this in wheat and other markets as well. To me one of the fundamental things in our marketplace is to make sure and assure there's convergence. I think you were saying something a little different but I was confused because you might be saying you didn't want convergence and that was confusing to me.

MR. LEA: Yes, sir. I fully support and want convergence and I think that the cotton market with the exception of the episode that Tom mentioned, generally speaking I've been in the cotton business for over 20 years now and we've always seen a convergent market largely because of the success of the no. 2 contract. But my comment wasn't, and you've mentioned wheat, I've got a paper where the former chairman of Pillsbury mentions that the delivery process needs to represent a relative inconvenience. Otherwise, if delivery is too convenient for the producer or even the consumer, then the futures market becomes the spot market. In other words, cotton is not traded on a spot market outside of the futures market and that's what I was suggesting, that by not putting delivery points at farm gates we will successfully be able to avoid turning the contract into a spot market.

We certainly want to do everything we can to keep convergence like we've had in my experience with the cotton market, but what I don't want to do, I but 100 percent of my cotton currently on the spot market or in the spot market. I rarely take delivery, I have, and I have delivered in the past, but what I want to avoid is I've seen instances in other commodities where you can't build inventory without taking delivery and Eastern Trading specifically, maybe I'm not representing the opinion of ACSA --

CHAIRMAN GENSLER: To clarify, you do think convergence is a good thing?

MR. LEA: Yes, sir.

CHAIRMAN GENSLER: You want some as you said relative inconvenience. But I also take it that you think it's important to be able to deliver against a contract.

MR. LEA: Absolutely.

CHAIRMAN GENSLER: I think some of the problem in the Kansas City situation is those delivery elevators really aren't taking delivery and there are a lot of farmers that I met with when I went out to Kansas City who said you can't do 5,000 bushels, that delivery elevators aren't taking delivery, so relative inconvenience or lots of inconvenience; small inconvenience.

MR. LEA: I would agree with you. Small inconvenience.

CHAIRMAN GENSLER: Thank you.

COMMISSIONER O'MALIA: We were just discussing trying to figure out what the contract terms are. Does the cotton contract have a hard position limit or does it flow with open interest?

MR. FARLEY: It's a hard position limit.

COMMISSIONER O'MALIA: Let me ask the panelists if they have an opinion on whether they prefer hard or something that floats with open interest in light of potential involvement from the massive passives.

MR. FARLEY: Can I make one distinction, Commissioner? Cotton is distinct from sugar or other commodities such as oil in that it's not just a delivery month position limit, it's all month hard position limit with no people accountability.

MR. LEA: My opinion would be a hard limit. Going back to the massive passive Woods mentioned, we like the hard limits and we'd like to see illustrated who owns those positions, that in our opinion massive passives are illiquid. We want the speculative activity because we want the open interest. It makes my job as a hedger easier. But I also want to know how much of the market is potentially liquid in periods of extreme volatility. I've never thought about your question and I think it's a very good question, but right now I'd say we prefer hard limits.

MR. BARRETT: I agree with him.

MR. EASTLAND: I also agree. We have a hard hedge exemption and we feel like we need that in order to plan our business. If it were floating then it would be dependent on what everybody else is doing and the size of the open interest which would not work for us. And since we have a hard one and like that, we certainly want the specs to have a hard one also.

COMMISSIONER O'MALIA: It was your comments that made me ask the question due to the bona fide hedging that you had raised and the criteria for that, does it make sense if we're able to look through the dealer to the position, does it matter whether it's a hard position or based on an open interest?

CHAIRMAN GENSLER: I was going to ask, Commissioner O'Malia, when you're saying hard versus floating, in January we put out a proposed rule that had something that reset. It was a hard limit but it reset once a year based on the size of the market, so you could say it was a little bit hard and floating. Which one were you referring to?

COMMISSIONER O'MALIA: I'm referring to

what's going on in the ag markets today and if you have an opinion about that. Obviously we're going to have to revisit that and I was thinking a little bit about our position on the proposal and getting everybody's opinion on what we're going to be addressing as a result of what bona fide hedging is and how we establish position limits and what the priorities should be.

CHAIRMAN GENSLER: In that context I think what we heard from the panelists was a hard limit is good in cotton at least is what you said, but if were reset whether it's a once a year, once every 2 years or something so it's relative to the market and you know specifically the hard limit maybe went up because the size of the market changed or sometimes went down, whether that would be acceptable in the sense that it would be known in advance but it might adjust once every year or 2 years.

COMMISSIONER CHILTON: Mister Chairman, I think the difference might be in what Commissioner O'Malia is saying is our proposal on energy was 10 percent, so if it's 10 percent of open interest, it fluctuates with the size of open interest. If it's a certain number of contracts then it's a static number. I have a lot easier time talking about percentages because if you go out and you say to somebody should a trader be able to have 30 or 40 percent of a market, they can give you a quick answer. If you give them a hard number, you really have to be familiar with the individual market. And so while I like the ease of a percentage like we had in our energy proposal, I'm not sure that that makes sense because it constantly would be fluctuating. Even with your annual reevaluation of it, if it's 10 percent of the market, that depends on how many traders are in the market. Is that what you were asking, Commissioner O'Malia?

COMMISSIONER O'MALIA: Yes, a little bit. I was obviously responding to Mr. Eastland's comments in light of the legislation that's going to essentially allow us to look through the dealer and look into who has the bona fide hedging, we'll have the fidelity and the granularity of those. Understanding who's in that market, does anybody have an opinion? I'm trying to understand everybody's thoughts on this and I think it would be a good topic for this committee here to discuss and get everybody's opinion on this. I think that obviously we're going to be dealing with it in how many days, Mister Chairman?

CHAIRMAN GENSLER: 255 in this one, and then we have to put a proposed rule out well before that. So any advice you have, I like Chairman Dunn's words, what we put out in January was really a hybrid. It was fixed for a year and then it readjusted and then it was fixed and readjusted and it allowed us not to have to readjust it but let it readjust formulaically.

CHAIRMAN DUNN: Future panelists be prepared. Commissioner O'Malia will be asking that question again.

Let me turn it open to the Ag Advisory Committee. Do you have any questions or the panelists or the reactors? Mr. Hicks?

MR. HICKS: The part where it says, December represents the new crops which should be big. It appears that new markets right now use available cotton stocks is tight. But it mentions that there's a 2-cent premium December and March but you have this big crop coming on. So theoretically if you have a big crop you have carrying charges.

MR. HORN: There are two parts to price determination. One is supply and we're going to have a good supply, and one is demand and we have considerable demand at this point.

MR. HICKS: The other point is what is the relationship between the open interest in December and open interest in March?

MR. HORN: December has the bulk of the open interest. I believe it's over 100,000 contracts. March has a very sizable open interest, I'm guessing in the neighborhood of 40,000 contracts. October has about 1,000, very, very small.

MR. HICKS: My concern is, one of the

questions I have, again I'm speaking on more of my interest in grain, but this catches my interest, what impact do the funds have in terms of trading the spreads between December and March? Do the index funds get involved in any of that at all, the price relationships?

MR. HORN: Index funds in my experience tend to stay mostly concentrated in the most active month, most of the index funds, and roll over on a set schedule, and some firms do it very mechanically and some firms do it with more discretion based on their possibility impact on the market and based on opportunities to roll over either ahead of the big roll or in a better way than doing it mechanically so that they tend to be 1-month traders.

MR. HICKS: I think the issue of convergence is one that's also tied to the confidence and price relationships in cash and futures and futures from one month to -- the relationship between Chicago, Kansas City, Minneapolis. I'll give you an example. When I worked at Cargill we were pretty successful and our division was pretty successful at trading wheat. Matter of fact, we were so good at it I thought I could do it on my own. I quit my job, bought my seat in Chicago. I bought my seat on the smaller exchange in Chicago which at that time was the Mid-America and became a spread trader. I look at this now as if I had to do that over again, I still would be at Cargill because of the financial ability that they have. I look at the guys when I was a clerk in Chicago and I look at the guys I admired who were spread traders. We have very few spread traders in Chicago now. We have no intra- market traders and we have no inter-market traders because of that exposure. It's my contention that this weakens; that this lack of confidence of traders like myself who will not trade that spread caused the elevators to widen their basis because there are no spread traders that will lay that risk off who will take that assumption like we were talking about this spread between December and March in cotton. I'm speaking as a grain trader and not as a cotton trader.

CHAIRMAN DUNN: This is probably a good segue into our next panel.

MR. HICKS: The other point I want to make is an observation on cotton. I lived in Louisiana so I was a cotton trader and the first markets that I traded were cotton and my interest was more of an interest in Civil War issues. That's how I started trading. I couldn't help but think about Darwin S. Fenner who was a member of the New Orleans Cotton Exchange, and when the recommendation was made to eliminate New Orleans I was thinking if Darwin Fenner were here he would turn over in his grave. But it also makes you wonder if we have these issues now, the magnitude of the decisions that the Commission has to make because it's going to be a confidence issue in that exchange if people who are farmers like Mr. Barrett, if he has a lack of confidence, then as a trader then I'm going to have a lack of confidence too. It's just an observation.

CHAIRMAN DUNN: Thanks for putting a little more heat on us.

MR. HICKS: It's an issue that listening to the discussion on cotton makes we realize the challenges we have in trying dealing with the issue of wheat.

CHAIRMAN DUNN: A good observation. Are there any other comments? If not, let me finish up with probably the big question to Mr. Farley. With the changes that you've made, are you relatively confident that we won't see a repeat of what happened in March 2008?

MR. FARLEY: Yes, I'm confident you won't see a repeat of what happened in March 2008. We've referred to it publicly as a perfect storm where you had this confluence of factors that were really unique. It seems like in the history of risk management in this country, each crisis is slightly different so I'm not confident we won't have the next crisis. Those sorts of things happen. But, no, I think the industry, and I want to thank the industry, has really helped us put in place mechanisms and controls that give us all a great deal of confidence that what happened in March 2008 won't happen again, although I'd be interested in hearing what the others' views are and whether or not they agree.

MR. EASTLAND: I would say, Commissioner, the significant change was letting futures have their own daily limits and not have them being margined to options that had to limit. That was the most significant change. As long as that's changed there, the next crisis will just be a little different. That's all.

CHAIRMAN DUNN: Thank you.

MR. LEA: I would agree with them. I hope that Tom is right. At my company we've obviously tried to amend the way we do things and even if another 2008 comes along, we're more prepared. The margining to the futures close, as long as we can maintain that, then I think shame on you if you do wind up in a similar situation as March 2008, shame you the trader, not shame on anybody else in here.

CHAIRMAN DUNN: Let me thank this panel. This was really, really good. We went way over our limit, but it really got some great discussion here amongst the Commissioners and I really appreciate what you've done here today as far as plant a lot of seeds for us to reap at a later date.

(Recess)

CHAIRMAN DUNN: Next we have wheat convergence with David Amato, Nicole Aulerich, David Lehman, Jeff Borchardt and Steve Campbell. Are the panelists ready?

MS. AULERICH: Yes.

CHAIRMAN DUNN: All right. Just as soon as I get two other Commissioners in here, we'll get started, and here comes one now.

Ladies and gentlemen, if we can get started with our next panel, and we'd like to start off with Dave Amato from the Division of Market Oversight.

David, if you will, please.

MR. AMATO: Thank you for the

opportunity to speak today. My presentation is going to be sort of a generic overview of Kansas City and the Chicago market, and then my colleague, Nicole, is going to kind of drill down. So this will just be the generic overview.

The first slide takes a look at Open Interest at Chicago and Kansas City. This is all futures and option combined Open Interest, AFOC Open Interest. The blue line is Chicago and the green line is Kansas City. And you can see, over this 10-year time period we've had a tremendous increase in Open Interest. At Kansas City the Open Interest today is about three times greater than it was in the year 2000. It went from about 300 million bushels to about a billion bushels over this time period, and as most of you know, the production tends to be in the 750-to-900 million bush range for Hard Red Winter wheat on a year-to- year level.

Chicago also has seen tremendous growth over this 10-year time period, going from about 800 million bushels in the year 2000 to over three billion bushels currently. That's almost a four times increase since the year 2000. The U.S. production for Soft Red, which is traded on the Chicago Board of Trade, is in the range of, say, 280-to-400 million bushels per year. So despite the Soft Red Winter crop being much smaller which trades on the Chicago Board of Trade, that's the contract that has the large Open Interest.

So we have a contract at Chicago and Kansas City that's been expanding, but we have had at times performance issues, and that main performance issue has been the weak convergence which we've talked about quite often.

So the next slide deals with some of the side effects that we see when we have poor convergence, the first one being price discovery is weakened. When you have a consistent weak basis, and we're seeing futures 80, 90, sometimes in Toledo in the past and Chicago it was $1.50 over the cash market. Clearly, there's a disconnect between what we're seeing in the cash market and what we're seeing in the futures market. So the idea that people can look to the futures for price discovery, obviously there's a disconnect there.

Hedge effectiveness, if you're a producer and you're used to having your basis be 30, 40 cents under and now you're having a very volatile basis, a basis that's now $1.50, maybe, under in Kansas City, obviously that reduces your hedge effectiveness ability.

Third point, crop insurance programs. The USDA crop insurance programs when they're trying to calculate potential revenue that a farmer can receive in a year, they use the futures price. So if that futures price is potentially overstated, if there's a disconnect between the cash and the futures and futures appears to be overpriced, it's overstating what the potential revenue that a farmer would be receiving, and therefore it sort of disrupts the insurance program, and the farmer won't be getting the protection that he actually should be getting because his real price is far under what the futures price is showing.

We've talked to several Ag banks that have talked about -- or Ag-lending credit crunch due to this volatile basis -- and, finally, the forward contracting we've talked to elevators that had sort of reduced their forward contracting based on some of the volatility in the bases and the weak bases.

The third graphic would be no review of sort of the supply and demand. This is the U.S. Wheat Ending Stocks as a percent of annual use. The blue bars are the Hard Red Winter on Kansas City; the red bars are the Soft Red Winter which is traded on the Chicago Board of Trade. If we just kind of highlight the last two years, 2009-'10 and 2010-'11, 2010-'11 being a prediction by the USDA. Just to give you a quick primer, the bigger the numbers the more ample supplies. So you can see the last two years for both Kansas City and Chicago. We've seen a tremendous amount of what is considered the ending stocks to use ratio.

If we look at 2009, the Hard Red Winter stocks use to ratio was about 48 percent, and for Soft Red Winter it was about 66 percent. And then now this year we see that Kansas City is expected to be just about the same area, maybe slightly a little bit more. Obviously, this is a long-term projection, and the Soft Red has come down substantially from the 66 percent ratio down to about 44 percent, but still if you look on this graph that 44 percent would be a very, very high number. So even though it's come down, we still have relatively ample stocks being projected.

Now, this number came out earlier in the month. With what we're seeing in Russia, maybe that's going to change rather quickly, but at least when these data was published, it was looking at fairly ample stocks for both Kansas City and Chicago.

If you can take one thing away from the briefing, I think this would be the graph that I'd like you to sort of remember. This is basically looking at the July Expiration that just happened back about, well, two or three weeks ago, and it's looking at a moment in time, so it's trying to compare the July Expirations that we've seen for over the last 10 years or so.

The green dot there is 2010, the blue triangle is 2009, the bars that you see is a high-low range for 2008 to 2000, and the red is the median over that same time period. The portion on the left that's highlighted, that's the Hard Red Winter at Kansas City, and the portion on the right is the Chicago Board of Trade contract. And the thing to focus on is the green dots. Obviously for the Kansas City section, you can see for this expiration that we just had, we see a very, very poor convergence. Kansas City went off the board -- these are truck bids just to keep everything consistent -- and it went off the board in the 70-cent range. You see, Selina, Hutchinson, and Wichita all within that 100-cent or under range.

Meanwhile on the Chicago side, you can see where we were last year, which would be the blue triangles on the low side of the range, however, this year the 2010 in green, you can see where a very, very good convergence pretty much right on that zero line for the three main points.

So, you know, I'll let maybe Dave or Steve comment on, you know, the causes of this, but the one thing that we can say with certainty is that the Chicago Board of Trade has instituted the variable storage rate which I'm sure Dave will highlight and Nicole will talk about as well. We do have the difference, if you remember the graph that we showed on ending stocks where we show the ending stocks decreasing a bit, being a little bit tighter for Soft Red, so that's another factor into this equation as well.

But Chicago has definitely seen an improvement over the last year. I believe there's been load-outs in the March-May and July Expiration, which would imply that at least at certain locations on the Chicago Board of Trade contract that there is convergence happening. So that is obviously very good news.

The last two graphics deal with positions, and it's sort of a controversial topic, and I know it was covered in the cotton conversation. And what this graph is trying to show, it's a little busy so, hopefully, I can make it a little clear. It's actually two graphs on one sheet here. And what we're trying to show is the Chicago Board of Trade Commodity Index Traders. I'll refer to them as CITs, and this would be looking at their all-futures and options combined positions and their percent of Open Interest. And on the bottom of the graphic here, we have the nearby price and the basis.

So just to kind of further give you a little bit of idea of what the graph is showing, the blue line is the CIT positions in net contracts, and that refers to the Y- axis on the left in blue, and the more yellowish line is the CIT percentage of AFOCO Open Interest. That's also a net percent, and that's the axis on the right side in percentage.

And again, on the bottom the green is

the CBOT Nearby Wheat Price, and that bleed that you see coming off of the wheat price in red, that's the basis under the future, cash basis under the future.

We've heard many, many people sort of target the declining X-traders as one of the main culprits in causing this disconnect between cash and futures as the conversation that we heard previously, people talking about a massive passive traders that just have gigantic positions, and no matter what the price does they don't necessarily change their position very much.

Looking at this data, it's -- we don't really see the smoking gun. If I wanted to highlight a section, if we take a look at the 2008 period, you can see a very, very weak basis. You see that red bleeding off of the green line, and you see very, very poor convergence in that section, but then if we go up and look at what the CIT actual positions were doing, for a good period of that time, they were drastically reducing their percentage of the Open Interest and drastically reducing their actual net contracts.

So the idea that it's a cause and effect at least in that one year on this graphic, you don't see that. And then again, if we highlight another section, the 2010 period, you can see as that green line basically makes the red line disappear, you're not seeing a weak basis anymore, and the CITs in terms of net contracts have basically close to record positions. They're percentages on the high side as well, so it's a mixed bag. We're not seeing exactly that sort of cause and effect that some people have postulated in the media and maybe this requires further study.

I think it's pretty obvious that someone being this large, traders being this big, they're going to have some impact on prices, but in this rudimentary type of analysis we're not seeing it at least in the Chicago market. And I'll get into the Kansas City market here now in a second.

If we look at the Kansas City market, it's the exact same setup in terms of the graphic, the positions on the top and the basis bleed on the bottom. Now, here one could say that there is this cause and effect possibility. We see that currently in Kansas City positions have over the last year or so have increased a lot on a net contract basis. Percentage, though has remained relatively the same over the last couple years, anywhere from the low 30s to the mid-20s; but definitely you can see that starting in about 2009 we started to have this weak basis start to occur.

So that part people would say, oh, there's your smoking gun; however, you know, if we look at other sections of the graph, namely the '06 period and, say, the '08 period, there are at times where we had very large net contracts in a relatively high position, and the basis was working, you know, wonderfully. So I think that, if I may make just an opinion, it would appear that the market fundamentals have the main impact on whether we have convergence or not. Obviously, like I said earlier on the slide previous, people that have positions of this size are going to have an impact, but I think overall the market fundamentals overpower the size of these positions.

And that concludes the presentation. If there's any questions, I'll be happy to try to answer them.

CHAIRMAN DUNN: Thank you, David. I think in order to expedite things, I'm going to let all of the panelists go forward before we do any Q and As. And with that, Nicole, if you could give us your presentation.

MS. AULERICH: Thank you for having me here today. I'm going to continue talking about the Hard Red Winter Wheat futures contract, and specifically about the convergence problems that Dave just addressed.

So first, what's at the root of convergence? Well, the future market links to the warehouse receipt market, and the warehouse receipt market links to the cash market. And between the warehouse receipt market and the cash market is where we're seeing a linkage breakdown.

So first, let's focus on the futures market and the cash market.

Now, we don't expect the futures markets to exactly replicate the cash market. There's frictions in the marketplace, so we have storage, transportation, different market dynamics, buyers and sellers. But what we do expect on the futures market to reflect a supply/demand, and the quality fundamentals up underlying crop. So for the warehouse receipt that lies between the cash and the futures market this is the instrument that's delivered by the seller to the buyer at expiration. So you're not getting delivered a rail car or a truck filled with wheat but rather this warehouse receipt that's giving you the right to this grain.

Now, you can hold this receipt for as long as you want as long as you pay the storage cost of 4.5 cents per month. So this warehouse receipt is the linkage mechanism between the cash and the futures market. It's the right but not the obligation to load out the grain.

So incentives are right now that we're seeing in the marketplace is for the warehouse receipt to be held and not loaded out. So basically what happens is you're holding onto it and not exchanging it for the underlying wheat.

So the question is, why is this happening? What are the incentives for you to hold onto the warehouse receipt? So I'm going to walk you through a brief example here. So let's say you are along the March futures contract, and you take delivery of the warehouse receipt. You can buy that warehouse receipt, then, at $4.96. At the same time you're going to sell the May futures contract short, 'cause you can deliver this warehouse receipt on the next futures contract as long as you pay the storage cost of nine cents for those two months, giving you a two-cents profit over your original investment. Four dollars and ninety-six cents will give you about a 2.5 percent return, annualized return. Well, this low interest rate environment, this is pretty attractive.

Now, this strategy is not just a one-time thing. You can repeat the strategy, so let's say at the end of March the spreads are attractive. You can close out your March, your May futures contract and roll it forward and salvage a July futures contract. Now you have more storage fees to incur for four months, but you come out with a profit of five cents over your original investment which was still $4.96, giving you about a three percent return.

So again, the strategy is to hold onto the warehouse receipt and not exchange it for the wheat and the cash market. So it's not linking the cash and the futures market.

So this optionality feature of the warehouse receipt creates a wedge between the cash and the futures market. The futures market starts to value the warehouse receipt, and the cash market is solely valuing the underlying cash commodity. So the larger, the optionality feature, the larger the value of the optionality feature of the warehouse receipt, the larger the wedge you're going to see.

Now the question is, can we see this in the data? Yes, we can. So on the vertical axis here, we have the number of warehouse receipts, and on the horizontal is the expirations of the futures contract. So our blue line, or our blue bar is the number of warehouse receipts issued at each expiration, and the red is the number outstanding. So the difference, the red being over the blue, is the amount of warehouse receipts held over from expiration to expiration. So at the end, towards the right, you can see an '09-'10 prof year. There was a large amount of warehouse receipts being carried over from expiration to expiration and not being redeemed for the wheat, so not connecting the cash and the futures market.

So this is consistent with the incentives of the return that we just talked about. Now --

CHAIRMAN DUNN: Nicole, just a clarification.

MS. AULERICH: Yes.

CHAIRMAN DUNN: This is on what contract now? This is on the --

MS. AULERICH: This is the Hard Red Wheat.

CHAIRMAN DUNN: Hard Red.

MS. AULERICH: Yes, from Kansas City. Now, all parties are acting in their best interests. The warehouses aren't issuing receipts because they know the grain isn't going to move anywhere, so they don't want it filling up their warehouse and then possibly disrupting their merchandising business.

Likewise, the warehouse receipt holders aren't loading out the grain because it's in their best interest to hold them. and earn this return in the futures market. So the question is, how do we remove this wedge?

Well, left alone, the market fundamentals will eventually change, so either we'll have higher interest rates, the spreads will eventually tighten due to a tighter crop, or additional near-term demand, or this strategy can be made less profitable. You can make higher costs through seasonal storage rate or the variable storage rate. Or you can limit the terms of the warehouse receipt. You can make it expire, devalue over time, make it nontransferable, or you can add additional delivery options.

This concludes my brief example of the warehouse receipt in convergence connection, and I can answer questions now or later.

CHAIRMAN DUNN: Thank you, Nicole. I appreciate that.

I'd like now to go to David Lehman from the CME Group to talk about the experience that we've had with the Chicago Soft Red Wheat.

MR. LEHMAN: Thank you, Chairman Dunn and Commissioners Sommers and O'Malia. It's a pleasure to be here today. I'll try to speed through this a little bit because I know we're short on time.

What slide 2 shows is a little background of the issue. We began seeing convergence inconsistency in '06 and it lasted through '09. We've made a number of contract changes, implemented shipping certificates as a delivery instrument instead of a warehouse receipt, new delivery territories, and seasonal storage rates were implemented, and then finally, variable storage rates were implemented effective with the July 2010 contract; also improved quality specifications by lowering the vomitoxin allowed-in deliveries.

The results of all of these changes we had good convergence in the March, May, and July Expirations. As Dave said, we have had load-outs against each of those three expirations in some of the delivery territories, and we've seen the calculated FOB elevator values at delivery equivalent in March of this year and USDA cash bids at delivery equivalent in July of this year.

We've also seen strong growth in volume and Open Interest in the contract since VSR was announced with Open Interest up about 47 percent, and year-to-date volume up 20 percent through June. And that's grown a little more. I got an update this morning; it's now up about 29 percent as of this morning's volatility.

Slide 3 explains how VSR works. I won't really walk through this, but it essentially allows the storage rate to increase by three cents per bushel per month if the nearby spread is a ratio to financial full carry is 80 percent or greater, and then also allows storage rates to decrease by three cents per bushel per month if that spread is 50 percent of financial full carry or less.

And it's interesting right now, we're looking at the -- we're monitoring for the September/December spread. That's running right around full carry, about 100 percent, 105 somewhere in that range, but if you look out into the smart spread, we're about 50 percent March/May; May/July are flat right now. So it's going to be very interesting I think to observe how VSR works as we get into this environment in the 2011 part of the forward curve where we have a very flat market.

Just to give you a visual of the July Expiration, these are cash bids at various delivery points. Chicago, I know there are a lot of lines here. The top dark blue one is the New Orleans Gulf. That should always be a premium to Chicago because there's a transportation differential imbedded in that price. And then the various delivery points: Chicago, Cincinnati, Mount Vernon, Ohio, the Gulf, Toledo, and Memphis on the Mississippi River.

The Northwest Ohio is not represented here, and that was in a shuttle-loading location in 2009, and that's a location that we've seen very active deliveries and also load-outs against canceled certificates in that location. But as you can see, we have a few points of above delivery equivalent value and a few points, delivery points below delivery equivalent value. And what we expect and as we go through an expiration is that we'll converge to the cheapest-to-deliver location.

The next two slides are just the May and

March contracts. I really won't talk much about those. We didn't have quite as good a convergence with the cash bids. Again this is a number that we talked about last fall at the meeting here that these aren't always the best representation of whether an elevator is going to make delivery; it's really what they can sell the wheat for in the cash market that should be compared to the future price, and that's this calculated FOB value in Chicago which is slide 7.

And this was the first snapshot of this data, first collection of this data that we were able to provide. It showed, you know, convergence back in mid-February and very close to delivery equivalent value through the March Expiration.

Just to drill in a little more into the composition of Open Interest in the Chicago Wheat Contract. This chart plots the supplemental commitments to traders or commodity index trader data that CFTC began collecting and reporting in 2006. The red dash line is Open Interest. You can see a very strong growth in Open Interest, and we're up near record levels of Open Interest, and this growth upward has occurred since late '08 or early '09.

What's also encouraging to see is that the middle dark blue line is the commercial hedging Open Interest in the contract. The top gray line is a trend following fund or noncommercial. It's not the index fund, but it's other noncommercial traders. They're beginning to converge, and that's what we want. We want to see an even distribution of Open Interest between noncommercial traders and commercial hedgers.

The index portion is the lighter blue line, and it has stayed relatively constant in terms of its percentage of Open Interest.

Just another snapshot to see that our Open Interest is maintaining or growing, actually, since VSR was announced, and year over year we looked on July 20th of this year. Total Open Interest $5.83 over $4.21 when VSR was announced, so up 38 percent. Commercial short Open Interest up 34 percent since VSR was announced. Commercial long up 137 percent since VSR was announced, and index long up 22. So I think the most encouraging number here is the commercial long Open Interest that's really come back into the market since VSR was announced, and VSR is thought to perhaps benefit the short hedger or the seller who may earn greater carrying charges as a result of increased storage rates but yet commercial long traders are embracing the improved convergence, it appears, as well.

Another concern that we've heard about VSR is that it's making the deferred spreads more difficult to trade and more difficult to price because of the uncertainty of what storage rates will be in the future, so what we've done in slides 10 and 11 is look at -- we've calculated a ratio of deferred Open Interest to nearby, and we've gone back five years with that data and are showing the five-year average as the purple line.

The 2010 number is a light blue line that stops over here in May. When we did this analysis, we were only through May, and then the

2009 number is the orange line. So that chart's a little hard to read, but the next chart give a table of the actual data points behind the chart, and what I'd like to point out is that since VSR was announced, this ratio of deferred to nearby Open Interest is at 58.9 percent, and the average over the five-year time period is 41 percent. So we're well above that average, and we're almost at the maximum with the exception of 2007- 2008. And these are looking at the same time periods, December 1 through May of each of these years since that's the time period that we've had since VSR was announced and the period of time that the market has possibly had concerns about how to price deferred spreads.

So just another indicator that looks like we're tracking or we're holding and in fact growing the Open Interest in those deferred months.

This is the same chart that Dave showed only this is just the Soft Red Winter Wheat. In addition to the stocks to use ratio, it also includes ending stocks themselves, so we have seen a significant drawdown in ending stocks in the Soft Red Winter Wheat market. We think that certainly has been a big factor in why we've seen this improvement in convergence. We had lower-planted acreage last fall because of wet weather during planting period, and as a result lower production.

So to kind of sum it up to give what our view is in terms of improved performance of the Chicago contract, we think it has a lot to do with the additional delivery points that we added that are more in the primary production inflow of wheat. We think it also has a lot to do with the changes in the fundamentals of the market, and we think variable storage rate has contributed to that as well, but it's really too early to give much of the credit, I think, to VSR.

Commissioner Dunn, I know we're running behind on time. I included a slide that you suggested when we last spoke that I might, about what our current activities are with regard to the swaps market, and we look forward to providing comments into Mr. Heitman's presentation. But, as you know, and I'd just like to let the Committee know that we have a pending petition submitted to the Commission in April of this year to list another 12 agricultural swaps in addition to the nine that we already have listed.

We also have submitted a petition to the Commission to request an exemption from the Ag trade option rules for cleared OTC Ag options. So if OTC Ag options are brought into a clearing house and in the same conditions that are applied to Ag swaps such as reporting daily settlement prices, market-to-market daily -- market-to-market Volume and Open Interest, market surveillance, we think those conditions would actually provide just as much secured, if not more than the Commission's ATO program does. And so we have those two petitions on file.

Thank you very much.

CHAIRMAN DUNN: Thank you, Mr. Lehman. Mr. Borchardt, if we could get you and then we'll go right into Mr. Campbell, since you're tag-teaming us today.

MR. BORCHARDT: Sure. Mr. Chairman, Commissioners, and Committee members, the Kansas City Board of Trade appreciates the opportunity to come before you today to discuss the weak basis issue and the Hard Red Winter Wheat. My name is Jeff Borchardt. I'm the president of the Exchange, and with me today is Steve Campbell with Louis Dreyfus Corporation. Steve is also our vice-chairman and a member of the Wheat Contract Committee as well.

Over the last couple of months, we've had we've had many visitors and guests where we've had discussions and input has been received from the interested parties concerning the weak basis issue and Hard Red Winter Wheat and lack of convergence, including CFTC Commissioners and staff. We've had National Grain and Feed Association in and the Kansas Grain and Feed Association, Kansas Association of Wheat Growers, and we've also had some discussions with members of the American Bakers Association.

The Exchange understands the concerns that have been expressed by all these parties regarding the weak basis issue and the lack of convergence at the delivery during the delivery month and in, here of late, and we've tasked our Wheat Contract Committee with coming up with proposed solutions to foster better convergence.

The Exchange Wheat Contract Committee is made up of a balanced diverse group of industry and commercial market participants. We have milos, we have exporters, we have grain merchandisers, we have elevator operators, and we also have Futures Commission merchant members with commercial grain customers. This committee has for many weeks now been actively and deliberately reviewing the Kansas City Hard Red Winter Wheat contract for consideration of structural changes to the contract to foster better convergence during the delivery period.

Many weeks ago, the Committee came to the decision that doing nothing was not an option, that, you know, something had to be done under these circumstances to foster better convergence. The Committee is aware of and has been looking at many different options available to them to foster convergence, and many of those have been discussed in prior years relating to the Soft Red Winter Wheat contract with their convergence issues. So they're looking at those proposed alternatives that were discussed as well as others.

Some of the more material potential fixes have a common theme and that is it moves the basis volatility into the futures spreads. You can do that one or two ways: You can come up with more immediate convergence types of fixes that drop it into the front month spreads, or you can come up with more gradual fixes that feather in over time and achieve convergence over a longer period of time. What the Committee is endeavoring to achieve is a balanced solution that fosters convergence during the delivery period without creating unintended consequences for market participants either on the long or short side of the market.

The Committee has -- and I've sat in on committee meetings since 1993 when we first headed the Hutchinson delivery point in '96, the deliberations began in '93 -- and I can tell you over the years their primary focus, and I think correctly so, has been to offer packages of change, of structural changes to provide the requisite balance to the contract so as to equally disincentivize longs and shorts from making or taking delivery and incentivizing them to liquidate their futures positions and foster that convergence.

We've received quite a few questions here of late about the deliberation process that the Committee goes through, and I wanted to kind of expound on that a bit. Historically, the Wheat Contract Committee has met in private to deliberate and hash through the different alternatives, which is the process that they're going through right now. What they're trying to do is come up with consensus or at least near consensus to be able to offer thoughtful recommendations to the Board of Directors for implementation of structural changes.

At the time that they get to the point where they achieve near consensus, or consensus on that, what they've traditionally done is at that point invite in outside parties to come in and go through the process that they have been through, the discussions, and the ultimate conclusion that they've reached so that they can receive input from the outside parties to make sure that there's something that they haven't missed before forwarding and on to the Board of Directors.

At the time they forward it to the Board of Directors, that proposal then goes public in the form of a circular that we put out that lets the market participants know that the Wheat Contract Committee has made a set of structural change recommendations to the Board, and they have an implementation date proposed, and it's to put all market participants on notice that if you intend to transact business in that effective contract month forward, that you'll be subject to the new terms and conditions assuming membership ratification and then Commission approval.

So that's kind of an overview of what we're facing right now, the Committee's challenges and what the process is, and what I'd like to do now is turn it over to Steve Campbell who can, for the benefit of the committee members who we haven't had one-on-one discussions with, can maybe enlighten you a little bit as to the factors that influencing the weak basis situation right now.

MR. CAMPBELL: Thank you, Jeff. I, too, would like to thank the Commissioners, Mr. Chairman. Thank you for visiting us in Kansas City and, certainly, Commissioner O'Malia and Commissioners Sommers as well.

You know, honestly, I think today that the market has, whether we're talking about cotton and wheat or Kansas City Hard Wheat has, in essence, covered the generic, the basic foundation of where we are in the market today. We are in a marketplace that is in transition. We are in a marketplace that has seen massive investment into our, you know,into the marketplace over the last four to five years.

We are a marketplace that has gone from serving a traditional producer with a traditional consumer, with a speculator that would ease the price transfer between the two, to today, which we've all discussed and had discussion about, to today trying to also serve an investor, an investor as created commercial demand and wants a place to hedge that demand, that risk. And so he's come to our markets and the commodity markets to lay that off. So we are in a transition.

We are 150-plus, that is slow to necessarily at times respond to transition, to those changes, but that is also with some understanding that unintended consequences can come about by making irrational changes subject to, you know, certain fads in the marketplace, so to speak. So again, it's sort of in the interest of time, I think David did a good job of illustrating the marketplace as it is today. I think Nicole did a good job in saying where is the breakdown. We understand that, you know, the -- that the deliver economics link the cash market with the futures market.

Today we have strong massive growth in our futures market, and in the Hard Wheat specific market, we have free stocks, free stocks growing at historical levels. In past years when we had those same surpluses in the market, we had the farmer moving towards a loan program that would maybe the go to commodity credit corporation stocks, and a lot of those stocks would be held off the market. The farmer could still get operating loans and, you know, move forward.

Today that's not in the case because prices aren't allowed to break that low because of this massive influx of -- so we have a divergence going on between our demand for our futures contracts, that balance sheet in conjunction with the overall demand of the balance sheet in the supply/demand situation in the real physical market.

So delivery economics, we understand that delivery economics allows us to cap the upside to premiums; that is to say I can always buy option price, my freight to the location I needed caps the high side of where premiums should go.

We also understand that delivery economics should cap the downside to premiums, meaning I can sell option price my freight to Kansas City market, for instance, is 50 cents, so therefore premiums at my location should never go below 50.

Now, we have also any of us who have traded cash markets, any of us who understands those markets understand that there's an asterisk on the capping of premiums to the downside, and that is to say when my elevator is full, where do I go with the next bushel? So we look at it and we say, well, we need to clear it, so we'd have to go and find the next home or the next place where it can go.

So delivery economics, while we

understand their function. they also, you know, have some -- the downside premiums have some linkage problem there naturally. We've seen that before in other years, but again the future market responded such that, you know, such that the effects of that break in the linkage weren't felt as bad.

So the cause really, I think the cause for lack of convergence under the current contract design is due to the fact that the wheat markets have experienced a structural demand shift in the balance sheet for futures without a corresponding structural shift in the consumption of physical wheat. So we have this strong growth in the futures; we have this strong growth in our free caria of Hard Red Winter Wheat. The farmer, you know, is selling it, and he wants a place to go with it, so we, you know, we've got a huge massive storage issue throughout the Midwest this year.

So, consequently, our warehouse space, whether due to constraints on actual physical space or to the constraints on credit and position limits -- you know, it's not just that my elevator's full -- it's that I'm at my maximum credit exposure with my bank because, you know, I've got the futures sold, but I'm getting margin calls. He's wanting to know if it's going to work, we got a problem with convergence. All that's tied together, so it is -- it is definitely a stress on the system because of the overall space.

If you look at Kansas, Colorado, Nebraska, all of the surrounding space for this year, we're projected in the fall to be 115 to 120 percent of the total space.

Now, you know, we can always, you know, say, well, we'll take milo and put it on the ground temporarily, or we'll do some other things. But the market becomes a bit concerned about that because really, are we comfortable with convergence. So we, you know, there is a breakdown. It is pressed on us because of the space utilization.

In previous years, the surplus future

prices have responded. Wheat was put under loan maybe forfeited and held by the CCC. That situation is not there today because of the strength in the futures market and a break in the linkage.

So we have this structural change and massive demand for our futures. We have this year a very high growth in our free stocks. We have a great deal of pressure upon the space, elevator space in the interior, and we have a market that's concerned down the road, are we going to take care of this lack of convergence and actually fix it? So that is also putting pressure no the markets today.

Kansas City Futures Contract was designed for a preindex investor marketplace, i.e. it has, as Nicole and David pointed, a fixed storage rate, and thus it has a fixed financial full carry. So, as Nicole pointed out in the warehouse receipt example, you will see a warehouse enroll at full carry; there is no incentive for them to put it out.

Now, that was, you know, the idea, the optionality behind that was to understand that, you know, if I sell boats today for -- if I sell vessels today for Oct., Nov., Dec., where do I put that hedge? If I put a hedge in the Sept. and then I actually cannot cover the cash and need to execute the September, it's going to take -- you know, I can't take it all out in the next day. I need some optionality to carry that, but I also need the optionality to carry it because, if, by doing that transaction what do you really want to happen? You really want the market to respond. Premiums go up, the spreads narrow, the flat price responds, the farmer moves a little bit of wheat, and the wheat flows because I've held onto that hedge, and the market starts to be pushed in.

But the market, you know, on the warehouse receipt is the market of last resort. So if the dynamic relationship between the cash markets, the spreads, and the futures are working, that's why you should never have to really see a great deal of taking or making delivery. But if you have no optionality and you want to just take and force it onto the market and say you've got to move it up, well, then, that becomes burdensome on the other side, on the -- uh, so when you look, you know, it is a balance contract that we're seeking.

And, but, so today this leaves a cash market, i.e., the basis to compensate because of the fixed storage rate and because of the high amount of free starch in our market, it leaves the cash markets the basis to compensate for the increasing demand for space over and above the fixed rate on the futures market, and has led to a lack of convergence facing the Kansas City wheat contract the past 12 months. The Committee does understand the concern. The Committee is working overtime to try to come to a consensus resolution on it to provide a balance contract, to not rush to, you know, not make an irrational mood that will have the unintended consequences that we fear.

I'll must stop there, Mr. Chairman.

CHAIRMAN DUNN: Thank you very much. I appreciate that.

I have gotten requests from Josh Curley, who is our trader, to be able to make a short presentation, and Josh has done this in the past, so, Josh, if we can get you to kind of keep this short -- we're running way over, but I appreciate you coming in. Josh comes in at his own expense, and we greatly appreciate that.

MR. CURLEY: Thank you, Chairman, Commissioners, and members of the Agricultural Advisory Committee. I will do my best to keep this brief.

While I'm certainly not qualified to speak on VSR's role in restoring convergence to the CBOT Wheat Futures Contract, as one of the more active high-volume traders, I am confident in discussing the effect VSR has had on the deferred months and spread markets. To put it bluntly, spreads, especially past the second month, have become virtually untradeable. In terms of liquidity, they are thin and skittish. It's not a healthy marketplace.

A healthy market is one where traders and customers can afford to be wrong, where they are able to offset a bad position and come back to trade another day. Currently in our back month and spread markets, this is not the case. Lately there are simply no out, making it nearly impossible to manage risk.

Many of these spreads are not actually trading. What I mean is that there is no longer a natural progression where bids take out offers one tick at a time. We are subject to just violent repricings often driven by relatively small orders. Liquidity majors like myself are exposed to several times the risk with a fraction of the position. I believe this is because VSR has destabilized our contract. Spread orders that were once absorbed by the market in one or two ticks are now moving at 10 or 20. Desk managers and floor brokers are reluctant to take orders past the first two months because positions are so difficult to get into and out of.

Spread order books are a skeleton of what they once were. I believe the variable storage rate has created needless uncertainty. Going forward five times each year, VSR will unnecessarily impose more volatility into our spread futures. What is worse is that by design VSR rewards rather than discourages market manipulation. Predatory funds that have the capital and ammunition will more easily profit if they're able either to hold the spreads above 80 percent or below 50 percent of financial full carry during the review period.

While there has been a significant recent spike in Volume and Open Interest, this merely served the interest of the Exchange. It would take an interest -- excuse me, and increase in true liquidity to benefit the core participants in a long-term viability of the markets. These increases in volumes and improved ratios between the third and front month Open Interest have not meant greater liquidity. To me, liquidity is how easily you can execute and order with minimal price movement.

Let's say you have to go to the market with 50 Dec/July wheat spreads. It doesn't matter if you are a broker in the pit or a trader on the screen, this is vastly more difficult and more expensive to execute than it ever was prior to VSR, and there's not a single market participant that will tell you otherwise.

And just real quick, a real like example because of what's going on in the market right now. If you went home yesterday with 50 Dec./July wheat spreads on, which is not a huge position, you woke up today $100,000 poorer, and that's just market to market. It'll probably cost you another $20,000 to get out of that position in terms of market movement.

Even if VSR has solved convergence, I don't know at what cost. The futures market is of no utility if you cannot trade past the front month.

Again, thank you very much for your time.

COMMISSIONER SOMMERS: Thank you, Josh. Commissioner Dunn had to step out for a few minutes, but he will come back, and I'm sure will want to engage in the conversations on wheat convergence.

I'll turn it over to my colleagues if they have any questions they want to ask this panel. Do you have any questions?

CHAIRMAN GENSLER: And I apologize 'cause I had a meeting that I had to attend to, and I missed some of this. But, so if I'm repetitive, I apologize.

My question is, what do we do to fix the problem? I thought the slides -- maybe I'm complimenting our own staff, but, Nicole, great slides, and whether you all accept -- maybe my first question is everybody accept what Nicole writes on page 2. She has a little "x", and it says, "breakdown in linkage," I think.

When I was in Kansas City and I met with a bunch of people, I said it's a broken contract, and I didn't even coordinate with Nicole. But, so my first question is, do people believe that there is this breakdown in the linkage?

MR. BORCHARDT: Well, Commissioner, I think that, as I said in my presentation, the Wheat Contract Committee weeks ago came to the conclusion that there is not a sufficient backstop mechanism in our contract to handle the type of situations we're in right now. Historically, we've been on the flip side. Normally, we have shorter supplies, and we're worried about short squeezes, and so we're trying to formulate packages of changes to bring assets to bear and diversity on the market to compel convergence that way.

We're not used to the situations we're in now. We normally. We did have a little bit of it in 1998, but we worked through it pretty quickly. But we're just not accustomed to having the tremendous supplies and scrambling for storage space in the interior like we have today.

So I think they understand that there is an issue and that there needs to be some sort of a mechanism brought to bear on the contract to alleviate the stress and to compel conversions, and there are several different ways to accomplish that, and they're in the process of trying to flesh out those alternatives.

CHAIRMAN GENSLER: And I know we were all together, however, and I thank you for that. It was four or five weeks ago, so it's a little bit of a blur. And at that stage I think I had asked you whether you thought you'd be ready by August 15th or something. But how long do you think you'll be ready before you have some firm recommendations?

MR. BORCHARDT: I feel confident that we will not be ready by August 15th.

CHAIRMAN GENSLER: You mentioned that four or five weeks ago, and --

MR. BORCHARDT: The committee -- you know, the Committee has had really good marathon, helpful discussions working towards trying to formulate consensus, which is really difficult because with the myriad of alternatives available to you, obviously you're going to have differences of opinion, you're going to have some that prefer one method for whatever reasons and others that prefer different methods because of maybe some unintended consequences or whatever.

So we're trying to work forward to come up with enough consensus to work down a particular path to flesh it out to see whether it's the right solution for our contract. And then at that point, once we have the mechanism decided on, then you can dress it up with other enhancements to the contract to create the requisite balance.

CHAIRMAN GENSLER: Will that be before the kids go back to school?

MR. BORCHARDT: Which year?

CHAIRMAN GENSLER: No, more seriously, this year. I really, you know, I respect that these are challenging things, but -- and I expressed this in Kansas City -- I'm just hopeful that you don't have meetings until, you know, Christmas and the, you know, people go on holiday, and then it's meetings until the spring and --

MR. BORCHARDT: I hope we don't have multiple meetings each week or twice a week before Christmas as well, but I think the Committee, in my opinion, I'm there as an observer, have been since 1993, I sit in on all the meetings 'cause I have to write the rules to accomplish what they decide, but I think they're making some good progress. I think they're looking at alternatives that foster convergence either immediately or over time, and, you know, I think most people can imagine what those solutions might be. It's either, you know, we all know about variable storage rate which I think can, taken by itself without the influences outside of the market like the Russian deal or whether you're going to have a short crop or what not, taken just by itself would be, in my opinion, a more gradual solution over time as the spread widens out to accommodate.

There are more immediate solutions, one of which I think the NGFA toiled for a couple years in putting together and recommending, and that was modified compelled load-out. I mean compelled load-out or a modified compelled load-out or some variation thereof, will effectuate convergence immediately. So --

CHAIRMAN GENSLER: Yes. I thank you, and I don't have any other questions, really. But I do think that it's important for each of the contracts that the CFTC oversees that convergence works. I think it goes to the heart of the market mechanism and that wonderful chart that Nicole put together that the cash market and the futures market for a certain number of days in the spot month should converge. And that's what farmers ultimately get confidence in that this contract, which is often so caught up in the financial markets and caught up whether it's index investors or other investors, but at some point in time it actually has a, you know, a relevance to the cash markets, and then they have the confidence that they can deliver into that contract on occasion -- not always but on occasion.

And so I would hope -- I'm glad that we agree that there is a problem -- I just hope that whatever solutions you come up with are soon, not, you know, many months.

COMMISSIONER SOMMERS: I had a question, actually for Mr. Curley. Thank you so much for being here and for your comments on the VSR, and I want to make sure that I understand correctly what's going on. And this is probably a little bit of a question for Dave, too.

The way I understood Dave's presentation is that as we look towards the future, the spreads are showing us the carry, it may be less than 80 percent. So this variable storage rate actually may lower in the future as we're looking forward. And so my question for Mr. Curley is, is that helpful that you're saying that the fluctuations in the VSR is a problem? Or just it, in general?

MR. CURLEY: It's a problem because the greater the variability, and variability increases the further away you get from the spot month the more difficult it is to price spread against that front month. If there is a static full carry, it's easier to price markets going forward in the second, third, and fourth option. If, you know, there's the possibility of it increasing every time or decreasing every time between now and then, it's much more difficult to price for someone like me that has to, you know, do rough math and price something, say, July 11 against Dec. in 2010. So it makes our job more difficult.

And you can see just by looking at the screens and since, you know, this is past, they're not as deep spread. They used to be a few hundred on the bid and offer and a tick wide; now it may be 10 on a bid and offer. Now they're pennywide.

So, you know, people have this great Open Interest in the back months, and when they go to get out of there, it's going to be very, very difficult. Whether they're taking losses or profits, it's going to move the market more when they go to get out of anything that's not in the spot month.

COMMISSIONER SOMMERS: You know, we talked for a very long time on solutions to the convergence issues in Chicago, and this was the solution that was put forward by the Exchange. Do you have other suggestions if the VSR isn't working for you in the market, but it is causing convergence? And what are our other choices?

MR. CURLEY: I have no idea. There's probably 20 Ph.D.s in economics in this room, and I've barely gotten an undergraduate amount of history. I really don't understand all that, you know, that abstract economics behind what's going on, but I can see the effects in the actual marketplace of somebody that stands in the pit and bids and offers and goes to the screen and looks at these markets, you know, you know, 16 hours a day, five days a week for the last however many years, these are the worse, unhealthiest markets I've seen in terms of if you have position, and right or wrong, there is no getting out of them. But I don't have an alternative proposal, no. Sorry.

COMMISSIONER SOMMERS: Thanks.

COMMISSIONER O'MALIA: Mr. Campbell, you had mentioned, you kind of pointed to strong problems with storage, fixed storage rates and the massive demand for storage. I'd like to get your impressions of what Nicole's thoughts, some of the options that she presented in her paper, specifically the expiration or revaluation of the certificates. What impact might that have on your market?

MR. CAMPBELL: Yeah, you know, honestly, that's a cotton. That works in cotton because cotton actually does devalue over the course of a lifetime. In the course of wheat from one year to the next, you really don't lose if it's properly stored. You really don't honestly lose much value vis-a-vis the quality degradation. So, you know, to just lose value in a financial sense, I guess -- and I don't know how one would measure that -- but in applicability from futures to cash --

COMMISSIONER O'MALIA: Well, I mean she -- you know, the charts she put up there, you know, played out that the incentive to carry this, if we took away that incentive, how would the market function, in your opinion?

MR. CAMPBELL: If you took away the incentive.

COMMISSIONER O'MALIA: Reduce that wedge.

MR. CAMPBELL: Well, if you can reduce the wedge, yeah. I mean it would perform better.

COMMISSIONER O'MALIA: Well, she had proposed a couple of solutions -- or not proposed but she outlined a couple of solutions that might do that. Do you have an opinion about that?

MR. CAMPBELL: Anything that moves the volatility from the basis to the spreads is going to aid in convergence. There's -- I mean there's, you know, as Jeff mentioned earlier, there's several, perhaps, tools. VSR is one way. Whether it is the perfect way is questionable.

Compelled load-out would certainly force convergence in a heartbeat. Would it have unintended consequences that would be, you know --

COMMISSIONER O'MALIA: Do you have a preference for either one of those?

MR. CAMPBELL: Probably not as a

representative of the Kansas City port of trade, you know, Wheat Contract Committee.

COMMISSIONER O'MALIA: You have no --

MR. CAMPBELL: I do have a preference.

COMMISSIONER O'MALIA: You have no preference.

MR. BORCHARDT: Well, I'm sure he does, but I guess what he's trying to say -- and I'll answer since I'm not a member of the Wheat Contract Committee -- is that right now in the fleshing out process of trying to drill down, which is the most preferred, and some of them had differing opinions from others, and it might not be proper for Steve to voice his particular --

COMMISSIONER O'MALIA: Well, I wasn't going to put you on the spot, but I thought I might get an answer out of him, though.

MR. CAMPBELL: Well, I read these presentations, you know, I mean online yesterday in the Reuters article, and so I'm a bit hesitant to put that out there today as I am a member of the committee, and that we are in the middle of the deliberations.

CHAIRMAN GENSLER: Can I say something? With all respect, I don't -- I don't think that's real. I mean you're a member of this Advisory Panel, too, aren't you? You're not a member?

MR. CAMPBELL: You're not a member? We haven't just --

CHAIRMAN GENSLER: Nor am I.

MR. CAMPBELL: I'm not a member, but --

CHAIRMAN GENSLER: All right.

MR. CAMPBELL: I understand what you're saying, Commissioner -- I mean, Chairman, and I do have an opinion, but --

CHAIRMAN GENSLER: If you can share with us, we'd love to know it.

MR. CAMPBELL: Look, the bottom line is, if you want to force -- if your own -- if your single re -- if your single goal -- if Your single goal is to force convergence, is to impact convergence, there's absolutely no question some form of compelled load-out will do that the most efficiently, pure and simple.

COMMISSIONER O'MALIA: Do you have a preference over VSR over compelled load-out? I'm trying to figure out how severe this problem is and what the appropriate solutions are. And we're going to have a responsibility. Whatever solutions you all develop, we have to enforce them and oversee them to make sure that we get the markets. We're going to be back here again. We're trying to get a better understanding of what you think is the preference, and happy to have the Committee's impression as well.

MR. BORCHARDT: Again, Commissioner, I appreciate your question, and I understand it. And I'm not sure that it would be appropriate at this time for Steve, as a member of the Committee, to voice his particular bias or preference with respect to the alternatives available.

Like he said, there's really -- there's VSR, you know. There's shipping certificates have been mentioned. You know, there's been forms of compelled load-out. I mean there are multiple different forms of variations of compelled load-outs, so I think that's really the circle of alternatives that we're looking at right now. We're not looking at cash shuttle contracts, so we're looking at, you know, the VSR shipping certificates and some variation of compelled load-out, which would be the -- I would guess would be the population that they're really focusing in on right now in trying to flesh out which would be the best alternative and the most balanced alternative in connection with maybe some other changes that could be made to the contract to provide that balance for the Kansas City Board of Trade.

CHAIRMAN DUNN: Commissioner Chilton, are you on the line? Do you have a question? Let's go ahead.

COMMISSIONER CHILTON: Commissioner Dunn, I'm sorry, I'm here.

CHAIRMAN DUNN: Sorry, Bart.

COMMISSIONER CHILTON: Sorry about that. I wanted a follow-up on Commissioner O'Malia and the question and what Chairman Gensler said for

Mr. Borchardt. I mean I know you all take this very seriously, Jeff, and I want to give you a chance to talk about it a little bit more, because there a lot of pissed off farmers out there and a lot of people who use this contract and are upset. They contacted us and they want us to work as hard as we can -- obviously this is your contract and you guys got to figure out how you want to go forward -- but they don't care if you worked very day from now until Christmas and beyond; they want it fixed.

So I want to sort of impart what I think what the Chairman was getting at, too, Chairman Gensler, is that there is some urgency to this. Obviously, you want to get it right, but this is important stuff for a lot of people out there who rely on this. And so I don't know if you had anything further you wanted to say on it, but, uh --

MR. BORCHARDT: No, I appreciate --

COMMISSIONER CHILTON: -- I hope you move forward expeditiously and thoughtfully.

MR. BORCHARDT: And I appreciate those words, Commissioner, believe me. You're not the only ones receiving the phone calls. We're hearing it from the production community, we're hearing it from our legislators, we're hearing it from, obviously, the Commission, and as well as the Associations that have people that are involved in the production side of the business. So the Committee absolutely gets it. We understand that, you know, a mechanism needs to be put into place to avoid the types of basis extremes that we've experienced over the last year.

So now they're working very diligently, but, you know, you have to also remember that this is our contract that we've had for 150 years. It's really the only contract of the Kansas City Board of Trades, and we've done, I think, a spectacular job over the years of handling it. The key for us is to get it done right.

Like Steve said, a knee-jerk reaction putting some mechanism into place that you're going to end up having to replace with something else and create more confusion down the road is probably not the best way to go; it probably would be better to take just a little bit more time as, you know, as painful as that might be, and to get it right the first time. And, you know, they're working diligently on it, and as soon as they come up with a consensus, we invite people in to discuss that. Then I think maybe we'll be in a position to try and, working with the Commission, to try and determine an implementation time frame with those changes.

COMMISSIONER CHILTON: Yeah.

MR. BORCHARDT: Thank you.

CHAIRMAN DUNN: Do you have a time frame that you may come up with a proposal contract-wise?

MR. BORCHARDT: Not at this time. They're in the process of, you know, fleshing out proposals going through the pros and cons, trying to formulate consensus on one in particular to be able to flesh it out, and at that point in time try and garnish consensus along with other changes to the contract.

So at the rate they're going, there's a lot -- there's a lot involved here. I mean I sit in on these. There's a lot of -- lot of discussions about impact, about time frames and what not, so I'm guessing three weeks or so, six to eight weeks probably. Because some of these have a lot of moving parts to them. There's things that have to be taken into consideration that you would definitely want to get right if you implemented them.

CHAIRMAN DUNN: Thank you. Mr. Lehman, just stay here, and I don't think you've escaped everything. On your slide No. 4 on the CBOT wheat bases at selected locations. I thought I heard you say that you did not include some of the new delivery points that you had and that there were a lot of activities in one of those. Could you expand upon that a little bit?

MR. LEHMAN: Sure, Commissioner Dunn. The location that we didn't include is the

Northwest Ohio 21- county territory that's had a new territory as of July of last year. And it's simply that we don't have a USDA cash bid for that location specifically. All of these other locations we're using a USDA cash bid that USDA collects and publishes to the market. So we don't have that data for the Northwest Ohio territory.

My comment about being active is that we have had active deliveries in that location, and we've actually had load-outs of unit car trains from that location in a couple of the recent expirations.

CHAIRMAN DUNN: Thank you. I'd like to open it up now for the Advisory Committee for any questions or comments that they may have, and we'll start and work our way around.

MR. WANDS: Well, again, thank you for allowing me to speak. I'm representing the American Bakers Association, and we are users of all three of the Exchanges -- Kansas City, Chicago, and Minneapolis -- and I think what the trader, the gentleman, the floor trader of the

Chicago Board of Trade, I think was alluding to is the problem that we have with the marketplace. It's not necessarily convergence of the cash and futures price; what we have to deal with on a daily basis if the ever increasing volatility that we've seen in all three Exchanges.

Just to give you an idea of what we have seen in the last 30 days, we've seen a 60 percent increase in our flour prices due to the volatility. And over the last 24 hours, we've seen a 15 percent increase in our flour prices due to the volatility of the marketplace. So it has caused us to drastically reexamine how we hedge our positions. For some of our smaller members it has been such a financial impact that they've simply gone out of business, and there's been a lot of consolidation.

And what we keep on talking -- we've met with the CFTC before, and we've met with a number of the commissioners. What we want to keep addressing is the presence of the index funds in our marketsplace. I mean we can talk about convergence and we can talk about why the contract is not working, but I think what we should initially address is who are the new players that have come into the marketplace, and that has been the index funds.

To give you a size of their presence, they own 367 percent of this year's Soft Wheat crop alone. I mean so their size is really what we think has caused the volatility in the marketplace, and we're not talking about high prices; we're talking about price moves. For example, the Chicago wheat opened up the limit today, and now it's trading up 42 cents. So it moved 20 cents in less than two hours. So to a baker that has to price flour, that is just an extremely expensive move on our part if we guess it wrong.

So I would just -- I would like to see if we could limit the -- we would like to have the limit on the index funds in the marketplace and treat them as traditional speculators instead of hedgers. So --

CHAIRMAN DUNN: Thank you, Mr. Wands. Next?

MR. ANDERSON: Yeah, John Anderson with American Farm Bureau. I guess I think I want to follow up a little bit on what Commissioner O'Malia was talking about. In the course of that conversation, we talked a little bit about forcing convergence, and there are a number of things can be done to force convergence, and, certainly, for our members who are affected by this, convergence is a big issue. But, really, I think to talk about forcing convergence is really to focus more on a symptom and not so much on the disease. The bigger issue here is, how do we make sure that cash and futures markets both reflect the same underlying fundamentals?

And as I understand the CFTC analysis -- I thought it was very good -- the primary issue there seems to be that because of the delivery process, there's an option value attached to these warehouse receipts that's reflected in futures prices. I guess I'd like to hear a little bit of follow up on that. If that's the fundamental issue, the most straightforward approach to dealing with this would seem to be to change the characteristics of the warehouse receipts that give it an option value so that that's not creating this divergence between the fundamentals of the cash and futures markets.

CHAIRMAN DUNN: Panelists, like to respond?

MR. BORCHARDT: Uh, with respect to the warehouse receipts, I know what you're saying and, like Steve said, they utilize that in the cotton area because cotton does devalue. But I think just sitting in on the meetings and what not, I think it's still good to have the warehouse receipt as an option in Steve's case, where he has a contract on and needs to stand on the market of last resort, if he needs to, to procure the procure the wheat.

I think there are other, maybe perhaps better mechanisms that can be put into place that will allow the warehouse receipts to preserve their attributes and contribute to the marketplace and yet compel convergence at the same time. And, really, what you're doing is you're, through whatever mechanism, you're allowing the front months in the case of not VSR but some variation of compelled load-out, you're forcing the futures price down to cash in the front month to what the true values are.

I mean that's what the farmer's getting is the real cash price. So if you're just looking for a mechanism that would force the longs to liquidate their positions rather than carrying and compel that convergence in the front, front end of the spreads.

MR. ANDERSON: If I could follow up, you know, I'd like to hear just fairly plainly what would be the consequence, operationally, for these end users if, for example, the warehouse receipts had an expiration date, for instance, an expiration that coincided with the termination of a contract month. What kind of difficulty would that present?

MR. CAMPBELL: Well, I think at the end of the day that would simply make a compelled load-out, right?

MR. ANDERSON: The difference I see between that and a compelled load-out would be that there wouldn't necessarily be a reason that the grain would have to leave its current position; it would just be then later stored at the prevailing commercial rate as opposed to the fixed rate under the warehouse receipt. It wouldn't necessarily be a compelled load-out.

MR. CAMPBELL: It doesn't move, though. It doesn't clear space, and it doesn't allow the local bases to improve. I mean it's -- that's sort of the whole function of it.

MR. ANDERSON: Well, there would be more incentive to move it because the -- I see it being similar to the VSR. It would -- it VSR increases the cost of exercising that option value, and so it's less attractive to exercising and so it's not exercised as frequently, be it a different way of doing the same thing.

MR. CAMPBELL: Look, whether a bank holds the receipt or whether a warehouseman holds the receipt, I don't know that there's really a -- there's really a difference. I mean if the warehouse hold the receipt, the actual value of his grain is not going to be reduced, so, you know, the space is still full no matter sort of who's holding the receipt.

If the bank holds the receipt and it loses value, then, yeah, you'll probably just put more pressure on them and that bank won't be there to stop the receipt. But the warehouseman today still have -- would still have that opportunity to roll a full carry, which is what they're doing today. I mean we saw very little deliveries on the marketplace because there's no incentive to deliver. The market's sending you the opposite signal. Why would you deliver? So the warehouseman will just do it.

I mean, you know, the fact that a few banks hold some receipts and can roll them is no different. That activity would simply move to the warehouseman.

MR. LEHMAN: If I could respond to Mr. Anderson's question, I think one of the things that we looked at when we -- and we considered compelled load-out or modified compelled load-out when we were working on the Board of Trade contract -- some of the difficulties are in transportation. You would put the, you know, the responsibility on the take of delivery whose receipt was expiring at that option to arrange transportation, and that's not always possible.

You are really forcing the long out of the market as I think Steve mentioned. And so it's really a tradeoff of the, you know, the distortions you might be causing in the transportation markets versus, you know, this wide basis. And from our view, VSR was maybe a little less onerous on the long side of the market because at least you're able to trade this spread or this opportunity. You have a maximum amount that that spread an widen over a one- year period of time, over a six-year period of time, and you can, you know, make bets. You can put your money in the market on where that spread is going to go.

And I'd kind of be curious to hear Josh's comment on whether a compelled load-out contract would be more tradeable or more conducive to liquidity into third-month spreads than VSR is.

MR. CURLEY: And the way I understand compelled load-out is the -- a similar effect to VSR, and there would be little reason to trade past for a month because the longs wouldn't be able to roll from one month in to the next. So my guess is it would still put the liquidity in the first option and not in deferred months. But that's just my take, and I'd, you know, maybe have to see it implemented and look at the markets and see how they react to know for sure.

MS. COCHRAN: Hi, I'm Christine Cochran at the Commodity Markets Council. I really have more of a comment than a question. Our organization represents both Exchanges and Exchange users, and we've had a number of conversations related to the contract in Kansas

City and also in years previous contract in Chicago.

And one of the things that I'm here today to communicate is our confidence in what the process is at the Kansas City Board of Trade. We believe that the Exchange is the expert, that they're talking to their constituents and the market participants, and we believe that they should have the ability and freedom to look at the range of options to address the problem.

I'm encouraged today to hear Josh make comments about trying to provide a balanced solution. We think that that is one of the most important things that they do as they go through this process is come up with a solution, which we do think there needs to be a solution, but one that is balanced: it doesn't favor the longs or the shorts.

CHAIRMAN DUNN: Thank you, Christine.

MS. PETERSON: My name is Dana Peterson with the National Association of Wheat Growers. I think the commissioners have a great handle on the issues that we're hearing from our grower members, and I would like to just publicly thank you for your attentiveness during this past year or so, and we have been in conver- --

CHAIRMAN DUNN: We don't get much of that, thank you.

MS. COCHRAN: In the last year, we have been communicating very closely with the Exchanges and with the growers. Our growers are just very supportive of having convergence happen, and we appreciate all of the attention and detail that's being paid by the Exchanges in making a decision on a long-term contract, one that is -- that provides our marketplace a competitive advantage over other production regions of the world where we do have the ability to have price discovery that everyone can participate in. Thank you.

CHAIRMAN DUNN: Thank you, Dana.

MR. DOUD: Commissioner Dunn, Greg Doud with the National Cattlemen's Beef Association. I, first of all, want to thank Commissioner Chilton for his comments and Chairman Gensler for his comments about convergence. I couldn't have said it better myself.

A couple questions I have -- one question I think you've already answered -- was, which would we prefer here in Kansas City, a compelled load-out or a cash settlement? And I think I heard that the answer to that was, Dave, with all due respect to you and all the great work you've done on variable storage rates, I think actually we're down to those, picking one of those, too, and I think we're going to have to get to that point.

Nicole, my question really is for you, though. Great presentation, and with regard to these warehouse receipts I have two quick questions for you: Did the fact that we have a lot of low protein weed in Kansas City affect any of this getting clogged up?

And the second question that is really the big question on my mind is that: What is -- how many people are in control of these warehouse receipts? Do we have a lot of these receipts and a very small, tightly held group of people, small number of hands? I'm a little concerned here that there might be a little market power at play with regard to this warehouse receipt issue in Kansas City.

MS. AULERICH: Well, first to address your protein question, three is no protein specification on the Kansas City Board of Trade, so it's supposed to represent the quality of the underlying crop is why they don't have a specification on that. So that really wasn't a factor here.

And, second, about the concentration of the warehouse receipts, I can't comment on that because that's proprietary information.

CHAIRMAN DUNN: Come around to the other side.

MR. CRYAN: Commissioner Dunn, I'm Roger Cryan with the National Milk Producers Federation, and I think the economic staff has done a good job today in previously demonstrating this issue, the wedge between the futures value and the cash value being associated with the optionality of the for storage in the contract. And it seems to me because -- the breakdown is because the warehouse receipt is not strictly -- it's not strictly the commodity, it's the combination of the commodity and that optionality.

One solution is to price that optionality separately. The variable storage rate approach is a kind of a clumsy attempt to do that, but it's very indirect. It assumes a certain relationship between spread and storage value. One, it may be possible that the Exchanges could come up with some approach that would offer maybe posted rates for storage as it to be attached to the contracts at the time of the execution instead of having just an option that a lot of people don't want.

So, for example, if somebody's buying a contract, if they want to carry it for six months, they can buy that option or buy that six-month storage rate; if you can separate the price discovery for the underlying -- for the storage commodity from the price discovery for the storage, you might be able to solve everybody's problem. That's all I've got, and thank you very much.

CHAIRMAN DUNN: Thank you, Roger. Edgar?

MR. HICKS: I have a couple of questions for Steve. First, Steve, you've got a great deal of credibility with me. I know who you are, so --

MR. CAMPBELL: Thank you.

MR. HICKS: -- I say that with a great deal of respect. But I also am here representing the National Grange and Farmers of Kansas and Nebraska, and I'll get roasted if I don't ask you some of the questions.

MR. CAMPBELL: Okay, fire away.

MR. HICKS: All right. You mentioned a couple of times the word "massive," and you applied it to investors, and you talked about influx, and are you giving equal significance to investors in this process as you are to farmers and as people we serve?

MR. CAMPBELL: I'm sorry, what was your name?

MR. HICKS: Edgar.

MR. CAMPBELL: Edgar. Okay, I just can't read them.

MR. HICKS: Maybe I should turn it down so you can't see it.

MR. CAMPBELL: Edgar, I don't know that I'm weighting one versus the other, and the reality of it is forget that I'm a trader, forget -- I'm wearing an economist's hat, and all I'm saying is we have had a massive inflow for the demand for our futures contract. That demand for our futures contract has not been offset by a physical demand for our cash wheat.

So, therefore, our futures contract market has responded to that demand whereas our free stocks in Hard Red Winter Wheat have grown substantially. They are -- so my point being they're not in sync. And when they have a financial futures investment type product that we sort of serve today that is going in an opposite direction of your cash market, you will have divergence. And when you then get -- you can have convergence up until you plug all your space; and once you plug all your space, you're done.

MR. HICKS: Okay, you mentioned --

MR. CAMPBELL: Under the current market.

MR. HICKS: You mentioned laying off. You mentioned the investor laying off. What is, relative to the farmer -- I see what the farmer's laying off -- what is the spec guy -- maybe I shouldn't say that because we need him -- the index fund guy, what is he laying off? You mentioned that he's laying off. What is he actually laying off?

MR. CAMPBELL: Again, I'm really not sure what --

MR. HICKS: Well, I'm --

MR. CAMPBELL: -- you're -- what in reference to.

MR. HICKS: I'm asking you that because the index is being qualified as a hedger, so --

MR. CAMPBELL: Oh, no. Listen. What

you say -- okay, I'm not sure I made that comment -- well, maybe I did. Look, I mean he's taking the investor, the investor's being pulled under one umbrella, because of that he's generating what's considered commercial risk, and much like we were talking about in the previous cotton example, that commercial risk has been deemed a bona fide hedge.

I'm not making comment if that's good or bad. I'm simply saying that we have now created demand which has gone to the bona fide hedge exemption status, and that's moved into our marketplace.

MR. HICKS: Okay.

MR. CAMPBELL: The farmer, he's laying off real risk vis-a-vis his long crop, and he's selling futures, and he's laying -- that's a traditional hedge.

MR. HICKS: Okay. Jeff, you mentioned how long the contract has been around. And, traditionally, in the early provocations of the Exchange, you have examples like in Tom

Hieronymus' book on the economics of futures trading which everybody, any commercial firm had to read when I came into the business. There was examples of freight rates in issues. The staggers -- deregulation, does that have anything to do with the challenges that we have now?

MR. BORCHARDT: Yeah, I'm going to let Steve take that, and I think it has, but in answer to your earlier question, you were asking about the Committee and their preferences to funds versus commercials, and I think what I want to make clear here is it's irrelevant in my opinion whether -- the Committee should not base the decision on one party or another.

The major point is, as the Chairman and commissioners have pointed out, you're supposed to have convergence at delivery time. The funds roll a month ahead of time, so if the funds have already rolled and they're out of the market interior, you're supposed to converge. We do not have, under these circumstances, an adequate mechanism for compelling that convergence at the delivery time.

And so that's what the Committee is charged with to come up with, is funds notwithstanding, there still needs to be a mechanism put into place that would not allow the basis to get that weak before some mechanism would kick in that would force the longs to liquidate their positions and for the basis to resume its normal levels accordingly.

So I don't think that their based in any decision based on any particular market class, if I was reading your first question correctly.

MR. HICKS: Okay. But the issue in my mind should be some of that market obligation should fall on the spreads. But like in Western Nebraska and Kansas, that obligation is being excessively put on the basis. And going to your point about the spreads, you know, as a hedger -- again I'm representing farm groups here, but I'm wearing another hat, too -- as a hedger, if I don't have his confidence in those spreads, how can I take advantage of the opportunities that the market today is giving us when we're at the limit, and I want to go out and take advantage of that? If I can't suck him in to take the other side of my trade, then my farmers are cooked. And I don't know what that --

CHAIRMAN DUNN: I'm familiar with some of those technical terms.

MR. HICKS: I don't know what -- I don't know the answer, Steve, but I just know I regard your opinion highly, but I don't think that's good enough for me to go back to Nebraska with, I guess.

MR. CAMPBELL: Well, Edgar, I think we've -- and, look, there's no defense here. We, as I said in the beginning, we have seen structural changes, the market -- the Committee is dealing with those structural changes.

Frankly, with all due respect, I mean we saw Chicago struggle, we saw the actions that they took. We had not at that point in time seen the level of activity toward necessarily movement on our part as far as committee and our lack of convergence on Hard Wheat; we've really seen that just over the last nine months, and we've seen that in conjunction with free stocks building to a record level. That, set aside, Edgar, we understand that there is an issue.

Now, as far as, you know, as far as I think where Jeff was going, is, look, if Kansas City is trading a close to par value, and the freight back to, you know, your farmers in Western Nebraska is higher, then by default the absolute basis, you know, that could fall into this current, you know -- I mean is going to be less.

MR. HICKS: But we had a period of time -- again I'm talking when I came into the industry -- we have a period of time where you knew that when you came out a year ahead that you could start, let's say corn. You knew that you could start in Central Nebraska even when that option first came on, that new crop option came on, you knew you could start at 40 under. I mean you didn't even have to have any -- you didn't have to have any -- you knew you could --

MR. CAMPBELL: No, listen --

MR. HICKS: You can't do that now. And you can't do that now because the guys like him that we can't get to participate.

MR. CAMPBELL: Again, Edgar, I'm not defending it. I understand. I mean we as a Committee do understand that you cannot do that, and you partially can't do it --

MR. HICKS: I know we can't come up with the answer. I -- Matt, I'm going to defer to you. The Commission's done three hours with what's going on in the marketplace right now, you know. I mean that's what I've heard, you know. You going to spend three hours on this when we're up the limit like this?

Matt, it's your turn. We just don't -- it doesn't seem like it's enough time to address this issue of what we're going through right now. It really doesn't.

CHAIRMAN DUNN: Thank you, Edgar, but this is the tip of the iceberg. The Chairman has been out to Kansas, all three of the commissioners have been out there.

MR. HICKS: Have you been to Nebraska?

CHAIRMAN DUNN: I have not been in Nebraska recently, but I have been out and listening to folks on this issue, and this is -- what we can do here is bully pulpit, and that's what I'm using today, and both these Exchanges have been bullied by me during my tenure.

MR. BORCHARDT: We have the scars to prove it, if you want.

CHAIRMAN DUNN: I really appreciate your coming in because my saying things to them and others saying things to them doesn't reflect the passion that you have in reflecting those members of the Grange that you represent, and I really appreciate that. And I think it's good to hear the concern for the producer out there and the impact it's having on them.

With that, Matt, we'll go to you.

MR. BRUNS: Thank you, Commissioner Dunn. My name is Matt Bruns. I represent the National Grain and Feed Association. I want to start with the major point, convergence matters. It matters to our groups, it's critical to her hedgers and producers in able to be confidence to hedge a risk and afford in a Futures Exchange.

So far, we are pleased to see the improved performance of the CBOTs. We contract over recent contract periods. Part of the performance, improved performance, could be due to the variable storage rate, but it's probably too early to say for sure. There are other factors at work, also, and we'll be watching closely with interest as the VSR takes full effect.

Now we see some challenges with convergence to the Kansas City Board of Trade Wheat Contract, and historically wide basis swings oppose challenges to producers and commercial grain hedgers. There are a number of factors at work in this market: a big Hard Red Winter Wheat crop, some quality concerns, extreme tightness of storage space, sluggish export demand, and an impact on investment capital that's, you know, come into our egg futures market.

These things in the Kansas City market are not terribly different, what we saw in the Chicago Board of Trade market here in the last few years. It's critically important that we reestablish the convergent as quickly as possible. We've been in close contact with the Kansas City Board of Trade to view our concerns, share information, and to discuss potential solutions. We know that KCBOT is working hard to respond to a challenge market situation to analyze the changes for their contract.

As of today, the NGFA has not made specific recommendations for changes to the Kansas City contract. We have discussed several potential solutions, and we have expressed our desire to the Kansas City Board of Trade to be involved in their process to help evaluate potential changes and provide feedback.

Our member companies rely on the Kansas City Board of Trade Contract. We have a lot of experience and expertise that we hope that the Kansas City Board of Trade will invite us to share as their process moves forward.

Back to our core message, convergence matters, and we urge the Kansas City Board of Trade to move as quickly as possible to implement the changes that will be needed to reestablish convergence that both producers and grain hedgers rely upon.

Thank you.

CHAIRMAN DUNN: Thank you, Matt. Kevin?

MR. SOMBKE: Hi, I'm Doug Sombke representing National Farmers Union. I'm a crane farmer in South Dakota. I appreciate the panel's presentations, and, Nicole, yours was exceptional. I think you nailed it on the head.

In light of time, I have to agree with Edgar what he was saying, and also what Hayden was saying. I think the speculators have created a huge mess here for us, and I just want you to know that what Commissioner Chilton was saying is, his passion is exactly what we have. Farmers are feeling this today, and I hope that you guys can get this fixed because we are -- we're hurting, and we do need the likes of the trader.

So with that, I just want to say the National Farmers Union supports the efforts of the Board, but at the same time, long enough already.

CHAIRMAN DUNN: Thank you, Doug. I appreciate that.

MR. NATZ: Thank you, Mr. Chairman, I have nothing to add.

CHAIRMAN DUNN: John, do you want to put a cotton shot in here?

SPEAKER: Well, I really, really appreciate this panel. This is something that I think you can hear from the Advisory Committee, from the members of the Commission is something that we're greatly concerned on for the Exchanges. There's a lot of pressure on you to fix it. It's your contracts, but if you can't use them to hedge, if you can't use them for price discovery, then they're actually worthless. And I'd have to go back and say, why do we even have those?

Thank you.

MR. WANDS: Can I just add one more

thing, Chairman Dunn? I don't think we've really talked about it here too much, but we're subject -- half of our wheat is exported, so we are subject to the price of world wheat.

Well, obviously, and we can about convergence but the basis levels in Hard Wheat down at the Gulf represent we need to compete on a world level. And right now, because of where the futures are and who's in the futures arena, the cash market's doing the job of what the futures should do. So that's going to continue as long as we have the entities in there, as long as we don't have those limits because we've got to sell half our wheat to the world. Has to. So --

CHAIRMAN DUNN: Again, I would encourage all of you to take a look at what we're going to be doing -- am I stealing your --

CHAIRMAN GENSLER: No, no, no. I was going to ask --

CHAIRMAN DUNN: -- of what we're doing under the new legislation and to get on and get your input into that. Mr. Chairman?

CHAIRMAN GENSLER: I was just -- Jeff, I was mulling over something you said. You said six to eight weeks. So I just want to confirm, here you say it again, you think that you're not going to have it before the kids go back to school, but you're certainly going to have it before homecoming dance, before October 1st.

MR. BORCHARDT: I guess what I was saying is that at the current rate of production, so to speak, to try and drive to a consensus I'm hopeful that the Committee members will be able to come to consensus 7-3, whatever it takes -- it would be nice if there were all 10 of them -- in consensus with a solution to go forward with and nail down and bring in the outside parties to bounce it off of them, and then try and work towards a -- well, I guess before bringing the parties in part of that consensus, though, being you have the other aspects that come into play --

CHAIRMAN GENSLER: I wasn't really terribly interested in your process, I was interested in the deadline. Six to eight weeks.

MR. BORCHARDT: I'm hopeful of that, but --

CHAIRMAN GENSLER: All right, I don't know what our legal authorities are. I think every one of the people in the room wants you to figure out a solution.

MR. BORCHARDT: None more than -- more than --

CHAIRMAN GENSLER: I'm more than hopeful that you do it in the six to eight weeks.

MS. AULERICH: We're working as hard as we can.

MR. HICKS: Commissioner Dunn, I have a question on -- just as comment on your Open Interest sheet. And so I guess this is your official CFTC document. Open Interest from an index fund piece, I think this is a little bit skewed because we have a lot of participants that are in and out the same day, and this isn't reflecting, and I think that's part of a lot of the problems that we're having with Fund.

I think if you're going to use this

chart in making a decision, somewhere it needs to say that a commercial hedger will put the position on, he may have it on for months, whereas the index fund may be five or ten minutes. And I think that skews the value of this a great deal.

CHAIRMAN DUNN: Edgar, you make a great point in here, and the massive passives, as some of the CITs have been called, are the ones that stay there for a long time. But it is a whole other related problem that we have of the high frequency traders. And that, again, is something that we're looking at here at the Commission, and, you know, our Commerce Office has been working on that as well. The Chairman has them tasked with doing a few things, and it's a great point and something that is good for us to keep in mind.

With the indulgence of my commissioners, I'm here. I apologize because I have run way over our time frame, but I think it's extremely important that we talk about the livestock situation, and I do want the Advisory Committee to be privy to what we are planning on doing on implementing the new legislation. So without taking a break, if we could go to the next group, or, if anybody feels like they've got to get up and leave, that's just great, go ahead and do that, except for the panelists. They can't get up while they're going.

But a shrinking negotiated marked and consolidated packing industries are combining with a poorly structured and nontransparent cash market price reporting system to cause a rise in complaints and an increase in the future of contracts susceptible to manipulation.

Our next panel will address some of the key issues in there. We have Harry Hild from the CFTC's Division of Market Oversight; Jay Johnson from GIPSA from USDA; Warren Preston, who is with AMS from USDA; with Reactor Group Paul Peterson from CME Group; Don Close from Texas Cattle Feeders Association; and Neil Dierks from National Pork Council. And so they are getting in place now, and soon as they do we'll ask Harry to begin.

MR. DIERKS: Yes, Commissioner, I grew

up about two miles -- his brother was my school bus driver, so.

CHAIRMAN DUNN: Harry, are you prepared?

MR. HILD: Yes.

CHAIRMAN DUNN: All right, if you will kick it off, I'd greatly appreciate it.

MR. HILD: Thank you, Commissioner Dunn, Chairman Gensler, and fellow commissioners. Today we'll discuss some observations in livestock markets related to price reporting and in-district trends. My comments will focus on the hog market specifically. I've prepared these comments, and views are my own.

The USDA's Grain Inspection, Packer's and Stockyard's Administration is here as well to comment on this trend, and the Agricultural Marketing Service is here as well, and I believe the Chicago Mercantile Exchange is on hand next to talk more specifically about the contract itself.

I will begin with a very brief description of the futures contract and how it's connected to the cash market. I'll then have a very brief description of the connection between the cash and futures market, but also I'll highlight some outlier situations and market transparency issues and how those issues relate to surveillance concerns. Finally, I will conclude with some discussion of industry trends, some concentration issues, and a reference to an academic study related to these issues.

The very next slide here is a screen shot of the 201 report. This is a USDA AMS report from which the CME derives the values that they use for their Lean Hog Index calculation. It's a two- to three-page report. There's a lot of information on this report, but I've highlighted the six cells that the calculation uses. As you can see, it is what they call producer-sold negotiated and producer-sold swine or pork market formula variables. There's a head count. There is an average net price and an average carcass weight. These numbers are multiplied each day. They get a value for one day. They have a value for another day, the next day, and those two are combined together. I think the CME can get into more details and question about that.

But what I do want to highlight from this screen shot in this report is that it's a daily transparent report, but you can see there's a big difference between the total head count in the Negotiated category compared to the SPMF category, and that's just -- that is something I think that we'll see a little bit more detail later on. But it is important also to note here that these are net prices. These are prices that are derived from hogs that have been delivered and have been slaughtered. I'll get a little bit deeper into that later.

And one final point from this slide is that in the SPMF category, it is industry practice for packers to buy hogs using long-term contracts, and each day a certain undetermined percentage of these contracts use the Western Corn Belt or the Iowa/Southern Minnesota negotiated base price as a reference base price, and we'll get into that on the next slide here.

This is the Western Corn Belt USDA Report. It's an afternoon report, and it's actually a report for July 30th. Lower down on the screen you can see that this is one of the more referenced prices and head counts in the industry. I've highlighted there that it's barrels and gilts on a carcass basis. The head count on that particular day was 4,953 and the base price range that day -- that's a range of obviously highs, lows, and a weighted average middle price -- the range that day was 75 to 8378, roughly $8.78, and the weighted average was 8149. The hog market generally trades and reports trades using these base prices. Again, the CME uses net prices for the index, but the cash market trades are base price. The base price becomes a net prices when the hogs are delivered and slaughtered. Each net price is determined by the base price and the packer's grid or matrix. Each packer has a different matrix, because each packer values different hog attributes differently. These attributes are weight, target weight, leanness, and just general yield of the animal. So, each packer has his own value for those. As the hogs are processed, this base price becomes a net price. The net price accounts for the hog's yield and determines what the hog seller gets paid. The CME, again, uses these net prices to calculate their index.

Before we leave this slide, I'd like to make a couple of quick points about the negotiated market. The negotiated market is spot transactions. The hogs are to be delivered within 14 days. There are some other rules, but I'm just going to highlight a few. The transaction sizes in the negotiated market can be quite large, and as you can see, the head count on this particular day on this particular report was roughly 5,000, but one of the other attributes of a negotiated transaction is that negotiated transactions can be can canceled after being reported. So, in other words, the price and the head count could get into this report but the transaction could be canceled and never been delivered.

And packers also have choices on where to purchase negotiated hogs and how and when to report the prices. This is an afternoon report. It compiles some of the prices and head counts from a morning report, and then later on there's a full day report, so there are different times and cutoffs from which packers can choose to report. And prices can also be reported on either a live or carcass basis, and that's kind of a real deep-in-the-weeds type characterization, which we can get into later, but the point I wanted to make is that it is a choice.

The next slide here shows hog procurement and pricing methods using that 201 report that I used on my third slide. It's kind of a summary of the head counts, how they've changed over time. Note that the Producer-Sold category is decreasing and, most notably, that the Negotiated category has dropped off quite significantly. Currently, the Negotiated category is about 5.5 percent year to date for 2010. Also note that the Packer-Owned category is increasing.

Further note that as currently reported by AMS, there are a lot of hogs in the 201 report that are not included in the CME index.

The next slide uses those two categories of SPMF and Negotiated. It boils out just those two categories in terms of how they changed over time. Now, this graph shows each category's percentage of the head count that went into the Lean Hog Index calculation. As you can see, the SPMF went from 78 percent of the head count in 2003 and is now about 91 percent and the Negotiated category was 22 percent and is down to 9 percent currently.

Slide 7 -- this slides breaks into the cash transaction site. We're talking about purchase data right now. This is the Western Corn Belt 212 report. This is the afternoon report, as I mentioned, and this is kind of a medium-term graph on the range. The Purchase report information -- it shows the high, the low, and then the weighted average of the day. A point from this slide would be that the weighted average tends to be near the high of the day. Again, it's a weighted average. It's kind of a special concept here in this type of reporting, but from the surveillance perspective here, we always see that there's a range and that there is a low and so we take note of that, because, you know, on a day where the weighted average is near the high, in surveillance we see that there is always cheaper hogs available.

Slide No. 8 takes that range from the Western Corn Belt, goes a little farther back, and does a 10-day moving average of that. The graph shows a 10-day moving average of the range, and that range tends to be about 10 to 15 cents per hundredweight. The graph also shows a period of outlier ranges, periods where the range exceeded 15 cents, and was as wide as 20 cents per hundredweight. Periods of sustained wide ranges can lead to surveillance or transparency problems. On such days, hogs appear in great supply on the low end and in very short supply on the high end. This is the Western Corn Belt range. It's not a range from the National Report.

Now, an example of this range -- if you take cents as a range, as an outlier, if hogs are trading roughly 40 cents or $40 per hundredweight, a 20 cent range if you split, it means that hogs are trading as low as 30 or as high as 50. If you're buying hogs at 40 and your next purchase happens to be at 50, that's a 25 percent increase just in one transaction. So, these outlier situations, again, lend themselves to some surveillance concerns.

Slide 9 again uses the Western Corn Belt purchase data but compares it to something else. It's called the carcass cutout. This is really essentially the USDA's estimate of the value of pork. The graph shows what could be called a packer margin, because it's the price of the product, which is the pork minus the cost of the input, which is the hog. Up until about February of 2008, the cost of hogs rarely exceeded the price of pork. Then you can see there was a sustained period where the cost of the hog was more than the value of the pork that was being sold. And I think there's been some recent developments in terms of the reporting of pork prices. Previously -- or currently I should say -- the reporting of pork sales is not mandatory, but I think one of the drafts of the new farm bill or one of the new suggestions, which Warren might mention, is that it's being proposed that pork price reporting become mandatory. So, this is a situation that was in the past that could remedy itself in the near future.

Slides 10 and 11 kind of get into some concentration issues. This is a pie chart of some of the larger packers in the industry from estimates that we took in 2009. It think Mr. Johnson of Packers & Stockyards has some comments about this, so I'll be brief on this slide. As you can see, the names of the major participants are Smithfield, Tyson, Swift, Cargill, and Hormel; and of those big one, two, three, four, five packers, I believe Smithfield is -- they're all pretty -- they all have some degree, I believe, of vertical integration, but I think Smithfield has the greatest percentage of vertical integration. And, again, slide -- this is slide 11 -- shows how the four-firm concentration has changed. Other than some of the statistics that Mr. Johnson will mention, I would add to this slide that in 1997 is when the CME first listed the Lean Hog Index futures contract, and there's been some significant changes in the four-firm concentration since then.

But before I defer to Packers and Stockyards, I would like to make one final reference to the following. In the fall of 2009, there was an academic study by Gomez, Frank, Kunda, and Garcia, which was published in the fall 2009 Review of Futures Markets. It was published by Kent State University. Academics as well as the public have taken note of the recent cash price reporting outliers, as well as the industry concentration trends. This study highlighted an increase in the basis variability of the cash hog market relative to the lean hog market. The study compares basis behavior, basis forecasting, and marketing strategies for both physically delivered hog futures and cash-settled hog futures, the difference between the two regimes, the physically delivered and the cash settlement period. They concluded that among other things, and I quote, "basis level and variability increased in the cash settlement period." The study also finds, "The use of futures generally reduces the variability in cash prices, but it's the ability to do so that has declined during the cash settlement period due to an increased basis variability." The study suggests that a possible cause of this behavior is the shrinking negotiated market and these industry concentration and vertical integration trends.

I will conclude my remarks, and if there's any questions specific to the slides that I've presented, I can take those. If not, we've got Jay Johnson here from the Packers and Stockyards Administration.

CHAIRMAN DUNN: Thank you. And, Jay, welcome. Jay and I had worked very closely in the past when I was Undersecretary for Marketing Regulatory, as with Warren. These are two guys that I have a lot of trust and confidence in, and I really appreciate them being here, and I note that Chris Sarcone from Ag Marketing Service is here from Public Affairs. So, I appreciate USDA sending us their very, very best here. And with that, gentlemen, if you would give your presentations.

MR. JOHNSON: Thank you, Commissioner Dunn and your fellow commissioners for inviting the Grain Inspection, Packers and Stockyards Administration to join you today to discuss the structural issues in the pork industry.

Examination of the pork production sector shows that producers raising more than 5,000 hogs per year produced 61 percent of the market hogs in this country. Producers raising more than 2,000 hogs per year produced 85 percent of the hogs. We have some truly large producers in this country. In 2009, the top 10 producers owned approximately 2.3 million, or 40 percent, of the nation's sows that raised about 46 million pigs. The top 20 producers have 2.8 million sows, or about 48 percent of the nation's sow herd.

Successful Farming magazine's annual survey of pork producers shows that Smithfield Foods in Smithfield, Virginia, was the largest producer in 2009 with over 922,000 sows, which represents about 16 percent of the U.S. herd. Triumph Foods, St. Joan, Missouri, was second with 371,500 sows; Seaboard Foods, Shawnee Mission, Kansas, was third with 213,600; and Iowa Select, Iowa, Iowa, was fourth with 152,500 sows. As a point of reference, each sow produces about 19.5 pigs per year. The top three hog producers are also included in the list of the top 10 pork slaughter firms. Currently, the top four slaughter firms have a market share of approximately 65 percent, or also known as the four-firm concentration ratio. In alphabetical order, these firms are Cargill, Smithfield, JBS Swift, and Tyson Foods.

The hog slaughter industry has become

significantly more concentrated over the past 30 years with the majority of the structural changes resulting from mergers and acquisitions in the industry. In 1980, the four-firm concentration ratio, which measures the total market share of the largest four firms in the industry, was 34 percent.

By 1990, the ratio rose to 40 percent and then to 56 percent in 2000. By 2003, the four-firm ratio had risen to 64 percent and has remained relatively steady since that time. Pork production and slaughter is very geographically concentrated in the Corn Belt as well as in the Mid-Atlantic Region, which is comprised of Virginia and North Carolina. There are other isolated areas of production in Pennsylvania, Utah, Oklahoma, and Texas. Probably the largest change in the hog industry in the past 15 years is how hogs are marketed. Today a very large percentage of hogs are sold on a formula basis or other type of purchase arrangement as opposed to on a negotiated basis.

In 2009, formula or purchase arrangements accounted for 62.2 percent of all hogs slaughtered. Most of the hogs sold with the formula or purchase arrangement are committed via long-term contracts. The formula-basis hogs generally use a publicly available price series as a basis for determining their price. The most widely used is the Iowa/Southern Minnesota Afternoon Report.

The popularity of contracts -- they increased significantly after the collapse of the hog market in 1998 and 1999. During the period, prices were as low as $8 a hundredweight, because there was not sufficient slaughter capacity to handle the supply of market-ready hogs. As a result, many producers were determined not to ever get in a position again where they did not have an assurance of shackle space to handle their production. By entering into long-term contracts or agreements, producers are guaranteed shackle space by the packer and, likewise, the packer is guaranteed a supply of hogs. A couple of plants were even opened by producer-owned cooperatives after that time.

In addition, the number of packer-owned hogs has increased from 19.5 percent of all hogs slaughtered to 31 percent in 2009. Currently, approximately 3 percent to percent on a weekly basis of all hogs marketed are on a negotiated basis. Of this amount, approximately one-third are sold on a live-weight basis and two-thirds on a carcass- weight basis. In 2002, the number of hogs marketed on a negotiated basis was approximately 15 percent.

In concluding, once again I would like to thank Commissioner Dunn and your fellow commissioners for allowing GIPSA to come before you today to discuss the current structural issues in the pork industry.

CHAIRMAN DUNN: Thank you very much, Jay. Warren?

MR. PRESTON: Thank you, Commissioner Dunn, and I appreciate the confidence that you have in us. I've had to edit my remarks here, and

I'm no longer going to say good morning, Commissioner Dunn; I'll say good afternoon, Commissioner Dunn, your fellow Commissioners, the members of the Agricultural Advisory Committee, and all the guests. I appreciate the opportunity to represent USDA's Agricultural Marketing Service at this meeting today.

You may recall in 2006 I had the privilege to speak before this committee in a similar meeting on the role of price discovery markets in USDA programs during a session on the economic and market implications of thinly traded priced discovery markets. It seems that we've returned to that same theme today. In the meantime, negotiated cash trade on the markets that we report continues to become thinner as evidenced by decreasing percentages of negotiated spot or cash-market trades.

My purpose here today though is not to speak as an economist but rather to provide an overview of how we at AMS provide price transparency to the marketplace through both

Voluntary and Mandatory Livestock Reporting Programs.

USDA's Livestock and Grain Market News consists of about two dozen field offices with about 75 federal market news reporters. Our Livestock Mandatory Reporting Program is carried out in two of those offices -- Des Moines, Iowa, and St. Joseph, Missouri. For our voluntary programs, we also have cooperative agreements with 29 states through which we train and supervise about 130 market reporters employed by those states. These cooperative agreements enable us to leverage our resources to provide greater breadth, in depth for livestock and grain market reporting, particularly at auction markets that might be of primarily local or regional interest.

However, continuing state budget shortfalls are threatening these state-funded programs. In 2008, for example, Wisconsin terminated its state market news program, and as a result we no longer provide coverage of livestock auctions in that state. As we monitor this situation, we will continue to deploy our resources to provide priority for markets of regional or national interest.

One of the most important roles for our supervisors for our Voluntary Market News Program is to ensure uniform reporting of the commodities that we cover. For the voluntary side, this means that we provide continual training on live animal evaluation. For example, when a state or federal market news reporter covers an auction market, we want a feeder steer report as a large frame number 2 thickness animal to represent the same characteristics whether that steer is reported at an auction in the far southeastern part of the country in Florida or in the far northwestern part of the country in Washington. That way, when reports are compared across regions or over time, users have the assurance that the categories of animals reported are similar in terms of class and grade.

Our mandatory reporting program operates quite a bit differently than our voluntary programs. The Livestock Mandatory Reporting Act of 1999 was enacted in October of that year, and the first reports under the program were released in April of 2001. Under the Mandatory Reporting Program, larger packers were required to report their transaction level data to us on cattle, hog, and sheep and lamb purchases as well as box beef, box lamb, and lamb carcass sales; and, as Harry mentioned, wholesale pork cuts are not currently included as part of the mandatory program. Larger lamb importers are also required to report to us their lamb imports. Processing plants slaughtering at least 125,000 head of cattle or 100,000 head of hogs per year are required to report livestock purchase information to us, as well as packers that slaughter at least 200,000 head of sows and boars regardless of individual plant size. In all, we have about 115 establishments that report to us under this mandatory program.

Plants slaughtering steers and heifers report purchase transactions to us at least twice a day, and plants slaughtering barrels and gilts report purchases at least three time daily. There's also some weekly reporting and some additional daily reporting that sometimes bumps those numbers up on particular days.

Under the Mandatory Reporting Program, within one hour following the data submission deadlines, we validate the data received from packers and lamb importers to prepare and disseminate over 100 daily, weekly, and monthly reports. These published reports cover an estimated 77 percent of slaughter cattle, 93 percent of box beef, 95 percent of slaughter hogs, 60 percent of slaughter sheep, 41 percent of box lamb, and 26 percent of the carcass lamb markets. Each entity required to report under livestock mandatory reporting is audited at least twice a year. Our auditors examine randomly selected transactions to ensure that the information is reported to us correctly, timely, and completely. Tabulations or the results of our compliance visits are posted quarterly on our website, and beginning in 2009 we also began posting monthly summaries of excluded transactions. These are transactions that would be omitted from our public reports at the discretion of our market news reporters. For example, in the process of validating transaction-level data, a reporter may market transaction to be excluded from publication for price aberrations, notably lower or higher than the bulk of the market due to discounts for premiums, for weight, quality, yield, dressing percentage, inferior livestock, or mixed classes of livestock in the same lot. A review of our excluded transaction summary shows that few transactions are omitted, and when there are transactions excluded, the impact on our weighted average prices is minimal.

In addition to our standard published reports, we have launched two new items to make our information more readily available and easy to understand. First, we now have a growing number of reports that are formatted for mobile devices, such as cell phone and PDAs. Users who have subscribed to these reports receive concise summaries of key information from some of our most popular reports. And I have little cards here if anyone's interested to pick up that tells you where to go to sign up for the mobile reports.

Secondly, just in the last month we released our direct slaughter cattle reporting dashboard. This dashboard was created as a result of a directive to the Secretary from the 2008 Farm Bill, and this interactive tool enables users to visualize key cattle market information in charts, in tables that can be customized and easily downloaded for further analysis and presentation. Links to both the mobile reports and the cattle dashboard can be found in the livestock market -- in the Livestock and Grain Market news section of the USDA market news portal at marketnews.usda.gov.

On a final note, I'd like to make the Committee aware that the Livestock Mandatory Reporting Act does expire on September 30th of this year. Bills have been reported by both the

House and the Senate Agricultural Committees to renew the statute for another five years. The House and Senate Bills are identical, and in addition to reauthorizing mandatory reporting, they would also require mandatory reporting of wholesale pork cuts and add weekly pork export reporting, as well as require electronic reporting to conduct the Mandatory Dairy Product Information Reporting Program. We believe that continuation of the Livestock Mandatory Reporting Program in addition of wholesale pork reporting to the program are important to provide transparency and full information to all market participants.

Thank you for your time, and I will welcome any questions that the Commission or the Advisory Committee may have.

CHAIRMAN DUNN: Thank you, Warren. I must say that Harry and I have discussed the new dashboard, and it's really a great new asset for all of us to use, and so kudos to you and the Department in putting that up.

Mr. Peterson, could you comment on the

CME Group and how this affects your contracts please.

MR. PETERSON: Certainly. Thank you very much, and we appreciate the opportunity to be here.

I was asked to actually cover, in addition to the hog issues that Harry outlined, to cover the other livestock area, so I've got quite a bit of material to cover, so I'm going to go through it rather quickly, and would be --

CHAIRMAN DUNN: We do have your written pieces.

MR. PETERSON: Yes, you do.

CHAIRMAN DUNN: And --

MR. PETERSON: Yes, you do, so --

CHAIRMAN DUNN: And if you can hit the high points, we'd appreciate it.

MR. PETERSON: I will hit the high points. I will do that.

CHAIRMAN DUNN: Thank you very much, Paul.

MR. PETERSON: Okay, and Harry, you're

going to drive.

MR. HARVEY: (Off mic)

MR. PETERSON: Okay. Okay, just by way of background, CME offers futures and options contracts on three major classes of livestock -- live cattle, which is slaughter-weight steers; feeder cattle, which are partially grown steers which are destined for a feed lot where they will be fed to slaughter weight, so that's sort of an intermediate category; and then lean hogs, which is slaughter-weight barrels and gilts. Especially I want to highlight the difference between live cattle and feeder cattle. That always seems to lead to a lot of questions.

Originally all three of these contracts were virtually clones. They had almost identical contract specifications, and that's because when the live-cattle contracts started in 1964 when the plans came to start what was then the live hogs in '66, they simply took the live- cattle contract and used that as a template. Likewise, when feeder cattle came along in '71, that served as the template once again. But over the years, because of differences in these different markets, it was necessary for those contracts to diverge, and today they are all substantially different. Only live cattle is still physically delivered. Both lean hogs and feeder cattle are cash settled. However, all three of these are highly dependent on the USDA AMS data and personnel.

Briefly, to go through the live cattle, as I said it's a live-delivery process. (Inaudible) delivery unit is 40,000 pounds of steers. Final settlement is by physical delivery in two methods. They can either be delivered live to one of thirteen delivery points where they're graded by Market News personnel -- USDA personnel -- or they can be delivered to one of fifteen packing plants where they're graded by meat-grading personnel, both under USDA.

The interesting point in live cattle is that the value of each animal or carcass is determined using published market-based premiums and discounts published by USDA Market News. From these we get the quality grade differentials for prime choice select and so forth. The yield grade differentials for yield grade 1, 2, 3, 4, 5 and also for carcass deliveries at the packing plants we also get differentials for light and heavy carcasses and condemned livers. So, the result is virtually any steer within the allowable weight range is deliverable, and this whole evaluation process, while it may seem rather complex on the surface of it, it's actually consistent with the grid or value-based marketing processes that are widely used in the cash market for slaughter cattle.

These various premiums and discounts come from a variety of USDA reports. I've detailed that on -- I believe it's slide 6 of your deck, so with the information that comes from each of those reports I won't belabor that point. In short, this has been a very successful process, and volume has grown. Recently -- actually, I believe it was in May -- we set an all-time record for volume and also had record open interest as well, so that's all been very encouraging.

Shifting to feeder cattle for a moment, here is one where final settlement is by cash settlement to the CME Feeder Cattle Index. Feeder cattle futures -- there's actually the oldest cash-settled agricultural contract. It was converted to cash settlement way back in 1986 when physical delivery proved to be unworkable.

In the case of feeder cattle, the Cash Settlement Index -- it's calculated by the exchange. It's a seven-day weighted average price. In other words, total dollars divided by total pounds, and it's calculated from all auction, direct trade, video sale, and internet sale transactions that are reported as weighted averages by USDA AMIs from a 12-state region, and those states are listed below. This index is designed to reflect a broad cross section of cash market transactions for feeder steers during the fall and springtime when we have peak marketing runs. The index includes reports from approximately 120 locations in these 12 states, and this is on a week, because the feeder cattle transactions, the feeder cattle auctions, tend to occur on a weekly basis, so it's a once-a-week affair. Therefore, we have a seven-day index so that as new information comes in, old information drops out. In 2009, this covered almost 1.6 million head that were used in that index calculation.

These are voluntary reports. Earlier Warren made the distinction between mandatory and voluntary. These are voluntary reports for the simple fact that the mandatory reporting system is set up to capture information collected from packers. Since these are the intermediate stage, they haven't yet made it to the packing plant. It's necessary to collect this on a voluntary basis, and that's done by the market reporters at auction facilities and various other venues.

We use a transparent calculation process. Again, it's performed by exchange staff. We post the results on the CME website each day with the complete calculation, along with a long history of historical data, and there's a surprising number of individuals who conduct parallel calculations and basically double check our figures. So, again, it's a very transparent process open and easily reproducible.

Looking at the average daily volume and open interest, you can see the seasonal patterns in marketings are matched by the seasonal variations in volume, and on the open interest we've seen a recent upswing in open interest.

So, finishing up with lean hogs. Here again, this is a cash-settled contract. This one's settled to the CME Lean Hog Index. This is the largest cash-settled agricultural contract. We converted to cash settlement in 1997 in response to some structural shifts in the hog industry. These shifts included a big move towards carcass basis pricing rather than live animal pricing.

In addition, we were losing our delivery facilities. We had had a number of terminal markets close, and because the industry was moving from sales through terminal markets or buying stations to sales direct to packers, that movement to a terminal market was actually taking hogs out of their normal market flows. This was inefficient, and it was clear that we needed to move. So, the result was conversion to cash settlement in 1997. We have made a number of improvements and adjustments to that since '97, which I'll talk about in a minute, but basically the Lean Hog Index was modeled after the Feeder Cattle Index but with several important changes. It's a 40,000-pound contract, keeping it consistent with the old live hog contract, but in terms of the calculation, here is a two-day weighted average -- two-day rather than seven-day because the hog market is much more volatile and we did not want it to be burdened by some stale prices or other outdated information.

As Harry indicated, we use net slaughter prices. This is not the base prices that he talked about. These are net slaughter prices that include all premiums and discounts, so this reflects the final payment by the packers to the producers, and it's for barrels and gilts. We use negotiated and swine and pork market formula transactions from that 201 report that he put up earlier. The reason we use those two categories is those are the two that are best suited for this process, and they also represent the cleanest sort of data. These represent approximately 50 percent of all the hogs marketed, and there are some good reasons not to include some other categories in there -- for example, packer-owned hogs, which I believe were something like 31 percent of the total. That's not an arm's length transaction, so that's not something that we would want to include in the index.

The index is, again, designed to reflect final payments from packers to producers and it's, again, a transparent calculation process performed by exchange staff. All the results are posted each day on the website, and it's a totally open and reproducible process.

I would also add on all of these cash

settlement calculations the hogs and the feeder cattle, as well as the reports that we use for the live cattle delivery adjustments. We pull those down from the USDA AMS website just like everybody else. There's no special arrangements. We don't receive any non-public information from them. We go in and grab them off the website just like everybody else does. So, it's consistent across the board.

In terms of volume, the volume has recovered recently. We were up 15 percent for the first half of 2010 versus the same period a year ago. There was a very nasty drop-off -- you can see in the middle of that chart on page 16 -- and that was largely traceable to this very ugly collapse in the hog market. Neil is nodding his head. It was just a brutal period for a couple of years, and that really hurt our volume. But, fortunately, things have turned around and are on the upswing, and we hope it continues.

Likewise, on the open interest side, you can almost see where the bad times hit on page 17.

Things dropped off dramatically but have been on the upswing.

So, just in summary, each of our three livestock contracts in the final settlement processes we use is different. These reflect the unique needs and different cash market practices of each commodity. All three of them are highly dependent on USDA AMS data and personnel, whether it be for grading or for cash settlement purposes or for other adjustments. CME Group is one of many consumers of these data. We are not a producer of the data. We are a consumer, and these data are used to create the indexes on which these contracts are based.

And, finally, the underlying livestock markets have detailed data on actual transactions. This is a big difference from, for example, the grain markets or the cotton markets. I think we heard today how difficult it is to get anything besides elevator bids or truck bids or things like this. Here we have actual transaction data -- actual dollars that change hands between buyer and seller -- which gives you a much better, much more accurate measure of actual economic value, and as a result these are -- because of the better price data as well as the wide coverage that we have, the wide geographical area and the different categories that these can be divided up in, we have a high degree of detail which is extremely useful in monitoring contract performance.

So, with that, thank you for your time and would be happy for any questions.

CHAIRMAN DUNN: Thank you, Paul, and we will have some questions I can guarantee.

If we can now move to Don Close to talk about the perspective from the Texas Cattle.

MR. CLOSE: Good afternoon, commissioners, remaining counsel members. Thank you for the opportunity to be here today.

My role with the Cattle Feeders is market director, and the Texas Cattle Feeders represents cattle feeders and feed yards in the Texas, Oklahoma, and New Mexico feeding area. Our members will market just over 51.2 million cattle annually. That represents just under 30 percent of the fed cattle supply in the United States. A primary service that my group provides to our members -- we start off each Monday morning, and we will canvass members to get an idea from them of how many cattle they have on their show list and their formula list each week. We'll compile that data and have it reported by 10:30 a.m. central time on Monday mornings not only to our members but to the wire services, and that total, on a typical week with the two different sources, will be between 75 and a 100,000 cattle. Initially, when those numbers are released on Monday, we will start canvassing our members of what their communication is with the packer buyers as they get to their feed yards and evaluate their show list every week, and when they start to bid on cattle we assimilate that information and turn it around to our members as rapidly as possible. That goes on to whenever in the week that trade starts to take place. Once trade is started, we have members calling in, reporting to us both the volume of cattle traded and the price, and we will turn that information around as rapidly as we can, and so in a typical week cash trade may last between an hour, hour and a half, and to get that volume of cattle reported in that time, it's a very active period in our office I can tell you that. But once that's done, we then will total -- at the end of the week we will total how many cattle have been sold and marketed, and we will match that against that initial show list to show just what our carryover is at the end of the week.

Now, I think there's two points to going through all this detail. The first is I think it clearly demonstrates that the price discovery process is alive and well. The second part of that is our service is probably the closest replication to the AMS mandatory system that is out there, and I can attest to the fact that at the end of the week our cash price and that reported by AMS will not differ by more than 1 to 3 cents per hundredweight on any given week. So, we're using that as a benchmark number, and it's extremely tightly correlated.

Before I go on with the AMS Group, Mr. Preston, the branch office in St. Joe, the Meats Office in Omaha, and all the field offices, I want to give them every compliment. They are extremely cooperative in working with us and answering any questions that we have and working with us in any way they can.

When you look at the mandatory price reporting service, I certainly don't think that any issues with the mandatory is due to a lack of information, nor do I think there are issues with the timeliness with the twice-a-day reports we get from packers. I think they're handling an enormous, mind-boggling amount of information and they get it turned around at breakneck speeds.

I do think that we can see some modest changes and recommendations that would make the system more transparent, make it somewhat more user friendly, and with those I would like to go in with -- we would like to see a report created that shows daily the intensions of all non-cash-traded cattle that are committed for slaughter for at least seven days forward. This report would be a replacement for the existing system that is intended to show a forward supply of the all cattle committed all/cattle delivered system that's -- it's just so aggregated it's difficult to pull out the detail that we're trying to get.

We would like to see AMS provided with the flexibility to request additional information as needed on a timely basis and largely seasonal. Two examples of this would be currently with the cattle imported from Mexico. Our members are having to sell those cattle at a $40-a-head discount. We would like to see the question picked up as is it a Mexican or Canadian animal and, in turn, if that is true what is the discount? Another good example would be seasonally, typically in the spring, with the Japanese deal we'll have a problem with some 30-month cattle, and when we get into those 30-month cattle they'll trade at typically about a

$15 a 100 discount, but that price varies. But those are two examples of how just a little bit more information on that packer questionnaire each day could provide our members significantly more detail.

We would like to see the transfer of responsibility to collect the retail price scan data to AMS and provide them with adequate funding to collect and analyze and report that information. I will remind this panel that that retail scan data was originally part of mandatory price reporting and it fell between the cracks along the way, and that's very valuable information to us in measuring that relationship of farm-to-retail prices.

We'd like to see and remove the existing category in the Premiums and Discounts Schedule. It currently reads "Carcasses weighting in excess of 1000 pounds." We would like to make a small change there and have a category of 1000 to 1050 and then "Carcasses weighing 1050 and over." There's two reasons there. One is because of the current live weights and yields on these cattle, we can have a 1000 to 1050 carcass that a legitimate carcass. If he gets over 1050, he really falls outside the grid. So, it impacts our cash market, but it also affects the delivery process with the CME. So, just that small change would make a big improvement.

We would like to see --

CHAIRMAN DUNN: Just a point of clarification here and, Paul, CME does periodically change its weights. Is that correct?

MR. PETERSON: Yes. Yes. In fact, we just recently changed them for the October 11 and beyond, so, yes, we change them periodically based on market trends.

MR. CLOSE: And I further share that Paul was in communication with us and asked for our input when they made those changes.

We'd like to see -- develop through USDA -- can collect, analyze, and report market price data relevant to mandatory country of origin labeling for feeder cattle, live cattle, wholesale beef, and HRI beef sales. I'll say again because of those imported cattle, our members are selling at a $40-a-head discount, but because there's no mandatory reporting on where that product goes into the HRI business, we're not convinced that the packers are suffering a $40-a- head expense in trying to handle those cattle. So, we would like to have the data to work on that one.

And then the last point I would make is because of the recovery in beef exports and larger exports and recovery of exports since the BSE occurrence in December of '03, I think it's critically important that we get an expanded recovery of short-term export sales and imports that we can more timely measure that flow of product in and out of the whole S&D balance table. And by implementing these changes and mandatory would make it more user friendly and would provide a needed degree of flexibility that would enable NPR to be much more responsive in improving the transparency for all market participants without radically disrupting the entire marketplace.

Thank you very much.

CHAIRMAN DUNN: Thanks very much, Don. I appreciate that.

Neil, let's hear from the pork side.

MR. DIERKS: Thank you, Mr. Dunn. If it's okay with you, I submitted written comments, that you have, and I would just as soon short it up, take a hint, and maybe move on and give everybody time for questions.

A couple of things. One -- and actually I was told this. I'm going to tell you about price reporting, not structure but it's going to be difficult to not talk about the structure of the industry as we talk about reporting, and I liken back hearing Mr. Farley this morning when he talked a about he never wanted to see his industry basically have his market short the entire production in the industry in a three-day period of time.

Commissioner, Dunn, unfortunately I know you were in place at USDA, and I was working with producers in the fall of 1998 where we saw literally for three weeks a panic done differently but we swamped our production capacities, and that's where Mr. Johnson talked about $8 hogs. The point that went with that is that that is, as he said, a major driver for why producers have chosen to look at other marketing ideas as far as to ensure and deal with some of the risk in the marketplace, which is taking hogs out of the spot market.

Now, in my comments I have reference to the fact that our counsel and our committees have been looking at this issue for some time. In fact, as recently as this summer we had some noted economists visit with us, and we asked the question: You know, we've been watching the spot market on negotiated numbers decline over time and is 5 percent too thin for confidence in the market? And the response was: We don't know. They did make the point that while just because the market is thin doesn't mean that it doesn't necessarily properly discover prices. So, the next follow-up question of course was: Okay, well, when will we know it's too thin? And the response was: Well, when people start using other mechanisms for pricing.

Well, a ramification of this spot market on the negotiated side is obviously, as Paul talked about earlier, a function of the CME's formula for settlement, for cash settlement, which is critically important to our industry for risk management. And as we look, obviously, at the fluidity of the markets -- now, there's other things going that -- I could make an argument that would maybe do away with our spot market very rapidly, but the reality of it is right now there tends -- I'm picking up, and I've had a lot of discussion with producers and been involved in several meeting with producers -- that there's an awareness of this issue by producers. They of course moved to formula pricing as a price volatility mechanism to reduce volatility and some risk, and now they're seeing the point that, you know, well, if I'm not participating in the spot market I'm not helping set the price. And I'm actually quite hardened since this last March of our annual meeting of producers saying well, I'm willing to take some time and negotiate into the marketplace.

I don't think we're going to see any move from percent to 10 percent overnight, but I do think there's a growing awareness by producers because of the concern that we want to make sure that we have options here. Now, with that -- and Warren talked about it; it's been talked about earlier, and obviously it was yesterday when the House -- Senate Ag Committee approved the Mandatory Price Reporting Bill -- it does include, as was talked about, mandatory wholesale price reporting which for the pork industry is very intricate, because as a specie we have the most differentiated carcass that is sold in different ways and the largest percentage of the carcass that is processed. So, it's going to be a very intricate process as we move from voluntary wholesale price reporting to mandatory wholesale price reporting to capture from the product and extrapolate back to cutouts, but again critically important for the exchanges because the cutout is also part of the formula for settling prices.

All that being said, one of our concerns has been -- you know, we've been concerned that, gee, the live hog market's thinner. That is thin. I think the voluntary wholesale market is much thinner, and it's being used, and in fact we've had producers that have used it as a price discovery mechanism in these contracts for their own volatility. Thus, we're anxiously supportive of getting wholesale mandatory pork price reporting, and again kudos to AMS and to Warren, your staff. We have had an excellent relationship in the 10 years there has been mandatory price reporting.

With that, the only other comment I would make, I get here, I think somebody said that packers can choose to report under mandatory live price reporting and under the -- they're required to report twice a day and again the next day. There are some issues in the industry with producers, because they look at some differences on what the market does in the morning report versus the afternoon report, but producers seem to be figuring that one out.

So, with that I will end in saying that there is one piece of information and if it's okay I'll forward to your attention, Commissioner Dunn -- Chairman Dunn -- and that is a study that was done by USDA by Mr. Ted Schroeder, some other economists that actually looked at some more of these issues, and it might be some use as we move forward into this. Thanks for the time, and I'm open for any questions.

CHAIRMAN DUNN: Thank you, Mr. Dierks. And I've got just a preliminary question, because, Harry, you had said that negotiated price can be cancelled after they're reported, and how prevalent is that and how much of an impact does that have?

MR. HILD: Well, there are two parts of that question is -- the impact that it has is that it's all about weighted averages and that that

SPMF category that's in the MER calculation. There's some -- you know, you can use math to get to that, I guess is what I'm saying. If 50 percent of that SPMF category refers to the negotiated Western Corn Belt price, the impact is going to be weighted each day, so if you have a day where, say, 80 percent of the SPMF category refers to the negotiated market and, you know, a high-range price in the negotiated market -- you know, and the high side or the low side gets canceled -- all those contracts that priced off of that Western Corn Belt are essentially inaccurate for that day or maybe the next day. It's that unknown percentage that it's hard to categorize, so the impact is hard to get exact on. You know, there's ways to get through that, but I can't speak to any of those specific percentages in this meeting.

Does that answer your question?

CHAIRMAN DUNN: It does, and I think it gets to a point that Don made in his written testimony that the need for transparency here is just extremely important for all of us. But then it gets to my larger question, and that is the nexus between the futures price and this shrinking negotiated price, and Neil hit the nail on the head: When does it become an important factor, and how do we know it at that time? And I'd like to have all the panelists discuss that, because I think it's extremely important that this contract that is so important to all livestock producers.

Paul, since it's your contract, I may start with you on that.

MR. PETERSON: Okay, fair enough, fair enough. Well, from our standpoint -- I'm going to refer to guideline No. 1, which drives the requirements for all futures contracts for those of you who may not be familiar with it, and one of the parts of guideline 1 is that cash settlement, you know, must be at a price reflecting the underlying cash market. Well, in the case of the hogs, since we're using mandatory data, we trust that -- and since we're using mandatory data on roughly half of the hogs that are transacted --

and I'd say almost all of the hogs are done on some sort of an arms-length arrangement, so it doesn't have other side conditions that might affect the validity of the data, but since we're using all of the best data that are available, we're confident that our contract does in fact reflect the prices that producers are actually seeing out in the country. Maybe not every last one of them, but in total I believe that's the case. So, you know, that's one of our requirements. Other things that might feed into this are questions like, you know, well, are those data accurate? Well, they're mandatory, so I believe that they are. If they aren't, Warren, you've got a problem. If -- and then if the cash prices are being distorted in some fashion, well, we really have no way of knowing that, so, Jay, I think that's your problem. So, this is a very complex issue.

CHAIRMAN DUNN: But, Paul, doesn't that become a futures problem if the cash price actually manipulates the futures price?

MR. PETERSON: Well, that's the assumption, but --

CHAIRMAN DUNN: I mean, that's the nexus here and the reason why we're having this discussion.

MR. PETERSON: But -- fair enough, fair enough. But, again, you know, there's a lot of things that we don't know. We don't know what the percentage of Western Corn Belt-based formulas are in the SPMF category, do we? Do we have a percentage? Either one.

MR. HILD: No, I --

MR. PETERSON: No. No, we don't.

MR. HILD: Well, I can't answer that in this meeting.

MR. PETERSON: Okay, okay. So, so, that -- and that's just one example. There are a lot of the inner things that we don't know. But at a high level, yes, I think we're doing the best we can with what we have to work with.

MR. CLOSE: I think the first thing that I would bring up on this point is as anybody knows, the economic performance of cattle feeding over the past three years has been less than stellar, and as we have seen as enormous erosion of equity in the industry, the lender -- loan -- the covenants of the loan agreements have forced hedge protection. So, that's caused a huge increase.

The last point that I would bring up on this is that we talk a great deal about the escalation and open interest because of the fund activity over the last several years and how those increased funds -- that open interest has forced those fund positions to roll further and further into the deferreds, that escalation and price premium in those deferred contracts is exactly what has enabled cattle feeders the loft in those deferred contracts to profitably hedge. So, you know, I'm not going to say that the escalation in outside money doesn't have -- isn't a double- edge sword. It is. But the positive side of it is it has provided tremendous opportunity in those deep deferreds.

CHAIRMAN DUNN: Jay, go.

MR. JOHNSON: Well, any time that the market has become thinner in a concentrated industry makes the opportunity that there could be potential for manipulation or effects in the prices on a spot market, and we do have specific section 202(e) of the Act that prohibits any firm from engaging in any practice in the course of their business with the purpose or effect of manipulating prices, and I will say that, you know, that is one area that we do take very seriously and when we have allegations of price manipulations that we actively pursue them.

CHAIRMAN DUNN: Harry.

MR. HILD: I'll go next. In surveillance, much like Packers and Stockyards, we're very concerned about powerful market players. Our surveillance programs are designed to detect and act on situations that are concerning to us, so these trends of increased concentration in the packing industry, a well as vertical integration, have changed things for us, and the example that I laid out in terms of, you know, the negotiated market that determines, you know, what all these contracts are priced at has us raising some flags, and that's why we're here. So, I think this is an appropriate forum to discuss that trend, that possibility, and, you know, where do we go from here. So, it has our attention from a surveillance perspective.

CHAIRMAN DUNN: Warren.

MR. PRESTON: Let me just comment briefly on the issue of canceled negotiated transactions. I guess our view would be that those are aberrations. We don't see those very often. And I know that we have shared data with both the CFTC and with Packers and Stockyards for their investigations, and perhaps they've had a different viewpoint on that, but at least in our audit of the program we haven't seen that those negotiated prices get canceled that often.

I guess in terms of price discovery, I think -- very encouraged to hear -- Neil mentioned that we do have producers who are looking to get into the spot market, because there needs to be a place for price discovery, and I do agree with the statement that you don't necessarily have to have huge volumes to have efficient and effective price discovery. I do agree with the concerns, though, that, you know, when you have big players then, you know, small movements by big players can have big ripple effects. That's not really a price reporting issue per se, but it obviously spills over into CFTC and Packers and Stockyards issues.

We, you know, we go in; we look at the markets; we feel like our coverage of the negotiated wholesale pork trade is fairly complete. We think we're probably getting 75 to 80 percent of that market. But it's very thin. And one of the things that we think that mandatory gives is that you do have that assurance that there's no selective reporting. We get everything. So, even though those markets may be thin, at least we are getting the assurance that we have everything. The double-edged sword, though, that Don mentioned that comes into play here, too, is that I think as the industry becomes more and more confident that our prices are accurate and replicable and meaningful, then they're willing to use those for formula trades. And then they go out of the negotiated market, and then there's nobody left to make the market, and that's where I guess if -- I think that if it gets to the point where people don't believe in the negotiated prices anymore, they'll just have to go to some other fixed price contracts or some other vertical coordination types of arrangements if they completely lose confidence in the reported negotiated prices.

CHAIRMAN DUNN: Neil.

MR. DIERKS: About three quick things -- one, to Don's comment's -- exactly right, the pressure from lenders on risk management is a powerful force group for the producer on what your options are. Also with that, and a little bit to Warren's comment and to Don's earlier comment, as we take a look at how mandatory price reporting is reauthorized, we were advocates that five-year reauthorization is appropriate. There were some that wanted to make it permanent, and we think it's important to visit these issues, like I would come in the advisory committee for visiting them now and being aware of them, because some healthy skepticism is a good thing.

With that, I'd also -- Mr. Johnson's gotten this lecture from me in the past. I will submit it to you, Mr. Chairman. As producer perspective, we expect the referees to be doing their job, and I realize you might not be able to talk in an open forum but the point being is that what we all need is a transparent, open marketplace that we have faith in, and if there are dangers they need to be addressed.

CHAIRMAN DUNN: I appreciate that. Sometimes you have to tug on the referee's jersey and make sure that they're observing when something has gone amiss, and that's what we're about here.

MR. DIERKS: Well, if I could be so bold, Mr. Chairman, I would suggest we'd like to see lots of referees like the umpire that cost the guy the perfect game this summer that actually recognized that, you know, sometimes we get in places as opposed to the referees that cost the U.S. soccer team its goal at the end of -- the work, but we appreciate that, and, again, the importance of it -- it does need monitoring. Thank you.

CHAIRMAN DUNN: Commissioner Sommers.

COMMISSIONER SOMMERS: I just have one quick clarification from Mr. Close on your recommendations that are in your testimony. I think some of them may need a statutory change, and some of them may be administrative. But of the ones that would take a statutory change, were those included in what was marked up by the House and the Senate?

MR. CLOSE: I believe -- no, they were not.

COMMISSIONER SOMMERS: They were not.

MR. CLOSE: No.

CHAIRMAN DUNN: Commissioner Chilton?

COMMISSIONER CHILTON: (Inaudible)

CHAIRMAN DUNN: Well, I'd like to thank this group, but what is apparent to me is it would really behoove us to, as Congress goes into the reauthorization this September of mandatory price reporting, for the futures industry as a whole or individually to make recommendations so that we can be assured that we have everything out there we need to ensure that we've got a viable futures industry, and I know you're going to be doing that individually, but I think collectively it would help as well.

Let's open it up here for the Advisory Committee, and Kevin, we'll start on your side over here if you've got any questions.

MR. NATZ: I don't at this time. This has all been an education on the livestock side for me, so I appreciate your presentations today. Thank you.

MR. CRYAN: We look forward to mandatory dairy reporting.

CHAIRMAN DUNN: On this side. John?

Well, thank you all very much, and, again, I think it would behoove us to take the opportunity that's coming up here this September and make sure -- I'll be talking to my fellow commissioners along with the area about anything that we think we ought to be telling -- the various committees and the House and the Senate to ensure that we've got this ability to have a futures market that works.

With that, I would like -- is Don Heitman here? Oh. There's Don hiding -- this is the absolute final things we've got on here today. Don is going to go over an overview of what the new Financial Regulatory Bill has to offer for us in the area of agricultural swaps.

And, Don, it's yours just as soon as you get in the chair and pull up your presentation.

MR. HICKS: Commissioner Dunn, can I ask the CME guy a question before -- I just have a question for the CME --

CHAIRMAN DUNN: Paul?

MR. HICKS: Is there anything in your arsenal that justifies that electronic trading may be doing more good than -- more harm than good because of the fact you don't have the visibility -- transparency doesn't exist? Is there anything -- as a trader, I like the electronic process, especially the way we get fills and everything, but I have a concern that it impacts -- the part of -- the issue is the lack of visibility and being on the floor and recognizing that transparency issue and seeing who's executing the trades and making -- even if the wrong identification, you do at least have an ability to identify or assume who's representing who on the floor. Any comment on that?

MR. PETERSON: No, I really don't have any comment on that except to say that the bulk of the trading is now on the electronic Globex platform, and that offers some advantages that you actually don't have with the floor- traded environment. For example, on most of the trading front-ends, you can see a portion of the book -- either the top three or top five bids and offers -- so, if you're planning to execute a substantial trade, a substantial, you know, volume, you can see where the air pockets are. So, you know where the next bid or offer is rather than just step into a hole. So, there are some advantages and disadvantages to each venue, and we've chosen to just let the marketplace decide where they want to conduct business.

CHAIRMAN DUNN: Anything else, Edgar?

MR. HICKS: Just so you know, Commissioner Dunn, I accept it -- as a commercial I accept that, but as representing a farm organization, that is a real concern of many farmers, many farm organizations that the electronic process is doing us more harm than good.

CHAIRMAN DUNN: And I think that is a concern that we have had as well, when I came on to the Commisssion as a commissioner in December of 2004, there wasn't hardly any electronic trading; it was all in the pits, and today there's hardly any pits and it's all electronic trading. I recently had the opportunity to visit the CME and looked at their old trading floor, which is now all of the monitoring that they do of the electronic trading, and I'm sure they could arrange something for you and the grange or anybody else that wants to come up there to take a look at that, we're very well trained here at the CFTC to look at pit traders and make sure they're not doing anything that would -- we've got videos trained on them and all kinds of other things. Well, that's out the window now. That's the bygone years, and your point is right spot on that the electronic trading is something that we've got to gear up for. Fortunately, Congress did give us some additional money to gear up for the new laws in developing our regulations.

And let me defer to the chairman of our Technology Committee and let him talk about what we're doing in that area.

COMMISSIONER O'MALIA: I don't think it's -- we ought to not waste any time to get on with Don here, but the trading styles and monitoring trading is very important in adapting to new trading techniques and practices. That is something that we are looking at, trying to understand what impacts they are having. The concern about whether -- I do -- we're not going to put this back in the bottle -- this genie back in the bottle. We're going to more and more electronic, and it is evolving, and we need to be prepared to address it head-on any trading styles, behaviors, etc. We need to understand that, because we can't, as Chairman Dunn said, go back to the old enforcement styles that we had. We need to adapt and use technology in a much more significant way.

I'm going to leave it at that, and let's get on with Don here and go from there.

MR. PETERSON: If I could just make one final comment, Chairman. I want to pick up on your statement of your tour.

I'd like to extend an open invitation to anyone here, anyone on the committee. If you want to come in individually or bring a group in, we would love to take you down and tour this facility that Chairman Dunn referred to. We affectionately call it Mission Control, because it is just breathtaking. So, we're very proud of it, and we'd love to show it off. So, please, come visit us.

CHAIRMAN DUNN: You all will probably understand a lot more than I did, too.

Don, if we can get you to go through.

MR. HEITMAN: All righty. I'd like to start out with just the standard disclaimer that we've got a bunch of interdivisional teams working on various rulemakings that came out of the Dodd-Frank Bill, and I'm in charge of the Ag Swaps Team, and we're just at a very early stage, so anything I say here is kind of preliminary and subject to change, and the opinions are my own, even not necessarily my own.

And I have one more disclaimer, and that is one of our team members is Nicole, and you saw Nicole earlier give an example of a really good PowerPoint presentation. This is a terrible PowerPoint presentation, and there's way too much information crammed on to every slide. My intent is that by the end of this presentation you will be so hopelessly confused that you will actually look at the hard copy and read it, because there is a lot of good information in there. But I'm going to --

CHAIRMAN DUNN: Some of us are already there, Don.

MR. HEITMAN: I'm going to be going through it at warp speed. So, looking at an overview of Dodd-Frank, some things don't change. The forward contract exclusion doesn't change. If a weak farmer goes to his local elevator to forward contract his crop, that's still excluded from the CFTC's jurisdiction, and Dodd-Frank doesn't change that at all. The rules for exchange-traded futures and options aren't going to change, because the exchange-traded futures and options are excluded from the definition of a swap. However, the definition of a swap is otherwise extremely broad. It includes not only traditional swaps, including Ag swaps and commodity swaps but also options of any kind. Any kind of an OTC option is now a swap and is going to be covered by whatever rules the Commission does for swaps, and as far as agricultural swaps go, the Bill says any swap in an agricultural commodity will be prohibited when Dodd-Frank takes effect -- and the next slide has got the timeline in it -- unless it's traded pursuant to an exemption under Section 4(c), which is the Commission's general exemptive authority. And anything that's already under a 4(c) exemption is grandfathered. So, the effective dates of Dodd-Frank -- some provisions are on a shorter timeline than others. The general timeline is -- the provisions take effect in 360 days from July 22, but speculative limits for exempt commodities have a 180-day deadline, and speculative limits for Ag commodities have a 270-day deadline.

What kind of transactions are going to be affected by the Ag swaps provisions of Dodd-Frank? There's basically four things. One is OTC agricultural swaps that are currently trading under Part 35 of the rules. They're grandfathered, and they may continue for now, but it is anticipated that whatever we do by way of Ag swaps rules would substantially revise or possibly completely replace Part 35, and it's not hard to figure out why that is, because the way Part 35 is drafted now, it would not allow cleared swaps, and obviously the Dodd-Frank Bill has a preference to push things into the cleared environment. So, Part 35 is almost certainly going to change substantially.

Another ongoing kind of transaction -- our cleared swaps, like, for example, the corn and soybean basis swaps and calendar swaps that are already trading on the CBOT, and those in fact are also subject to a 4(c) exemption, because they couldn't trade under Part 35 unless they were exempted, because the base -- Part 35 rules don't provide for clearing. So, those -- the corn and soybean basis swabs and calendar swabs are grandfathered, but any new, similar cleared swabs would likewise have to a 4(c) exemption.

The other two categories of transactions that are going to be covered are options and trade options, and there's basically two classes of commodities that are going to be covered, and one is the traditional, enumerated commodities that are listed in the Ag -- wheat, corn, soybeans, livestock -- and there is actually a whole set of rules in the CFTC rulebook for trading agricultural trade options. And as people that have been on this committee for a while know if you've been to previous meetings, the Commission's Ag trade option rules have been a complete and total failure. Only one firm ever registered as an Ag trade option merchant, and they withdrew their registration after a couple of years. So, the only trade options in the enumerated commodities that are currently trading are pursuant to an exemption in those rules, and the exemption basically says that you're exempt from the Ag trade option rules if the buyer is a commercial -- a producer, processor, merchant handling the commodity, and the buyer is using the transaction for hedging, and both the buyer and the seller have to have $10 million net worth.

And the other type of agricultural trade option -- what most people would think of as a trade option in an agricultural commodity -- involve agricultural commodities that are not enumerated and not on that list in Section 1(a)(4) of the Act, and those -- the obvious examples of those are coffee, sugar, cocoa; and coffee, sugar, and cocoa trade under the basic trade option provision that would likewise apply to petroleum or gold or anything else, and that's an even simpler requirement. The only requirement is the buyer has to be a commercial -- again, hedging, using the transaction to hedge, and that's it. There's no financial requirements for those trade options. And all of those agricultural trade options are not covered by a 4(c) exemption, and they are not grandfathered, and they will become illegal when Dodd-Frank takes effect unless the Commission adopts some other rule under Section 4(c).

So, how do we approach any exemption for Ag swaps? The Ag Swaps Rulemaking Team -- we're shooting for publishing proposed rule for Ag swaps in November, and they -- again, we have to do it under the Section 4(c) exemptive authority, and one of the -- so, for example, there's a public interest test in 4(c), and so they have to be consistent with the public interest, but, more significantly, the most significant requirement for Ag swaps is, like all OTC swaps, OTC agricultural swaps could only be bought by eligible contract participants. That's OTC.

Now, if it's a swap that's listed on an exchange, then anybody could trade that. But if it's an OTC swap, it could only be purchased by eligible contract participants. Who is that? Eligible contract participants would generally include large institutional or commercial traders, and as far as agricultural producers go, that's going to be the subcategory within NECP that's going to fit farmers -- is a corporation, partnership, proprietorship, organization, trust, or other entity that, one, has a net worth exceeding a million dollars and, two, is hedging. And that's who would be in NECP and that's who could purchase an agricultural swap.

The other category that might apply would be just an individual with amounts invested on a discretionary basis, the aggregate of which is in excess of $10 million or $5 million if they enter the transaction for hedging. And I'm not sure what the hell that's supposed to mean. The Congress stuck that in there when they -- as part of the Dodd-Frank Bill.

The major policy issue that we're facing in trying to come up with an Ag swap's rule is that Congress -- when Congress said CFTC, you can only adopt an Ag swaps rule if you do it under 4(c), that seems to imply that farmers and other persons trading Ag swaps should be subject to some kind of additional special protections beyond those available to people trading swaps and other physical commodities, because there's a little bit higher threshold for a 4(c) exemption than for a normal rulemaking action. So, that leaves us with the question: Should OTC agricultural swaps be subject to any special conditions or protections beyond those that would apply to OTC swaps in other physical commodities, and if so, you know, what should those protections be -- more restrictions on who can buy, more requirements for who can sell, or some other type of restrictions or conditions?

COMMISSIONER O'MALIA: Don, can I ask a quick question. On part -- the relationship to an exemption under 4(c) and Part 35 rules, is there any guidance there that might answer this question about special protections that you can think of -- condition to Part 35? Anything special?

MR. HEITMAN: Not off the top of my head, Commissioner, that Don -- Part 35 originally wasn't even put in with agriculture in mind. Part 35 was put in, in 1993, and it was the exemption for all swaps, and then when the CFMA came in and the CFMA basically pulled everything else over into Section 2(g), it exempted all the rest of the swaps' business and Part 35 was just left over. Agricultural were all that was left, because agricultural commodities couldn't be traded under 2(g) -- under the swaps exemption that was in the CFMA.

CHAIRMAN DUNN: Let me interject in here, Don, if I can, because these two questions that you're raising here are really important for the Ag Advisory Committee to have input on, and as I said at the beginning of this that you can go on CFTC.gov --

MR. HEITMAN: Commissioner, you're stepping on my presentation.

CHAIRMAN DUNN: Okay.

MR. HEITMAN: I've got a whole big pitch for this.

CHAIRMAN DUNN: Oh, okay. Continue then.

MR. HEITMAN: Alternatively, rather than making Ag swaps subject to some special protections, should Ag swaps be allowed to trade subject to the same terms and conditions as OTC swaps and other physical commodities? And really, it's a balancing act. Do we want to give agricultural producers additional protections and restrictions on swap trading so -- to avoid the kind of a situation that people got into under hedge-to-arrive contracts where people got into contracts that they didn't really understand, and nobody really understood the potential implications and a lot of people suffered serious financial harm -- or, alternatively, are we concerned that if we put extra bells and whistles on producers' ability to trade Ag swaps, are you denying them opportunities to hedge their risks, that they -- you know, they need in their farming operations? So, that's the question, and that's one of the questions we're going to be asking in the proposed rules, and we certainly hope that when those proposed rules come out -- and again we're shooting for late November -- that the members of the committee will comment. And in the meantime, if anybody has any preliminary thoughts or suggestions, there is a special Ag swaps web page on CFTC.gov on the Commission's website, and the very last slide has a MapQuest map of how to get to that section on the website.

COMMISSIONER O'MALIA: Don, I hate to interrupt again. I've got to run another meeting. But I'm curious as the relationship between Ag swaps under either the exemptions they have -- and I understand the current exemptions are they're exchange traded but not cleared?

MR. HEITMAN: The current conditions -- there are four conditions for agricultural swaps under Part 35, and I can't give you all four of them off the top of my head, but one of them is that counterparty credit risk is not a material consideration -- or -- I'm sorry -- is a material consideration, and so if it's a cleared contract, you don't care about counterparty credit risk, because the clearinghouse is standing in between. So, that effectively means that an agricultural swap under Part 35 couldn't be cleared. And there's another one of the four is that it can't be fungible, and that's another -- so that again would take you out of clearing, which is why when the CME Group came in with the calendar swaps and basis swaps we had to give them -- they wanted a, you know, clear OTC calendar and basis swaps. They wanted it clear on the CBOT. The only way they could do that is if we gave them a 4(c) exemption from those provisions of Part 35.

COMMISSIONER O'MALIA: Let me ask -- my question is what is the relationship between the 4(c) exemptions we have or the Part 35 rules we have today and what we're doing in the policy decisions we're making regarding energy products under the Clearport model where we have blocked in -- they're not exchange traded but they are cleared, and we're trying to understand what the future of that exchange will be going forward. What is the policy relationship? Are we trying to tie those together?

MR. HEITMAN: You just exceeded -- you just exceeded my area of expertise, Commissioner, because I haven't been involved in that part of the Commission's mission.

COMMISSIONER O'MALIA: Fair enough. Thanks.

MR. HEITMAN: So, another part of the Dodd-Frank Bill says that another part of the actual Ag swaps provision says that they apply to any swap in an agricultural commodity as defined by the Commission, which means that -- and for the first time ever the CFTC has to publish a definition of the term "agricultural commodity." And the Ag Swaps Team is also doing that. And that is actually on the 180-day deadline, because the spec limits for exempt commodities apply to -- well, under Section 1(a)(14) of the Act, an exempt commodity is a commodity that is neither an excluded commodity nor an agricultural commodity, and there's only one term in there that's defined in the Act, and that's an excluded commodity.

So, if you want to have spec limits for exempt commodities, you've got to define "agricultural commodity" so you've established the boundary between agricultural and exempt. So, the Ag commodity definition is on that 180-day deadline, and what we we're hoping to do is that we would actually publish the agricultural commodity definition in the same issue of the Federal Register as the proposal to establish spec limits for exempt commodities, which would be things like oil and petroleum and metals. And then you'd cross reference the two definitions in the Federal Register. And in terms of what the definition is going to be, we're generally trying to draw a line between products that are derived from living organisms and are used for human food, animal feed, or natural fiber, which would be covered by the definition, and plant- or animal-based industrial products -- things like butenol or denatured ethanol, which would be outside the definition.

And so again we would hope everybody would be on the lookout for the proposed definition rules, which will -- those should come out around mid-October, and we would hope to get your comments. And then the Ag commodity definition would also be used in the speculative position limits contract, because Dodd-Frank requires the Commission to issue spec limits for agricultural commodities, and that, as I think has been mentioned multiple times, including just now, is a 270-day timeline.

And again when those come out, again we would love to have comments from the members of the Ag Advisory Committee, and in the meantime we don't want anybody to wait until these Federal Register rulemaking proposals come out. By all means, if you have any preliminary comments, we would love to hear them, and this last slide has a link to the spot on the CFTC website where you could submit your comments, and alternatively there's a little roadmap of how to get there. You know, go to the CFTC website and it shows you what dropdown menus to click on and you should -- when you finally get on it, you'll come up with something that will just have a little email address that says AgSwaps@CFTC, and by all means send us an email. And that's my presentation.

CHAIRMAN DUNN: Any questions or comment

to Mr. Heitman?

MR. HICKS: Just a question. Any comment on what impact this would have on farmer-owned cooperatives as they try to originate grain and compete with the larger international companies in this area?

MR. HEITMAN: We -- I don't even have an outline of proposed rules yet, so, I mean, that -- but, please, if you've got any thoughts on that, send them to the website. But, I mean, literally, we're just at the very, very early stages of drafting, so I can't predict anything that's going to be in the rules. And anything we do put in the rules -- you know, that's just a staff proposal. The Commission makes the final decision obviously.

CHAIRMAN DUNN: The last point that Don made is that they make recommendations to us. But it's much better if they hear from you early on what you'd like to see in there. To ensure what you'd like to see in there are part and parcel of that recommendation, and that's why I said in my opening statement it was so important to take part in this.

And I really appreciate, Don, the roadmap there on how to get into it.

Roger, do you have a question?

MR. CRYAN: Yeah, I do have a question. It was my understanding as I looked at least at the pieces of the bill that I was asked to look at, that there were very broad exemptions for end users which included producers -- farm Ag producers from requirements for clearing and I thought regulations generally, but if I understand you right, the swaps are basically going to require reporting and regulation of all sorts of farmer transactions. Is that right?

MR. HEITMAN: Well, I -- again, I -- the traditional, you know, forwards and exchange-traded items aren't going to change at all. The rules for Ag swaps -- one of the questions is would they be treated the same as other swaps transactions or would they have some special different rules? But I -- the agricultural producers are not going to be exempt from -- there is going to be a basic requirement of who can trade agricultural swaps, and that's going to eligible contract participants. And so farmers are going to have to fit into one of those categories, and as I said on one of the slides, the logical category that you would expect a farmer to be able to fit into would be, you know, a million dollars net worth and hedging, and it's, you know, a corporation, partnership, or some other entity like that as opposed to just an individual.

MR. CRYAN: And both sides have to be eligible swap participants? I'll give you an example. It's my understanding that there's a large processor that is trying to do some price hedging by basically doing swaps with producers that are not necessarily delivering milk to their own -- to their plants. There, as I understand from your presentation, would be an agricultural swap that would be subject to all this regulation.

MR. HEITMAN: Well, I -- presumably -- I mean, we haven't written the rules yet, but I'm --

any large commercial that's on the other side would almost automatically be an eligible contract participant. You know, a big coop or a big business would meet one of the tests.

MR. CRYAN: So, that's still a question then whether both sides would have to be eligible, or you're saying just one side --

MR. HEITMAN: Well, no, I'm saying -- yeah, no, I was just -- in this context I was trying to look at it from the viewpoint of agricultural producers, but you'd have to have an ECP on both sides, but --

MR. CRYAN: On both sides.

MR. HEITMAN: But -- yeah, the seller's side would -- it would be hard to envision somebody that would be a big commercial firm offering swaps that wouldn't qualify as an ECP.

MR. CRYAN: But you're saying both sides would have to qualify.

MR. HEITMAN: Yeah. I mean, the farmer has to qualify as an eligible contract participant as well.

MR. CRYAN: With assets over a million dollars?

MR. HEITMAN: That's what the statute says.

MR. CRYAN: Okay. Thank you.

CHAIRMAN DUNN: Yes.

MR. NATZ: Thank you for that presentation, Don. Did a good job of outlining what your rulemaking group is doing. We've gone through the Bill and picked out a handful of rulemaking areas as you've defined where our co-ops have interest, and we appreciate having the opportunity to weigh in, in the process, and look forward to doing that shortly.

Now that we know who you are, I'm hoping that we can maybe find out some of the other individuals in those different rulemaking areas so we can start providing input.

CHAIRMAN DUNN: If -- again, if you will follow that roadmap that Don has or what I said in my opening statement on how to get in there, it will give you an address to the persons that are making those changes, that are writing those rules. So, you're going to have direct input to the staff, and there are 30 of them, you'll see, when you get in there. And, I mean, I feel sorry for these folks because they've got deadlines that they've got to do, and they've got to do their regular jobs as well. But they arethere and that gives you the ground floor, and what I will commit to the members of the Advisory Committee is I'll have my staff let you know when key thresholds are coming up so that you can get in there. But it's in your own best interest to go in, take a look at those 30 areas, find out what you are interested in, and then before -- as Don says, he's grappling with all of that stuff. As they begin to take pen to paper, now is the time to get your concerns in there, because, believe me, it's a lot easier to get them in early on than after something is written. So, this is an opportunity and, as the Chair of the Ag Advisory Committee, I want to make sure that you all have as much input as you can into this major watershed in the way the

Commission operates.

MR. HEITMAN: And I'd just like to second that, because just speaking from the perspective of trying to put these rules together, you know, the more -- the better we -- you guys understand how your business works better than we ever could, and we're trying to write rules that make sense for your businesses. The better we understand your issues, your concerns, your problems, then the better we are able to write a rule that makes sense and works for you. So, again, the more background information we can get, the easier it makes our job and the better the rules are going to look from your perspective.

CHAIRMAN DUNN: Don sometimes is a standup comedian, and he's milked a laugh but he's never milked a cow, so those of you that have, it's good for you to give some information to him.

Well, with that, I want to thank all of you. I want to thank my commissioners, that we ran way over on our time, but these were very, very important issues, and I want to thank, as always, the Ag Advisory Committee for you giving up your time coming in today, but we've got a lot for you to do in the future, and anything that you think we ought to be conveying to the agricultural committees as they begin meeting their deadline on the mandatory price reporting reauthorization -- oh, Bart is back on the phone? Is that -- am I right?

COMMISSIONER CHILTON: Yeah, yeah, yeah, but I don't need to say anything. Thank you for everything, Mike. Thank your staff, and thank the Committee members.

CHAIRMAN DUNN: Oh, thank you very much, Bart, for staying with us. The good thing about being on audio --

COMMISSIONER CHILTON: Yeah, I wish that's what I was doing.

CHAIRMAN DUNN: Thanks.

(Whereupon, at 2:48 p.m., the PROCEEDINGS were adjourned.)

* * * * *

CERTIFICATE OF NOTARY PUBLIC

I, Carleton J. Anderson, III do hereby certify that the forgoing electronic file when originally transmitted was reduced to text at my direction; that said transcript is a true record of the proceedings therein referenced; that I am neither counsel for, related to, nor employed by any of the parties to the action in which these proceedings were taken; and, furthermore, that I am neither a relative or employee of any attorney or counsel employed by the parties hereto, nor financially or otherwise interested in the outcome of this action.

/s/Carleton J. Anderson, III

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