U.S. COMMODITY FUTURES TRADING COMMISSION

AGRICULTURAL ADVISORY COMMITTEE

First Floor Hearing Room
Three Lafayette Center
1155 21st Street, N.W.
Washington, D.C. 20581

Wednesday, July 21, 2004

The meeting convened, pursuant to notice, at 2:05 p.m.

BEFORE:

JIM NEWSOME, Chairman

WALT LUKKEN, Vice Chairman

SHARON BROWN-HRUSKA, Commissioner

PARTICIPANTS:

ROBERT CASHDOLLAR
FRED CLARK
TOM COYLE
BERNIE DAN
ROSS DAVIDSON
TOM ERICKSON
NEAL GILLEN
TRENNA GRABOWSKI
DAVID HEITMAN
REECE LANGLEY
PATRICK McCARTY
BOB METZ
JIM MILLER
TOM NEAL
JOE OTT
JAMES OVERDAHL
PAUL PETERSON
ERROL RICE
SEAVER SOWERS
SAM WILLETT

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P R O C E E D I N G S

I. CALL TO ORDER AND INTRODUCTIONS

CHAIRMAN NEWSOME: Welcome to the CFTC. If everyone will go ahead and take their seats, we'll get started.

Okay. I know that many of you flew in today and have flights out this afternoon. I apologize for being a few minutes late getting started, but we'll try to conduct the meeting in a timely manner and make sure that we get all the issues appropriately addressed and finish on time so that those of you that need to make flights can do so.

My name is Jim Newsome. It is my honor to chair the Commodity Futures Trading Commission. I think this will be certainly my last public meeting to chair the Commission and one of my last meetings, period, at the Commission as Friday is my last day. And I would like to say to this group, as an aggy, it was the agriculture industry that brought me to the table at the CFTC. That is something that I have taken very seriously during my tenure here, and I have appreciated the personal relationships, the personal support, as well as the support of the CFTC from many of you around this table, and on behalf of my colleagues, I say thank you to each of you for supporting the Commodity Futures Trading Commission.

The industry over the last couple of years has gone through some substantial changes, most of which have been very positive. It's been an exciting time to be at the CFTC over the last several years as we've seen the addition of new exchanges, the tremendous growth of existing exchanges, record new contracts listed, records set with regard to volume of which the agriculture community has shared in a portion of that record-setting volume. So many changes going on within the business, but any time you have changes, that always represents new challenges, new challenges to you as market participants, new challenges to us as the oversight regulator; and several of those challenges, we're going to have the opportunity to talk about today, and

Commissioner Lukken later in the program is going to go into more detail about some of the changes that are ongoing in the industry.

We don't have a long list of topics that we're going to discuss today, but the topics that we do have on the agenda, I think are very timely. I know that they are very critical to many of you. So I look forward to the debate.

I would remind everyone that as we get into the sessions, when you speak, please turn on your microphone, and then after you speak, turn it off. Typically we don't get that feedback I've had until two or three are turned on, but please remember to try and do that.

I will ask my colleagues if they have any comments, and then we will follow that with self-introductions around the room.

So Commission Walt Lukken.

COMMISSIONER LUKKEN: Thank you, Jim.

I appreciate Chairman Newsome hosting the meeting today as chairman of the Ag Advisory Committee. I am also very excited to see some familiar faces around the room. Many of you I have worked with in the past either here at the Commission--I recognize Commissioner Tom Erickson here today--and also from the Senate Agriculture Committee, when I worked with you on farm bills and the CFMA and other things.

You know, the Agricultural Advisory Committee, in my view is a very important voice for the Commission. It provides us with guidance as a barometer of how we gauge which policies we want to take on at the Commission that affect agriculture. It takes on an even more important role as we go into reauthorization; and next year is a reauthorization year for the CFTC. So it's good to have these agriculture interests around the table giving us views on where they would like us to go.

Like I said, I am going to keep my presentation short. I will give a brief overview of the CFMA, but to start off, Jim had mentioned that this is his last week here at the Commission, and we want to take this opportunity, Sharon and I, to recognize him for his work on these markets and for the agricultural community. In honor of that, we want to publicly thank Jim for everything he has done at the Commission, and in so doing, we want to present him with a small token of our appreciation, which Sharon will give to him.

We were going to save this until the end, but I thought presenting him with a gavel at the beginning of a meeting might be more appropriate than at the end in case people go long on their speeches. It says: James E. Newsome, Chairman, Agricultural Advisory Committee, for your service to agriculture, July 21, 2004

[Applause.]

COMMISSIONER BROWN-HRUSKA: I would just like to say a couple of words, as well. It is a pleasure to see many of you here, some familiar faces and some new faces to me that I haven't had the opportunity to meet. So I'm really looking forward to having interaction with you.

I just want to say that Jim Newsome has

been an incredible leader at this agency. He has been a mentor to me and I think Walt would agree with that, as well. Jim’s leadership is strong. His integrity is rich, and his heart is big, too. So we have really accomplished a lot here so far. We will miss him, but he gave us the tools and the skills to go forward into our reauthorization year.

You know, we've got, I think, a very strong team here, Walt and I, at this time, and I think we're ready to go and am really looking forward to interacting with the Ag Committee going forward. But we couldn't be where we are today without this guy, Jim Newsome, and I just want to thank him very much for all that he's done for us.

CHAIRMAN NEWSOME: Well, thank you both. That's very nice, a pleasant surprise. Hopefully, since I know this group very well, I won't have to use this gavel very much this afternoon, but thank you.

I too wanted to welcome Commissioner Tom Erickson back to the Commission. Tom was a good friend and a colleague during his time with the

Commission, and I know that the one-year period is up and we welcome you back with open arms, Tom. So thank you.

MR. ERICKSON: I bet you wish you had that gavel a little earlier in your career here.

Jim, congratulations to you, and I just want to say that I'm living proof today that old commissioners don't die; they show up at Ag Advisory Committee meetings or any other advisory committee meetings. Congratulations and all the best to you.

CHAIRMAN NEWSOME: Thank you very much, Tom.

Again, on behalf of my colleagues, we're glad that you're here. We'll get into details, but before we do, why don't we start with Reece and let's go around and introduce yourself and who you represent.

MR. LANGLEY: I'm Reece Langley with Independent Community Bankers of America.

MR. MILLER: Jim Miller with the National Farmers Union.

MS. GRABOWSKI: Trenna Grabowski with the American Agri-Women.

MR. RICE: Good afternoon. I'm Errol Rice with the National Cattlemen's Beef Association.

MR. NEAL: I'm Tom Neal with the National Grain Trade Council.

MR. CASHDOLLAR: Bob Cashdollar with the National Farmers Organization.

MR. SOWERS: Seaver Sowers with the American Bankers Association.

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

MR. METZ: Good afternoon. I'm Bob Metz, First Vice President with the American Savings Association.

MR. ERICKSON: Hi. I'm Tom Erickson with Bungy North America, representing the North American Export Grain Association.

MR. DAVIDSON: I'm Ross Davidson, the administrator of the Risk Management Agency.

MR. GILLEN: Neal Gillen, American

Cotton Shippers Association.

MR. COYLE: Tom Coyle, representing the National Grain and Feed Association.

CHAIRMAN NEWSOME: We do have several others that are expected to be here today to join us for this meeting. So we'll introduce them as they come in.

At this point in the program, we thought it would be useful, since so many changes have taken place with regard to new rules and regulations in the oversight of futures and options trading, to ask Commissioner Walt Lukken to give an overview of the Commodity Futures Modernization Act. Many of you are familiar with that Act. Many of you worked with the Congress several years ago as they drafted that Act. Of course, implementation of the Act took the agency almost a year. We had numerous rule-makings and studies that were part of this implementation, and since we've finished the implementation, the industry has responded very positively in using the tools that were a part of the Act, and I think in great portion, much of that is due or much of the growth that we have seen in the industry is due to the flexibility that is provided in the Act.

I wanted to mention Commissioner Lukken serves as the Vice Chairman of this Advisory Committee as well as Chairman of the Global Markets Committee meeting and provides tremendous leadership there. Commissioner Brown-Hruska chairs our Technology Advisory Committee and provides great leadership for that advisory committee as well. So all of us are active within industry groups, chairing advisories committees. We consider these committees a key component of the policy development at the agency. Certainly we welcome your viewpoints, and this is an opportunity to collect those as well as the many comment periods that are open on numerous issues.

So at this point, Commissioner Lukken, I'll turn it over to you.

II. AGRICULTURE AND COMMODITY FUTURES MODERNIZATION ACT OF 2000

COMMISSIONER LUKKEN: Thank you, Jim.

This PowerPoint really is a very broad overview of what occurred during the CFMA back in 2000. To start with, it's sort of broken up into three sections. The first is the organizational changes that have occurred at our Commission since the last time this committee met and how we do things in different divisions here at the Commission; secondly, trends and demographics of what has been occurring in the futures markets over the last ten years or so that might be relevant to the agricultural community; and, lastly, the CFMA--what the structure was and why Congress did what it did and its impact on the agricultural sector.

Just a quick overview, we were created 30 years ago to monitor the futures and options markets in the United States, primarily to protect market participants against manipulation, abusive trade practices, and fraud. Certainly for the agricultural community, one of our mandates is to foster price discovery and markets through liquid, fair, and financially secure trading facilities.

Again, next year, our reauthorization expires at the end of September 2005. Congress, the Senate Agriculture Committee and the House Agriculture Committee will be charged with writing that reauthorization.

We are a part of the annual agricultural appropriations bill. This year's budget was around $90 million. We don't collect any type of industry transaction fees. Our budget currently is tied up in the agricultural appropriations bill which has not been passed as of yet.

Here is the general organizational structure of the CFTC. As you can see, since the last time the AAC met, we have a new Division of Market Oversight, a new Division of Clearing and Intermediary Oversight, continue to have the Division of Enforcement, General Counsel's Office, and other divisions involved with analytical research and administrative work at the agency.

The Division of Market Oversight--one of their functions is to surveil the markets. They oversee markets using our large trader reports, for which traders provide data to our agency to ensure that commodities are not being manipulated. The Commission receives, a weekly surveillance briefing in which different products are highlighted to show which products may have the potential to be manipulated and what we are doing to prevent that. Often times, despite the volume percentages of agricultural products, they're one of the topics of our surveillance briefings every week, those and other physical commodities because of the potential of manipulation.

DMO also does product and market review to make sure that all products and markets that are coming to the agency are meeting the Act as well as compliance. DMO continues to audit those people once they are designated as part of our oversight. Again, we have a new Division of Clearing and Intermediary Oversight. One of the things the CFMA did was to break off clearing as a distinct function of exchanges and require those organizations to register. As a result, we, under

Chairman Newsome's leadership, thought it was important to tailor our regulatory structure to meet that recognition. So we now have DCIO, which looks at both intermediary oversight, making sure that they comply with the Act for financial integrity of the firms as well as protection of customer funds and clearing organizations to make sure that we designate them, that they will be an appropriately regulated clearing organization and that they have financial integrity.

I sort of term those last two divisions the pre-event divisions. We're trying to prevent and detect things from occurring that are violating the Commodity Exchange Act. If something does occur that violates the Commodity Exchange Act, we turn it over to our Division of Enforcement, which is the largest division at the agency. This is our litigation arm. These are the lawyers that go to court to sue people for civil penalties, for fraud manipulation, false reporting, trade practice, and registration violations.

These are sort of the trends in the

industry. As you can see, volume has been in a very strong upward trend. We broke a billion contracts in 2002. We passed 1.2 billion last year and on pace this year to set more records. So certainly this business is growing.

If you look specifically at agricultural volume, last year we were up over 100 million contracts traded in agricultural bits. It was flat over a period of time, but definitely agriculture is growing as fast as the futures markets and this year is on pace for a record year as well. If you break that into percentages, you can see agricultural commodities make up about 8.5 percent of the total volume, interest rates being the largest chunk of volume on the futures exchange, the Euro dollar, the short-term interest rate product at CME, the bond complex at the Chicago Board of Trade with equity indexes at about 25 percent in foreign currency and small segment energy about nine percent, slightly bigger than agriculture.

Here is a break-down of the different

exchanges and the volume that they're handling: The CME, about 50 percent; the Board of Trade, about 36 percent; and NYMEX, third, about nine percent.

This is a graph showing the trends in electronic trading over the last four years. As you can see, these are the Chicago Mercantile Exchange numbers. Electronic trading now accounts for over 50 percent of their trading volume, which I think is very significant if we're looking as policy makers at what we need to be doing. Here is the Board of Trade also around 60 percent of the trading. As far as agriculture, agriculture still is a small percentage being traded electronically, somewhere around two to three percent, but that also is growing significantly. So these trends are happening also in agriculture, although in a smaller context.

Again, the Commodity Futures Modernization Act of 2000 was our last reauthorization effort four years ago. It really was broadly based on the President's Working Group report that was issued by this agency and the other members of the President's Working Group: the Department of Treasury, the Securities Exchange Commission, and the Federal Reserve Board. The three major elements of that report said that there is public policy to provide legal certainty to the over-the-counter derivatives market. There is a public interest to provide regulatory reform for the futures exchanges and their participants and that lifting the ban on single- and narrow-based security futures products is obtainable as long as you provide a joint structure between the SEC and the CFTC.

Congress used this report to write the CFMA. The first of the three legs of the CFMA was legal certainty for over-the-counter derivatives. Generally our Act excludes over-the-counter derivatives if the product that is being traded is not ready susceptible to manipulation, mainly financial products, and the entities or persons trading those products are large sophisticated customers. Part of the reasoning behind them allowing this exclusion is that institutional customers who are trading financial products are generally regulated by other financial regulators, either the Fed, the FDIC, the SEC, or other state insurance regulators.

The second leg of the CFMA was dealing with regulatory reform for the exchanges. It created a tiered regulatory structure for the exchanges based on the types of products being traded and the sophistication level of those trading. It also shifted the regulatory structure from a front line structure to that of an oversight structure through the adoption of core principles. Instead of prescriptive regulations, we now have flexible core principles that allow us to tailor our regulatory efforts to the nature of the markets. And it also allowed exchanges to self-certify products and rules without prior CFTC approval.

As I note there, there is an exception for material rule changes on listed enumerated agriculture products with open interest. I also note that we continue to have authority and oversight abilities over these rule approvals and these product approvals, but the burden has shifted from the exchange proving that they meet the principles to us showing that they don't or--that they don't. I think I stated that correctly. So we still maintain authority over these changes; however, we are not involved prior to the rule going into effect.

Lastly, security futures products. The ban on these products was lifted after 18 years. The Act outlined a joint regulatory structure for those products to trade between the SEC and the CFTC. Two exchanges are now trading those products, Chicago and NQLX, with limited success.

What are the agricultural issues that came forward during the CFMA? The first is that Congress continued to recognize agricultural products as a special class of commodity deserving of greater oversight. Agricultural products are required to trade on the highest regulated exchange designated, a designated contract market. They also are specifically not allowed to participate in different types of exclusions and exemptions. Congress chose not to address in 2000 the HTA cases or the cash or forward exclusions for agricultural products. We will be discussing that a little later.

And, obviously, Congress required a report on making futures exchanges more accessible to agricultural producers. This was completed a year after the Act was done and delivered to Congress, and if you're interested in reading that report, you can get on our web site for that.

Well, what might be the possible issues for agriculture next year during authorization? These are from talking to people in the agricultural community, but I saw three different areas. One, is there a need for greater legal and regulatory clarification for off-exchange risk management products? Again, we'll be diving into some of these subjects a little later.

Should “agricultural commodity” be defined due to the term’s use in CFMA exclusions, exemptions, and other sections? Although corn is considered an agricultural product, should we also protect ethanol as an agricultural product since it is derived from corn? Lumber versus wood pulp? How should we divide the line? It's not delineated in the Act, but it's something we as policy makers should think about.

Lastly, should Congress continue to treat the oversight of agricultural products differently from other commodities? Has the agricultural community reached a point where they don't need greater oversight or need some more flexibility in this area? And that's something that this group should think about.

So thank you very much.

CHAIRMAN NEWSOME: Thank you, Walt, for a great overview of the CFMA, and I would mention that it's not too soon for any of your organizations to start thinking about the CFTC reauthorization. We've had the opportunity to bring it up in testimony a couple of times on the Hill recently. I know that at least from the House standpoint, Congressman Moran is looking at some field hearings this fall with regard to reauthorization. So I know that many of you in your organizations, you have limited times to get your boards together to talk about broad policy items, but I would encourage you to go ahead and start putting that on your agendas and discussing it so that your view points will be heard and will be heard early in the process.

Does anyone have any questions for Commissioner Lukken before we move on with the program?

Okay. Thanks again, Walt.

III. FEDERAL SPECULATIVE POSITION LIMITS

CHAIRMAN NEWSOME: One of the topics that we thought was very timely to discuss today was a request from the Chicago Board of Trade with regard to Federal speculative position limits, and that's an area that we definitely wanted to put on the agenda for this meeting, to hear some discussion, and I would add at the front end that there's not parity among agricultural products with regard to these position limits. The livestock complex at the Chicago Mercantile Exchange does not have Federal limits. Those are handled by the exchange with consultation from the Commission. So I mention that just to say that there's not parity and not to assume that all ag products have these Federal limits, because they don't.

So I think it's a very legitimate discussion to bring to the table that the Commission is considering at this point. Because this issue is under consideration or is in front of the Commission, I don't think you will hear any viewpoints expressed by the three of us. We're here to listen and to gather information.

So to start off this discussion, we've asked Dr. Jim Overdahl, who is chief economist at the CFTC, to provide some background on how we gotten to the point we are.

Dr. Overdahl.

BACKGROUND FROM DR. JAMES OVERDAHL

DR. OVERDAHL: Okay. As Chairman Newsome mentioned, we thought it would be helpful here given the petition before us from the Chicago Board of Trade and the Kansas Board of Trade and the Minneapolis Grain Exchange to have just a little bit of background or orientation on the Federal speculative position limits and how we got to the point we are today.

First of all, there are several different types of position limits. We have the spot month limits and then for other contract months that are non-delivery months that are non-spot individual limits and then all months combined limits. In addition, there are accountability limits, and actually there are different types of accountability limits. I won't go into the details there, but I think it's helpful just to recognize that there are different types of limits, and that will be part of the discussion that we'll hear more of when Bernie Dan takes over.

And through the years, there have been many proposed purposes for Federal limits, to reduce potential threat of market manipulation or congestion, to perhaps reduce the potential for price distortions in the market, and to mitigate clearinghouse credit risk. There is a long history of Federal speculative limits that go back to at least 1938, but at that point, the predecessor of the CFTC, the old Commodity Exchange Commission, established Federal limits on a certain set of enumerated commodities, the wheat, corn, oats, barley, flaxseed, the ones listed there in 1938, and through the years, there have been other commodities added and taken out of that list. Currently, there are ten on the list. You'll see 1987, which is actually after the founding of the CFTC, and that was added really for consistency sake with soybean oil and soybean meal to be consistent with the soybean contracts.

Interestingly, the Commodity Exchange Commission never established speculative limits on many agricultural commodities for which they did have jurisdiction. You'll find a whole list of those that they chose not to impose Federal standards for. So it has not been a consistent treatment across all agricultural commodities through the year. In addition, we've seen that the number of exchanges under their own authority have established their own speculative position limits prior to the CFTC, for example, the CME with pork bellies and live hogs in 1966, and these are actually even prior to their being placed under jurisdiction of the Federal Government in Federal oversight.

When the CFTC was established in 1974, it retained these speculative position limits that had been on the books prior to that, and these are incorporated in CFTC regulation 150.2, and, in fact, the petition that is before the CFTC is related to this regulation. That is the one that's in the Board of Trade petition and you can find in the current Federal Register release. By the way, if you're looking for the Federal Register release, the CFTC web site has it available, CFTC.gov.

For each of these enumerated commodities, Regulation 150.2 established position limits in the spot month, the non-spot months, and all months combined. So it really followed the form of the pre-CFTC regulation. Going forward, in 1981, the CFTC passed a rule, 150.5, that required exchanges to establish speculative position limits for those commodities that were not subject to the Federal limits. So we have here two different types of regulation, one that has actual Federal limits that are set by the CFTC and others that are set through Commission oversight by the exchanges.

So to summarize, really, the history of position limits, Federal speculative position limits in the year 2000 and the passage of the CFMA, we've had these limits on these ten enumerated commodities that were brought into the CFTC in 1974, and then we have another agricultural commodities positions limits and accountability limits that are set by the exchanges subject to CFTC oversight and enforcement.

Just to list the ten commodities, here they are. Most of them are on the Board of Trade. We have two Minneapolis Grain Exchange products, cotton at the New York Board of Trade, and the Kansas City winter wheat contract. So there are

Federal limits on the single-month limits for the non-delivery months, all months combined limits, and then spot month limits.

So going forward, then, to the Commodity Futures Modernization Act in 2000, this has, as Commissioner Lukken mentioned, changed the way we regulate commodities from prescriptive rules to more of a principles-based approach, and you'll find in the CFMA designation criteria and core principles for which designated contract markets must comply in order to maintain their designation. The one that is most relevant--there are I think 18 core principles with respect to designated contract markets. I say 18 because I think one of the 18 is you shall abide by the core principles, so 17 or 18. One of the 18 is Core Principle 5 that deals specifically with position limits and sets out or requires that the exchanges adopt position limits or position accountability limits for speculators where necessary and appropriate.

The guidelines, which is a separate part of our regulations, there is guidance to interpretation of Core Principle 5, and the guidance says, you know, that spot month limits should be adopted in these markets, and there should be those in which there are deliverable supplies or where they may be constrained or where there is susceptibility to market manipulation or price distortions. In addition, markets may elect not to provide all months combined or non-spot month limits. So, really, the core principle, the guidance says really just spot month.

The petitions that are before the Commission currently would repeal the CFTC Regulation 150.2, the Federal Speculative Position Limits. In addition, the petitions ask that if the regulations are retained, that the Chicago Board of Trade has proposed certain levels that the limits be set to, and the Kansas City Board of Trade and the Minneapolis Grain Exchange have asked that there be continuing parity in these limits across the wheat contracts traded at the different exchanges.

So what questions are we looking at here at the CFTC? In the Federal Register release, you'll see six questions, and here they are summarized in this presentation. First of all, should the Commission continue to impose these Federal limits that are enumerated in 150.2? If we do, should these commodities be treated differently from other agricultural and non-agricultural commodities where the Commission does not impose these limits? We need to reconcile that in some way. The third question we'll be asking is should the CFTC Regulation 150.2 be modified to eliminate either the non-spot month or the individual months or the all months combined limits? And if 150.2 is modified, what criteria should we use in determining what acceptable position limits, what they are? And if these position limits are retained, should the increases requested by the Chicago Board of Trade be granted and should the request by the Kansas City Board of Trade and the Minneapolis Grain Exchange for parity in setting these limits be granted? And, finally, should the acceptable practices, the guidance that we have for

Core Principle 5 be revised in light of these petitions?

So with that, I will turn it over to Bernie Dan.

CHAIRMAN NEWSOME: Okay. Thank you, Dr. Overdahl.

Are there any questions for Jim before we move to Bernie with regard to that overview?

Okay. Next on the program, we've got Bernie Dan, who is the President and CEO of the Chicago Board of Trade.

And, Bernie, I think by your presence here, it shows the importance of not only this advisory committee to the CFTC, but the importance of this issue to the exchange, and we're glad that you're here to share your thoughts behind the request.

PRESENTATION BY BERNIE DAN, CHICAGO BOARD OF TRADE

MR. DAN: Thank you, Jim, and it is my pleasure to be here today. It is a significant issue for the Board of Trade and I think for the agricultural industry at large, and what I am about to present is some rationale about how we're proposing to address a hopeful request to increase limits for speculative users.

Before I get into that, I just want to take one moment and thank Chairman Newsome for his support as commissioner or as chairman of the CFTC, and at the same time, we look forward to working with Commissioner Lukken and Commissioner Brown-Hrsuka during the transition and beyond. They've been great supporters for the industry and have really helped the industry grow. So I just want to say thank you very much.

Good luck to you, Jim. You can join my side of the fence, which is nice.

So what we're here to do today is talk about the Board of Trade's petition to repeal the CFTC Reg 150.2 and we want to talk about a proposal to increase single- and all-month speculative limits. Okay. When you talk about the proposal, we're really focused on really three things. We want business to be centrally located in terms of price discovery. We want to have the benefit of the regulation and the oversight that comes not only from the exchange, but from the CFTC, and we want to enhance the transparency associated with how hedgers and speculators go through the price discovery or risk management process.

So in doing so, and we're going to show some data that leads to allowing the exchanges the authority to establish and monitor these limits that are consistent with CFTC guidelines and include their oversight, but don't require their approval, and at the same time, as we go forward, we want to maintain those guidelines and oversight to ensure that the integrity of the process and how we monitor those markets, that we guard against things like manipulation and excessive trading and other practices that the Board of Trade through their SRO duties has been performing very well for many years. So we're addressing in this proposal how we attempt to do both.

So why do we want to do it? First off, it allows for quicker responses to the changing market. The last time a change was requested, it took seven years to fully implement, and it wasn't necessarily it took seven years to make a decision, but it was a very staged process in trying to understand what the impact would be on the increased limits. But nevertheless, seven years in a dynamic market environment where the growth and demand for access to price discovery for these underlying products is clearly growing is in our judgment not a reasonable path to follow going forward in the future. Two, it enables the regulated exchanges to better compete with the OTC markets to attract the capital. One of the things that really driving our comment here is that with the report of large speculators in the market and large hedgers in the market and with the growth of OTC markets, we recognize that that growth is always hedged back in the primary market of the Board of Trade; however, it could distort the users in the market and the data of who is the speculator and who's the hedger.

So the advantage of having centralized liquidity, allowing larger limits for the speculators, will enhance the price discovery associated with those seeking to use the market for hedging and other risk management purposes.

Finally, we think that repealing this regulation is consistent with the CFMA core principles that Commissioner Lukken reported on earlier. Specifically, this request will also require some changes in the Board of Trade Regulation 425.01 that governs our position limits. So with respect to spot month limits, there would be no changes at all. With respect to single-month limits, these are again based on guidelines from the CFTC, and we use data through 2003. We would be proposing the following limits for single month: Corn would move from 5,500 to 10,000 contracts; wheat from 3,000 to 4,500 contracts; soybeans from 3,500 to 6,500 contracts; soybean oil from 3,000 to 4,500 contracts; and soybean meal from 3,000 to 4,500 contracts.

On the all-month limits, again, based on data from the FTC and using 2003 data, corn would move from 9,000 do to 17000; wheat from 4,000 to

5,500; soybeans from 5,500 to 10,000; soybean oil from 4,000 to 6,500; soybean meal from 4,000 to 6,000.

So when we look at the CFTC guidelines and what we base these recommendations on, spot month guidelines is no greater than 25 percent of the spot month deliverable supply. The guidelines used to drive the Board of Trade's recommendation for increased limits for single and all months is no greater than ten percent of the average combined futures and delta adjusted option month-end open interest for the most recent calendar year up to 25,000 contracts with a marginal increase of 2.5 percent thereafter. So with respect to just that statement, the largest increase that we've proposed is for all months combined 17,000 for corn. So we're still well within the guidelines in terms of what the Board of Trade is proposing and well within the structure that has been offered by the CFTC.

The guidelines also suggest that the breadth and liquidity of the underlying cash market and arbitrage opportunities between the futures and cash markets may also be relevant considerations, and this begins to address the issue and concern associated with parity amongst Kansas City, Minneapolis, and the Board of Trade with respect to the wheat product.

To give you a little bit of a breakdown on just where some of the underlying products are from a futures and options perspective, I have several slides on just the products, and again, I want to remind the advisory committee that we based our recommendations on 2003 data, which is in the reddish color. So the weekly average corn futures and options open interest from 1999 to 2004 for corn suggests that the data for 2003 is representative of all the years prior and clearly doesn't take into account some of the increased growth that we've experienced in '04. Our approach would be to look at this if, in fact, granted these limits, is to look at the average open interest over a several-year period like we have from 1999 to the year 2003 and not really respond to any one year. So I have added what the weekly average open interest is for 2004, and you can see it's almost double, if not triple, what corn is for '03.

In wheat, it's a similar picture. We base the data on 2003. Clearly, we have not taken into consideration in our recommendation some of the large volume years in 2000 and 2001, and this should, again, give the committee some comfort that we're considering all data. We're not just focusing on any one year. We're focused on a period.

Soybean futures and options for the same period, again, it's representative of the prior three years and does not take into consideration a large growth in '04. Soybean oil, it's a consistent story as is soybean meal.

So one of the reasons why we're here before the committee is we firmly believe that more liquidity helps hedgers and producers of all levels. Markets have clearly attracted more speculative capital from large traders, and they're represented in lots of different types of users, whether they be managed futures, trading arcades, hedge funds, small commercial users, medium commercial users, large commercial users. What makes the market strong is the combination and the diversity associated with those profiles.

Similarly, the data from the CFTC will show that not only has large traders that are for speculative purposes increased since the last change, but also that the large hedgers have also increased. We'll see some data on that in a second. This speculative activity allows hedgers to trade more effectively and reduce--and keep the spreads tighter and deeper. The result is simply more liquidity and open and transparent markets. Transparency and real-time dissemination of prices and trade data and the need to centralize it on one trade medium ultimately helps all users because price discovery is more ready available. It's more transparent, and it encourages trading.

This is from the CFTC large trade data, and I have highlighted soy beans just to show that since 1999, when the last change was made, that the percentage of open interest held by large speculators was 18 percent. The percentage of open interest held by large hedgers at that time in 1999 was 49 percent. The difference at that time was 31. After the changes and given some of the industry growth that I've shown for soy beans and other products, the relative percentages are the same. In 2004, the percentage of open interest held by large specs is 20 percent. The percentage of open interest held by large hedgers in 2004 is 56 percent, and the difference is 36 percent. So this should give the committee an indication that by increasing the limits the last time and managing that growth within the centralized market, we've been able to maintain a relatively same level of mix which supports how the industry has grown and helps with the price discovery and efficient trade.

So, in summary, we think that repeal of the CFTC speculative limits is good for regulated markets, good for the overall ag pricing. Clearly, we are strong proponents and supporters of maintaining the guidelines and the oversight on behalf of the CFTC, and we think increasing open interest that we've seen from 1999 to 2004 supports higher single- and all-month position limits, and we also believe that price discovery is enhanced with diverse market users.

I think that one of the things I'd like to point out is that large traders--I'm assuming that this request is approved--will continue to report their positions to the exchange, and this information in terms of large speculators and large hedgers will still be made available, and we're confident that be centralizing that at the Board of Trade and other exchanges, that the ag industry will benefit from that data and will accurately redirect speculators and hedgers within the agricultural world. Secondly is that on the transition, we would manage the transition. While we're asking for these limits, our approach would be such that we would support these expanded limits and we would introduce them on a graduated basis. We would do so to ensure orderly markets, price integrity, and trade certainty. So whether or not we actually fulfill and exercise the authority within the limits we're requesting, sitting here today, I can't judge that, but we will do so on a very measured basis to ensure that we don't compromise the markets we have today.

Finally, I would like to say that enhanced data and the dissemination of that data in a centralized format clearly enhances the price discovery that we all enjoy on the Board of Trade today.

So with that, I would be happy to answer any questions about the presentation or anything else.

CHAIRMAN NEWSOME: Thank you very much, Bernie.

Some on this committee are more familiar with this topic than others. Some certainly have more interest in this topic than others, and we want everyone to feel very comfortable in terms of asking questions or making comments. So regardless of your interest or knowledge level, I would assure you that no questions are too basic, and we would invite anyone to make comments or ask questions. So at this time, whether it be for members of our staff or for Bernie, I would certainly like to open it up for any questions or comments.

Neal.

GENERAL DISCUSSION

MR. GILLEN: Thank you.

Bernie, presuming everything happens that you request, what procedures will you have in place for non-members of the exchange to have a voice in any potential increases in the future?

MR. DAN: I think there are two points to make in that. Thanks for the question. First off, we're going to follow the guidelines that are outlined by the CFTC, and we will operate within that 25,000 limit that I shared earlier and incremental increases beyond that. With respect to revisions above and beyond what we're asking today, we would do exactly what we've done the first time, is solicit the input from the industry, demonstrate that we're operating within the guidelines. We would still be subject to CFTC input at that level, and so I would envision a similar process that we're going through today, and it doesn't create any sort of scope on the part of the Board of Trade to exceed those that were requested today about without good strong interaction with the users as well as from the Commission.

CHAIRMAN NEWSOME: Okay. Other questions?

Jim.

MR. MILLER: You indicated that the last time the spec limits were changed, it took seven years. Would you expect that if you went through the process today, it would take seven years to reach the end?

MR. DAN: No. I don't expect it would take seven years today, but the point we're trying to make there is that on recognizing and meeting demand of users, defined as both hedgers and speculators for our market, and responding to the changing market conditions, that as a marketplace, we want to be in a position to make those judgments and determinations in the context of the Federal guidelines and oversight in order to maintain our market and meet the demand that's there. So we only use that as an example to demonstrate that the duplicity associated with this process doesn't add any value in terms of why we all use these markets, and we think it's better and consistent with the Commodity Futures Modernization Act to streamline processes and shift some of this responsibility from the government regulatory body, the CFTC, to the marketplace and do so consistent with their guidelines, like we have many other practices post-2000.

I think the other point I would like to make on the seven years is that it was done in a very organized fashion in the sense of there was three phases, whereas part of the Commission, we introduced some changes, did some studies, did some other changes, etc., and they were all done in the context of ensuring trade certainty, integrity associated with pricing and orderly markets. Those are principles and guidelines that the Board of Trade is clearly self-interested in maintaining, and those are areas that over the last 50-plus years, we've demonstrated our ability to do so.

So we think that by asking for this repeal, we as a marketplace are in a very strong position to manage the transition and do some so in conjunction with industry users as well as operate within the guidelines that are provided.

CHAIRMAN NEWSOME: I would follow up on that just a little bit too, Jim. On top of what Bernie has said, even the things at the Commission have changed greatly that wouldn't allow something to drag out for that kind of time period as in the past. One of the things with regard to the Commodity Futures Modernization Act is that it not only created the flexibility, but it created time sensitivity as well, and I think over the last couple of years, you've seen a number of general areas at the Commission, for example, rule changes or the addition of new contracts, that at one time took months or even years, now takes days and weeks as compared to how things have operated in the past.

So I won't be here, but certainly I wouldn't envision anything taking seven years.

Seaver.

MR. SOWERS: By way of background, I should tell you that while I'm here with a banking hat, a lot of the bankers that you will see out in rural America, these country bankers that you all know are often farmers themselves. So a lot of times we will hear from bankers who may feel the same way that, you know, Jim's members may feel or Errol's members may feel. So I guess I just want to make the point that bankers heavily invested themselves in agricultural.

I guess my question was I guess the most recent case we would have would be the BSE cases, and I know that livestock is not one of the enumerated commodities, but what should we learn from the BSE case? I understand, actually, I guess before the BSE came around, that, in fact, there were some adjustments that were made on some of these loss limits. So what should we gather and what should we learn from that process?

MR. DAN: I think, Seaver, that's a great question, and whether it's BSE or whether it's energy or any product where there's a lot of volatility associated with it, exchanges have the authority to do a couple of things: Increase margin requirements that represent the risk associated with the underlying commodity to ensure that those that are in the market are truly in there for whatever reason they want to be in there, and that helps reduce the speculative activity. Two is that, you know, you can--there are price limits that can be adjusted to keep the trading intraday in a far tighter bid-ask or trading range than prescribed, and we can do that within the scope of our rules. And, three, during that time with BSE, and I think the CME did a very good job, is, you know, we have access through our regulatory arms to understand the users of the market and ensure, you know, their intentions in terms of these positions, that they actually understand the risks. And I think that as these situations arise and if you look back even beyond the BSE situation, one of the chief, you know, goals and objectives of the marketplace is trade certainty and price discovery. Those two objectives are the highest priorities that we govern, and it's in our interest as a marketplace to ensure that confidence surrounds those, and we would follow similar practices in the event of these increased limits.

Finally, I would like to say that I want to reemphasize that we would introduce these limits on a graduated basis. Our concern is, you know, we don't want--the worst thing for the Board of Trade is to have any issues associated with pricing manipulation or anything like that, and so we would do it on a graduated basis to ensure orderly markets and these limits get absorbed. That is another way that we would guard against, you know, any sort of sudden change or any uncertainty associated with these increased limits.

CHAIRMAN NEWSOME: I would follow up on that too, Seaver, since we lived through the BSE scenario. That was the example you used, and I think it's relevant. Many of the senior staff here--I see Paul from the Merc in the back. He certainly lived through it. But I think, to me, what that indicates is that the markets work. You allow them the opportunity to work. Certainly, some serious decisions had to be made on a very timely basis with regard to the BSE outbreak. The Merc was meeting almost daily in terms of how to respond to the situation. Those discussions were in consultation with the CFTC every step of the way.

So I would expect, regardless of how it moves forward, that that would be how things would operate, whether it's the Board of Trade or the Merc or anyone else.

Tom.

MR. ERICKSON: Bernie, have you given any thought, looking forward, presuming the petition is approved, to how the exchanges might utilize that authority as far as when you would have spec limit increases proposed? Would you look out the 18-24 months where there's no open interest, or would you look at making decisions in the more term for dynamic--I guess to the respond to the dynamic market change?

MR. DAN: We've talked about it. You know, we've attempted to reach out to the various industry associations to see how best to manage it, because dependant on which path we choose, it obviously has some impact and some discussion with the CFTC. So we haven't reached a formal conclusion on that yet, but we're quite--we're quite prepared to just say looking out forward, if people within the industry are too concerned about making changes on the near-terms months. So I think that's a valid question, and I don't have a specific answer because that dialogue continues, and as we go through this comment period, we're seeking--as we feel we're gaining support and we're talking about the implementation, but if the result of this is that it's just looking forward, that is something that we're prepared to live with and move forward on.

CHAIRMAN NEWSOME: Yes, Robert.

MR. CASHDOLLAR: Just for background, as

I recall one other time looking at this issue, the definition of whether someone is hedging or speculating is a little bit loose and dependant more on who they are than what they're doing. Could you refresh my memory on that?

[Mr. Dan confers with Ms. Polaski.]

MR. DAN: I just was asking Ann Polaski just so I don't misspeak. Essentially, a definition of a hedger is anybody who has deliverable stock or product. A speculator--maybe it's better to define a speculator, somebody who doesn't have any value associated with the supply chain.

MR. CASHDOLLAR: I understand that that's the dictionary definition. Is that how it really works in the oversight of the market?

MR. DAN: Well, here's the thing, is obviously we have hedge exemptions which are granted through the Board of Trade, and as we request information to support those hedge exemptions through our surveillance and market teams, it would reflect that, yes, that happens.

Okay. If people are beyond that, that's what our--our audit and investigation group would address that. But yes.

MR. CASHDOLLAR: But it's basically assumed if you're Cargill or Tysons, that you are hedging?

MR. DAN: There is an assumption made, but they could have hedge exemptions beyond those basically we will monitor.

MR. CASHDOLLAR: How often do they apply for that exemption?

MR. DAN: It's reviewed every 18 months.

COMMISSIONER BROWN-HRUSKA: I would just sort of pipe in, because I've actually looked at some data over the years, and I think you raise a really valid question, because I've seen some cases where traders are classified as non-commercials and subject to speculative position limits, but they do, in fact, go into the market and secure product and make delivery, and they can take delivery and they do it on a very frequent basis. So I think it's a good question, something that I think needs further thought for the exchanges to take look at that.

So I just wanted to mention that.

MR. CASHDOLLAR: My concern would be more on the other side.

MR. WILLETT: I want to look backwards a little bit. Obviously, the corn market has been fairly volatile here in recent history. If your petition, that is the repeal of the limits, had been in place back when trading of corn was ceased on one day, what could we have seen back then, if the limits had been raised? I think earlier this year, some trading was stopped when corn was going to a certain level, and I can't recall the actual value that day. What would the result have been?

MR. DAN: There would be no--I mean, if we have a limit up or down period in corn, it's not going to impact a speculative position, at least in and of itself, and so I don't really understand what--I mean the price movement each day is not going to drive whether we're at 5,500 or 6,000. It may in the case of the BSE example allow us to adjust throughout, but a limit move where maybe the market is taking a time-out for a while is not going to change the limit.

MR. WILLETT: Okay. I'm just kind o relating a question from one of our good producers here earlier this week who had some questions about the petition who saw it posted on the DTN.

MR. DAN: I think let me make two points. Just on the spot month, maintaining that position at 600, which I believe it is, is a critical non-change and affirmation of as we get down to that spot month, you know, how important it is to maintain that. So we're focused on that. Secondly, the price volatility throughout the life of the product is not a determining factor in either the current limits or how we would monitor it.

MR. WILLETT: Thank you.

CHAIRMAN NEWSOME: Tom.

MR. COYLE: I don't have a question. I guess I just have an observation. We've had a fairly good dialogue at the Risk Management

Committee of the National Grain and Feed. We've had some pretty good contact, amazingly very quick response from each of the exchanges related to this issue. As a general rule, the association supports streamlining approval and increasing the flexibility for the exchanges so that they can support their customers and meet market requirements.

On this specific issue, a lot of our dialogue came after starting with the issue of limits, really came down to market information, but the limits themselves were not quite as critical as long as there was some oversight and the exchanges were required to follow the core principles, on which they have stated they will and they're require to do. So we support the request, and we'll provide formal comments later.

But, really, the issue came down to the information. It maybe gets to your question as well about definition of hedgers and speculators. To the extent that a traditional hedger actually has off-exchange contracts, swaps or something that's being hedged, it would seem to me that those transactions would appear to be hedges when in reality it's actually a speculative interest in a market, so that by increasing the limits, those contracts actually come direct to the Board of Trade, and so that the transparency the market sees would actually be better.

CHAIRMAN NEWSOME: Thank you, Tom.

And certainly any comments don't have to be questions. Tom Neal, you've been pretty quiet on this. I know it's something you're very involved in. Any thoughts or comments from your standpoint?

MR. NEAL: Well, having the pleasure of appearing before you not as my company, as an individual trader, I can speak on behalf of the National Grain Trade Council, and after a very thorough review and a lot of discussion, our members came pretty much to the single point where we would like to support the Chicago Board of Trade in their petition and the Kansas City Board of Trade and the Minneapolis Grain Exchange in their desires as well. We, I think, share similar comments made by Tom Coyle a moment ago where we feel, really, that it's in the business interest of the Board of Trade to run itself properly and in so doing will conduct itself according to good business realities as well as maintain a positive and open type of communication with their customers. In doing so, we really think that something that the position limits can be ultimately a vehicle to enhance, as Bernie said in his presentation, the liquidity and the transparency of the markets.

Not only do we recognize what has occurred to date with regard to the existing contracts, but with the new contracts and the potential development of other cultural contracts throughout the world, it is more important than ever, from my perspective and I think from the Grain Trade Council's perspective that we continue to do whatever we can here in the U.S. to make our markets as open and competitive and as transparent and as user friendly as we can.

So as long as Bernie is on record on behalf of the Board of Trade that he will endeavor to do certain things that will enhance and create good communication or good customer relations, I think that these things ultimately will be very much to the benefit of the marketplace.

Thank you.

CHAIRMAN NEWSOME: Okay. Thank you, Tom.

Errol.

MR. RICE: Just to be on record on behalf of the National Cattlemen's Beef Association, obviously recently our livestock complex had just gone through a bit of a modification on the daily price moves and just to encourage--maybe the first question from Mr. Gillen--to encourage your industry involvement in this sort of a transition, one of the things that we experienced with our modification on a daily price move of contract, there was obviously some concerns as to being able to bear some of the economic, so to speak, concerns about that. But what we were able to do is we were able to bring CME to the table, have some very open dialogue at our annual meeting as well as having very open dialogue with representatives of the CFTC to make that a much smoother transition, so just to encourage that.

CHAIRMAN NEWSOME: Other comments or questions?

Yes, Jim.

MR. MILLER: Well, I'm not short of questions, but I'm going to restrain myself.

Since my colleague from the wheat growers is here, I would like to ask a question because it appears in your approach, you're going to use a formula, basically, to establish whatever the spec limit would be. How does that create parity between the exchanges when the volume and characteristics of the contracts between the various wheat contracts are so significantly different? And if it doesn't end up with parity, then I gather that doesn't present a problem for the Kansas City or Minneapolis exchanges.

MR. DAN: I'm going to make a general comment and then I'll turn it over. I mean, the Board of Trade clearly supports spec limits in wheat that enable arbitrage and spread trades between Minneapolis, Kansas City, and the Chicago Board of Trade, and we also support parity generally. Okay. However, we don't support reducing limits for Board of Trade wheat, as an example, if that is necessary to maintain equal limits for markets with significantly smaller open interest than the characteristics that you just defined. And that is how I would respond, but I think it's from Kansas City's perspective that that might be a better answer for you, because that is where the open interest is different.

MR. OTT: Let me introduce myself first. I'm Joe Ott. I'm vice president of compliance with the Kansas City Board of Trade, and it is very important for Kansas City both to maintain parity with the other exchanges as far as position limits, and the reason is because a great deal of our volume is generated from market spreads between

Kansas City-Chicago as well as Kansas-Minneapolis, and we if we don't have parity, then we felt like that will reduce our trading volume and allow people to maybe trade more in Chicago than they would in Kansas City.

In addition to the formula specified in the regulations, we feel it's also important for the Commission to look at some other valid issues such as the size of the underlying cash commodity as well as the deliverable supply of the cash commodity and the winter wheat, which is a contract underlying our product. It's by far the dominant wheat contract that is grown in the U.S. that accounts for approximately 45 percent of the total wheat production in the U.S., and because of that, there is a greater potential for the deliverable supply in our product. We feel with the potential for bigger deliverable supply, that it would make it more difficult for possible manipulation of our market.

So we feel like with our large underlying cash commodity, which is typically is twice that of other wheat exchanges, and due to the fact that typically our deliverable supply is equal to pr in excess of the other exchanges, that we feel like we should be able to go up to Chicago. And I think Bernie does make a good point in that by parity, we want to go up to Chicago, not force Chicago to have to come down to us. So those are some of the reasons that Kansas City feels like we hope the Commission will look at some other things besides the formulas brought about in Regulation 150.5.

MR. MILLER: But if the Commission repeals its regulatory authority in this case, why is the Commission going to have anything to say about what Chicago does versus what Kansas City may or may not wish was the situation, other than from an oversight basis?

CHAIRMAN NEWSOME: I'll answer that. Even if we repeal the specific rule, we still have the general oversight responsibility of the core principles, and we feel, not specific to this, but that in general, you know, that the Commission would have the authority to come in and make changes or recommendations as needed.

COMMISSIONER LUKKEN: I just wanted to add, as I mentioned in my presentation, if there is a material rule change on an agricultural product with open interest, we still have the ability to have prior approval of that rule change. Materiality is a case-by-case basis. We really look at things such as, is the product more likely to be manipulated or is it going to affect the behavior of typical traders? So if the concern is that the spot month spec limits might be lowered to a point that might cause manipulation problems or raised to a point to cause manipulation problems or people to change behavior, most likely we will have a chance to look at that prior to that decision going into effect.

MR. DAN: Mr. Chairman, may I make a comment?

Even today, as an example, where wheat is at 3,000 today, you know, Minneapolis Grain Exchange, for example, relative to the guidelines is below that limit today. The markets still work orderly. People are focused on how it works, and parity is maintained. So I think with the oversight and how well--all the controls that are in place at each individual exchange, together with the oversight of the CFTC, what our common objective is is to recognize how users wish to trade the market and at the same time balance the integrity and trade certainty associated with each individual marketplace, but meeting the demand.

So we're currently doing it today and we have this issue of parity, even though we have it, it's not prescribed, and even though some of the smaller exchanges may not have sufficient open interest to support it.

CHAIRMAN NEWSOME: Tom.

MR. NEAL: One other comment in this regard: I think it is important to notice what has occurred over the years, most recently the last five to seven years in my experience in terms of where the capital is coming from, that's coming on the speculative side. You're seeing more and more development of managed money groups, whether they're private moneys or collected public moneys, they're coming in with professional traders who are well aware of the rules and are well aware of good trading, and good discipline means good outcomes, and here the dilemma for the smaller exchanges, from my view, is really one that if you don't make the door open large enough for these groups, then they won't bring any capital at all. It's not like they'll trade small smaller. They have certain limits within their own organizations for certain events for them to participate, that certain conditions must occur, open interest, size of trading, and so on. If there are artificial constraints put on the level of activity in some of the smaller exchanges, these contracts will die from a lack of participation on the speculative side, and I don't think that benefits anyone here.

CHAIRMAN NEWSOME: Okay. Thank you, Tom.

We're glad to see Fred Clark, represents U.S. Rice Producers has joined us. Thank you, Fred.

I would just add as well, and, Seaver, I still go back to your BSE example, because I think that is a relevant example that is recent that many of us lived through back in December of how the system works during a crisis period, and certainly with regard to a cattlemen, I can't think of a much bigger crisis than the BSE announcement, and while it is very unnerving time period and certainly critical, I think the system did work, and the discussion between the Chicago Mercantile Exchange, the cattlemen, and the CFTC was an appropriate discussion and dialogue, and, you know, we saw that given the opportunity, the market worked even though everyone was nervous about it at the time.

Sir.

MR. WILLETT: Just one more question: With approval of the petition, what kind of projections are you forecasting on liberalizing this regime in terms of your volume of activity? Because obviously you're on a nice increase right now.

MR. DAN: Well, that has more to do with just the fundamental demands of what's out there, but what we would expect is more activity that's represented as speculative would appear in the exchange. It's back to the point of Tom, is that maybe the overall, you know, mix of business, you could argue isn't going to grow, but the way it gets profiled will more represent the users, is one point. Two is that we definitely expect an increase from the very sources of capital that Mr. Neal is referring to. Okay. We would expect that those limits, as we introduce them on a graduated basis, get absorbed by funds, hedge funds, etc., together with other speculators that basically want to have exposure to the commodity sector generally and ag specifically. So we would expect them to get used.

I think in terms of overall growth of the Board of Trade, if that's what you're asking, by modify, you know, we haven't quite done the math of all the speculators out there and where they have are in terms of full utilization of the limits today, but we will see new participants. It's difficult to put a number of on it because some people don't participate at all because the current levels are too low.

So it will be increased, and I think I'll just leave it at that. It will better represent speculators versus hedgers, which I think is very important for agriculture.

MR. WILLETT: Would you foresee--with this additional transparency, will that have an indirect impact on the producer participation even at their level?

MR. DAN: I think we've clearly demonstrated, I think, in other markets that the more open the market is and the speed with which the data gets transmitted, the more participation you have. So I think from a producer perspective, it will benefit from more data readily available and, as a result, more than likely use the markets more.

MR. WILLETT: I hope so. CGA completed a risk management survey, and we were somewhat surprised by the current level of participation and, in fact, kind of disappointed at where we are at this point given where we are with the new farm bill protection, some of the improvements in the Federal crop insurance programs.

Thank you.

CHAIRMAN NEWSOME: Before Sharon makes her comment, I want to give Paul a heads-up. I don't want to put you on the spot over there, Paul, but I think we would miss an opportunity to look at a relevant scenario of a contract that doesn't have the Federal spec limits that's currently traded. So after Sharon gets through, Paul, would you just on behalf of the Merc be willing to make any comments about how the process has worked in the livestock complex?

COMMISSIONER BROWN-HRUSKA: Thanks, Jim.

I just was going to add to what Sam was saying, and it kind of goes back to what you were talking about, Mr. Cashdollar, which is this issue of large hedgers not necessarily hedging, but actually speculating and going over the top. It actually turns out that because what we've seen sort of looking at the market, because you increase this speculative interest on the part of pension funds and large position holders that are capable of actually going in and operating in the cash market, you actually provide some market discipline to some of these larger traders who have been by virtue of their hedge exceptions able to be very dominant in the marketplace.

So increasing--in some cases, it seems increasing a speculative presence brings information and liquidity to the markets that actually decreases the power of large commercial would-be speculators themselves.

CHAIRMAN NEWSOME: Thank you, Sharon.

Again, Paul, I apologize for putting you on the spot, but I think your scenario with the contracts at the Merc are just very relevant to this discussion, and I would hate to the miss the opportunity to get your thoughts about this discussion today.

MR. PETERSON: Thank you. We have used

the mathematical method that Mr. Dan had in his presentation where it's open interest-based, ten percent of the open interest up to a certain point, two and a half percent after that. We review this annually with all of the open interest on our livestock products, live cattle, feeder cattle, hogs, and so forth. It's a very simple straightforward process. It's easy to verify, and as I said, we review it annually, and we find that it requires adjustment only rarely. It takes a substantial increase in open interest over an extended period of time before it's really worth the trouble to file for an increase.

Keep in mind that two and a half percent of the marginal increase part in the last part of that long paragraph there in the presentation, it takes a big increase in underlying open interest before that two and a half percent will amount to any appreciable interest in a non-spot limit. So we've used it quite successfully.

The spot month limits, of course, that is based on a deliverable supply calculation and that's a separate process that we're all subject to.

CHAIRMAN NEWSOME: Okay. Thank you.

Neal.

MR. GILLEN: I would just like to add to the dialogue here, and Commissioner Brown-Hruska made the point with the advent on the funds, there are no longer any big fishes in the small pond from the commercial side, and going back to the last time we had the petition for increase in the limits, I was probably one those and a colleague in the back for the three-stage. It was a compromise we put together. That was Commissioner Sheila Behr who put it together, but there was a great concern about increasing the position limits. It was fear.

We requested a study. Unfortunately, the study came during a bull market, so you couldn't--so our fears weren't borne out in the study, but I think that looking at the experience, at least from a cotton perspective, because that is all I have standing to quote on, state on, is that I think it's been a positive experience all in all.

But I want to repeat my initial concern about input from the industry. In the NYBOT new structure, we have a cotton contract specification committee that is made up of members of the trade, the ultimate consumers the textile mills, the cooperatives. As of yet, there are no non-member producers on the committee, but that request has been made and is being considered. I think that creates a very healthy understanding for participants in the market to go forward on and reach a consensus, and I would encourage your exchanges to include non-members on an active basis and, as opposed to calling up a trade association executive or going to a convention, that you should have meetings sort of like this with participants in the market and to develop a consensus and, more importantly, an understanding, because what I have learned in my 40 years in the commodity industry is that fear is a prevailing factor, and there is great misunderstanding; and also to what the corn people have said, there are not enough producers using the markets.

Now, options have changed that, but more education has to be done. That's why this committee was set up. End of speech.

MR. DAN: Neal, I think it's great advice, and I just want you to know that the recommendations for soybeans, corn, and wheat came from industry meetings we hosted at the Board of Trade in '03, and we're firmly supportive of your comments, and we've actively been engaging industry in all the recommendations about the products, not just the impacted limits. So I take your point and we're doing it and we're going to continue to do it. So I appreciate it.

CHAIRMAN NEWSOME: Okay. As we wrap up part of the program, are there any final questions or discussion points that anybody would like to bring to the table?

Yes, sir.

MR. MILLER: You've talked about how effective the market worked during the BSE incident, and without wanting to belabor that, did the spec limit change in the cattle market during that period of time?

So really the spec limit had absolutely nothing to do with the success or failure, depending upon one's perspective of the market action during that period?

CHAIRMAN NEWSOME: Right. And I didn't mean to represent that it was relevant just to the spec limit, but I was trying to talk about a contract that operated under the standards that we're talking about now and how the process in general worked even though it didn't include spec limits as part of that.

Any other questions or comments?

If not, we're going to take about a ten-minute break. There are restrooms through this door on the left, and there is coffee. So let's hang in the area, and we'll try to get started in ten minutes.

[Recess.]

V. OFF-EXCHANGE RISK MANAGEMENT PRODUCTS FOR PRODUCERS

CHAIRMAN NEWSOME: If I could get

everyone to come to the table so we can get started.

The next part of our program is going to be a series of shorter presentations, and it certainly doesn't mean that the topics are any less important. Walt mentioned legal certainty earlier in his comments as one of the primary components of the CFMA, and that was most specific to the legal certainty of over-the-counter products, but legal certainty of all products, whether they be futures or cash, we understand is very important not only to the users, but to the markets that they serve, and I think it's an area that the agency has made some progress. I would be the first to admit that there's still work to be done.

But we're going to start off this discussion with an update from Don Heitman, who is a senior counsel here at the Commission, with regard to ag trade options.

So, Don, we'll start with you.

ATO STATUS REPORT FROM DON HEITMAN

MR. HEITMAN: It's kind of interesting

to be speaking to the committee. I have always been at the previous ag advisory committee meetings because I worked for the staff of the last three years chairs of the committee, and may I say it's a lot more fun to be a presenter than to be responsible for logistics of the meeting. And I would also like to compliment Commissioner Lukken and his staff on the improved quality of the cookies under the management.

At the last meeting of the AAC, Paul Archisel, Chief Counsel of the Division of Economic Analysis, was available to answer questions on agricultural trade options. Now that Paul has left and joined the private sector, I seem to have inherited the title of resident legal expert on ag trade options. I approach this role feeling rather like a house painter who has been asked to stand in for Vincent Van Gogh. Nevertheless, I'll do my best to bring you up the date.

I've been asked to report on basically three points involving ag trade options: A brief history, statutory and regulatory history; a recap of the discussions from the last Ag Advisory Committee meeting when ag trade options were on the agenda; and some questions regarding ag trade options and other over-the-counter ag contracts that the committee may wish to think about in future meetings.

As far as history, going all the way back to 1936, problems blamed on speculative abuses led to a statutory ban on all options trading. The ban applied to both on- and off-exchange options in the basic agricultural commodities which were the only commodities then regulated. When the CFTC was created in 1974 and given expanded jurisdiction over futures and options in all commodities, including plenary authority over options trading in non-agricultural commodities, the Commission used that authority to allow exchange-traded options, and the new non-agricultural commodities came under its jurisdiction.

The statutory ban on agricultural options was left in place, and it wasn't until the Commission's 1982 reauthorization that that statutory ban was lifted. That allowed the Commission to authorize exchange-traded agricultural options, which it did, and obviously have been quite successful. Even then, the Commission let stand a regulatory prohibition on off-exchange agricultural trade options even though trade options in all other commodities could be offered to commercial users subject to only to anti-fraud rules. It wasn't until 1997 that the Commission finally proposed lifting the regulatory ban and permitting ag trade options, and rules to allow ag trade options subject to registration, disclosure, record-keeping, reporting, and other requirements were published in April 1998. The rules met with what we in Washington would characterize as limited success, which is to say nobody participated in ag trade options.

In December 1999, the rules were further amended in the cash settlement and streamline registration and disclosures requirements, and under the amended rules, one firm has registered as an ag trade option user.

Recapping the discussions from the last meeting, at the time of that meeting, which was in March 2001, a little over three years, the Commission was considering new regulations to implement the provisions of the CFMA, and Commissioner Lukken basically went through what the Commission adopted. So the relevant agenda item was entitled "Review of Ag Trade Options and Other Risk Management Alternatives in Light of the CFMA and Proposed Regulatory Changes", and we had three witnesses, a panel of three speakers: Jack Dougherty of Kent Feed, Phil Dodds of Anderson and a member of NGFA, and Melinda Shram of the National Introducing Brokers Association, and the committee asked Mr. Dougherty to appear because his firm, Kent Feed, was and still is the only firm to register as an ag trade option merchant. He explained that Kent Feed developed a program to help their feed customers and the independent hog producers to manage their risk and basically to stay in business. By offering to put options to producers, Kent allows them to lock at a minimum price and at the same time, they can lock in a price to the amount of feed necessary to raise the number of hogs covered by the option.

The program is fairly simple and straightforward. Mr. Dougherty said Kent did not experience any problems complying with the Commission's regulations. He did note that the program wouldn't have been possible without the '99 amendments, the 1999 amendments, because the cash settlement provision allowed Kent Feeds to offer the option; otherwise, had it been left with the delivery requirement, they wouldn't have been able to take delivery, so they couldn't have participated in the program.

Mr. Dodds from NGFA stated their view that APO issues are simply a part of a much broader issue, the need for greater legal certainty for off-exchange forward agricultural contracts. He noted that cash forward contracting is the predominant form of risk management used by grain producers and others, but uncertainty about how the CFTC might use certain contract terms, and the resulting perceived litigation risk may reduce the use of otherwise beneficial contracts. Mr. Dodd submitted hypothetical examples of a number of contract terms and asked how the Commission would view each example, and the Division of Economic Analysis later replied to his question in August 2001, and we sent a copy of that letter out to all the members of the committee.

With respect to the ag trade option program specifically, Mr. Dodd suggested that the Commission should approach commercials in the grain, cotton, livestock, and other commodity sectors and asked what changes are needed in the APO program to attract them to begin writing trade options.

Ms. Shram of the NIVA, National Introducing Brokers Association, suggested her view that the program is underutilized because, quote, the current large players in the grain trade, closed quote, are reluctant to open themselves up to registration with the Commission or other regulation. Instead, they are, quote, hiding behind the forwards exclusion and offering transactions that are very APO-like, but are doing so without the disclosures and other customer protections offered by the Commission's regulation. Mrs. Shram suggested that if the APO regulations were further relaxed, quote, the atmosphere for fraud as a customer would definitely be increased.

And my third and final topic is just to kind of go over some of the questions and issues regarding the ag trade option and other agricultural contracts that might be appropriate for the committee to consider at some future meeting. Let me just read through. These are questions that were--some of them were sent out to the Ag Advisory Committee prior to the last meeting and still remain open, and others are issues that have come up since that meeting.

The first and obvious question is why hasn't the current ag trade option program been more utilized? Is the program's limited use a function of the ag trade option rules? Is it due to the generally low commodity prices experienced since the rules came into effect? In other words, why use an option to lock in a loss? Is it due to competition from government price support programs? Why pay a premium for something you can get from the government for free? Should ag trade option rules be amended so that the exemption from the rules is based only on the $10 million net worth requirement rather than the current three-prong test, which would then allow hedge funds to participate in ag trade options and provide more liquidity to over-the-counter agricultural derivatives.

The third question is the CFMA's thrust is to have tiered regulation based on the nature of the participant. As noted, the ag trade option rules provide for an exemption for participants with $10 million in net worth. Should the net worth exemption level be set at a lower level, perhaps a million dollars, as some have suggested? That in turn gives rise to the question, Would such an approach disenfranchise smaller producers, because if ag trade options could be offered to producers with a million dollars net worth and above without any regulatory requirements, would elevators or other option grantors have any incentive to offer the regulated instruments to the smaller producers? In other words, would there be a critical mass of potential customers that would ever make the program?

If the ag trade option program is further modified, should the Commission retain the prohibition against producers writing ag trade options and thereby assume the potentially greater risks associated with the granting of options? Should the Commission drop the ag trade option program altogether and allow trade options and agricultural commodities to trade without any regulatory restrictions subject only to the general anti-fraud rule just like trade options in all other commodities? Finally, would allowing unrestricted trading in ag trade options increase the potential for fraud against producers?

And those are the ag trade option questions. There are just three questions, also, about other ag derivative contract: One, is any significant amount of distance currently being done in bilateral agricultural commodity swaps? Two, the CFMA's swaps exclusion, which is Section 2(g) of the Act, does not apply to agricultural commodities. So if you're trading bilateral swaps, you're basically exempt from everything in the Act unless you're trading in agricultural commodities. So agricultural swaps remain subject to the more restrictive provisions of part 35 of the Commission's rules, which is the pre-CFMA regulatory swaps exemption. That stayed on the books solely to govern agricultural swaps. So question arises should part 35 be amended to allow bilateral agricultural swaps to trade subject to the less restrictive conditions that apply to all other swaps, for example, allowing agricultural swaps to be fungible and standardized?

The last question, the CFMA allows for future CFTC rule-making to permit the new traded agricultural commodities to trade on designated transaction execution facilities, which has basically been characterized as "exchange light". It is the next step down from a designated contract market. At what point in developing B to B trading platforms should the Commission consider such rule changes? What criteria should the Commission look at in proposing the ground rules for agricultural commodities on ETS, which is a little bit of a moot issue, really, because so far, there are--nobody has actually applied to be become a designated transaction facility. We had talked with some people about it, but nobody has actually applied.

So that is the update on ag trade options.

CHAIRMAN NEWSOME: Okay. Thank you very much, Don.

During my early tenure at the Commission, at every Ag Advisory Committee meeting, ag trade options were the topic of discussion, and I think by anyone's stretch of the imagination, of obviously the products have not been successful, and I think it's up for discussion why that may be the case, but certainly it's an issue that the

Commission is open to revisiting. I know some of you have thoughts on that, but before we get into it, I want to ask our general counsel, Pat McCarty, to give us an update on the hedge-to-arrive cases, and then I know, Tom, you guys have a statement. I think that would be the more appropriate time.

HTA UPDATE BY PATRICK McCARTY

MR. McCARTY: Good afternoon. I know this is everybody's favorite part, when the lawyers get up and start talking about 2(g), 2(g), and all of these other sections. I'm sure you guys are just starting to say where is the coffee.

I want to say in advance, I'm going to try to keep this a little above the minutia and talk to you a little bit about where things have gone on the HTA cases and then raise a couple of questions about where things could go and see what the feedback is. So, hopefully, in less than 15 minutes, I'm going to give you all something to think about, and then hopefully you'll have some comments you can provide us about where things are in this world.

Just background-wise, I guess you all know that these problems with the HTAs started back in I guess in 1993 to 1995, and that, I guess, we had all types of HTAs out there, the standard ones, the flex ones, the cross-country ones. You know, the minds of marketers, I guess spin in a lot of different ways. But they're primarily for the corn and grain people, and there's been lots of litigation both in the state and Federal courts.

The primary issue has been whether, in fact, a hedge-to-arrive contract is going to be a cash forward contract, which is excluded from the Act, or whether it's going to be a futures contract that's subject to the Act. In fact, before the provisions of the Act of 2000, if it was a futures contract, it was off-exchange. It was illegal and void. So it was a pretty big problem if, in fact, it was a futures contract.

Well, let me just say that I guess there's some good news, because I can tell you the cash forward exclusion is alive and well. Based on my review of the law in this area and the state and

Federal case law as well as the Commission decisions, I think that all but one of the decisions I've looked at in the last couple of days basically have found HTA contracts to be cash forwards, which are excluded from the Commodity Exchange Act, and they're enforceable. So I think that that's probably a positive. Now, I did read Tom Coyle's comment in advance of this. I think he's right. Even if you're correct on law, it doesn't really help you if you have to spend hundreds of thousands of dollars to defend and enforce what you think is your right under a contract, and I think that legal certainty is an important issue. So, you know, once you're right, whether you've spent hundreds of thousands of dollars and maybe alienated some of your best customers, it's probably not a good thing to have that occur.

So, yes, legal certainty is a good idea.

Let me go through, I guess, the three recent cases that we came out with, and, in fact, I guess it's the trilogy that came out November 25,

2003. I'm going to give you a brief summary of the facts, what we found, and I guess explain to what I think they mean. Two of the cases actually confirm that they're cash forward contracts. One of them says basically this HTA is actually a futures contract, and let me just tell you what they do.

The first one, the Grain Land Cooperative decision that came out basically said that the contractual provisions permitting rolling did not turn an HTA into a futures contract, and I think that is a huge issue, people wondering if you could roll, did that actually mean that you're speculating and that you actually may not have to deliver. I would like to qualify that a little by saying rolling indefinitely so you never have to deliver actually would probably put you into being a futures contract, but I think the idea that if you have a roll provision doesn't necessarily mean that it's going to be a futures contract. I guess nor having a cancellation provision is going to turn it into a futures contract.

But the Commission in Grain Land basically affirmed the totality of the circumstances test that we have. We're going to look to see if, in fact, deliveries are made, if you are a producer, if you're an elevator or a farmer, and you have product and you have need for it, then I think the thing is if you see that there actually is an intension to start with and, in fact, you see a follow-through--not in every case but in a certain number of cases--well, they're probably going to be a cash forward.

Competitive strategies, this is the outlier. This is the case where we actually ended up with a bunch of, I guess, marketing of HTA contracts, the cross-country HTA contracts, well outside of a geographic area for the elevator, and I think really what you should take out of this is basically if you're--if it's impractical as a matter of economics for a farmer who has entered into an HTA with an elevator that is located two states over, and the cost of actually delivering into that particular elevator is not going to make this a worthwhile transaction, then, in fact, it's probably going to turn out to be that there is no intention to ever deliver that, and you're not going to be able to get into the cash forward exclusion. So I think that is the one where the facts in this situation indicated that the people who were so far away from the elevators, it just made no sense economically for anybody do that, that, in fact, there really was no intention ever to deliver product.

The last case is a summary affirmance in the matter of Cargill. This is my favorite acronym here, the POC, the Premium Offered Contract. This case basically determined the fact--it was asserted by the Enforcement Division that the premium offered contract was an option. The court said that--the ALJ said below, no, it's not an option, and the Commission said you're right, it's not an option, and therefore it's not within our jurisdiction; this is not inside of the Commodity Exchange Act.

I'd say that even though we've just

issued this trilogy, I thought we had finished with everything in front of the Commission on HTA cases. I have just been informed, no, we have one more. It's the Wright case which is from Ohio, and the ALJ decision in that case, initial decision, is basically, no, it's not a futures contract and, no, it's not an ag option. The Commission is currently preparing an options memo that, and I think that it will be resolved within the next three months.

At that point in time, we have no further cases in front of us on HTAs, and I tell you that the cases out there in the Seventh Circuit and Eighth Circuit and Sixth Circuit are pretty uniform. Hedge-to-arrive contracts, where it looks like you've got a producer or farmer and you've got an elevator and it looks to people that they do that on a frequent basis in terms of delivery, it's a cash forward. It's not a futures contract.

I have a list here of cases, and I'm not going to bore you with that. I do want to mention something before we move on. You may have heard of it. There is a recent case in the Seventh Circuit that came out that could have some impact on the HTA case law. It is not about an ag. So it may be of limited applicability, but I will mention it nonetheless because it's got some play in the press. It's the Zelner decision, which is a spot forex case, and it was decided on June 30th, and the Seventh Circuit ruled that, in fact, it was a spot contract, not a futures contract as the Enforcement Division had actual asserted. We're reviewing that decision right now. We have a date, August 14th, by which we have to file if we're interested in getting a rehearing. We haven't made any decisions yet, but that is out there, and it could have some impact. And, in fact, actually if you think about it along with the other case law decisions, it means that things are moving in the courts and others, are moving more into the direction of calling something spot or forward as opposed to calling it a futures. So I think that's probably from your perspective a better thing.

Let me get around to, I guess, a couple of things or an observation or two. I think the big problem in the HTA area had been had the HTA contracts been found to be futures contracts, they would have actually been void. They would be off-exchange futures contracts and therefore not enforceable, nobody gets the benefit of their bargain, and I guess part of this problem was addressed in the CFMA which was enacted in 2000, and both the Commissioner Lukken and Chairman Newsome have alluded to this. One of the big things that the CFMA did was provide legal certainty for certain types of contracts, and it was actually focused on the swaps market. It does apply, however, to I guess the ag market in some way, shape, or form, because under our Section 22(a)4, if you're an eligible counterparty, then it says that no agreement shall be voidable or unenforceable.

Now, you have to be an eligible contract participant, and just to get away from the legal stuff on this for a minute, it means that you basically as an individual had to have $10 million in total assets, not net, total. If, in fact, you're an individual who is using it for hedging, as a hedging contract, it's only five million. So that may take care of a lot of the large farmers who may enter into some of these agreements that you find. So, in other words, part of the problem with legally certainty may have been addressed through the CFMA in terms of saying even if it's found to be a futures contract, it may be okay, and, in fact, the parties are eligible contract participants.

So that actually may solve some of the problems. It's not going to solve all if the problems, and I think that's the question that I'll leave you with here. Now that we've seen all this case law come out, and it's all very positive in terms of supporting the cash forward exclusion in the Act, the question is whether, in fact, there needs to be further clarification in the Act or whether you actually need to try to extend the legal certainty for a contract that's not with someone who's got $10 million in total assets or five million where the hedging is occurring with respect to an asset that they have. That is probably the issue for you all to consider about HTA and where things have gone. I think a lot of the problems have been resolved by the Act for the large people, but the question becomes what does it do for someone who doesn't meet those income requirements or--excuse me--asset requirements.

And with that, hopefully I've stayed under my time frame, and I hope I wasn't too lawyerly for you.

Thank you.

CHAIRMAN NEWSOME: Okay. Thank you, Mr. Counsel.

Before we go to our next presenter, I want to take a few minutes to discuss this topic, recognizing that it's been a while since it's been on the agenda. So what I would suggest, even though certainly we invite dialogue today, but I would ask you to go back to your organizations, look at the things that have been talked about today, and just make written suggestions to the Commission about your recommendations on how we could move forward on these topics.

So I know when we were having the discussion several years ago, there was no one more active in this than the National Grain and Feed Association. Certainly, even today, you still have comments about it. Tom, I know that you guys have prepared something, and I would invite you to make whatever comment you need to make today.

MR. COYLE: Okay. Well, I will make them very brief, because everybody has a copy of our written comments.

I appreciate your comments, Mr. McCarty, about the fact that legal clarity is important, because, for us, it's really been the better part of eight years that we've wrestling with this, and I can say today that the market continues to change, contract offerings continue to change, and we continue to struggle with the legal issues and the flexibility that we're adding to contracts.

I show a picture here. We were looking--in fact, we had a commission at one point that was for a bright line task force, we called it, because there used to be quite a bright line between a cash forward contract and a futures, and then we started providing different kinds of flexibility, and from this bright line came something like this that had all kinds of different kinds of contracts, some with farmers, some with elevators, but as you start adding levels of flexibility, we ourselves got a little lost on what's appropriate, what's not appropriate.

The lack of clarity actually makes it much more difficult for us and others in our industry to create newer contracts. We are very encouraged by the recent rulings that appear to first recognize this relationship, this contractual relationship, between an elevator and a farmer, and also to appear to recognize a broader exclusion for cash forward contracts, which we support.

At this point, I guess our real issue today is we're wondering if it wouldn't be helpful to try to further narrow this or clarify these issues, if it wouldn't be possible to have some kind of interpretive statement. Again, after eight years of various rulings from the CFTC and from the courts, that may be able to--even if it's in the form of core principles, that these type of contracts are or this certain environment is acceptable, the contract terms are acceptable. We struggle with the idea that no matter how you write a contract, someone can use a contract improperly, which was not intended, which again gets you into this area of a futures contract.

So while we would like to see something that's very clear and no look-back, that the terms in the contract are understood, they're accepted as being legal, as being not challengeable, because what happened in this case back in '95, '96, is that there was significant losses, and so people looked for ways to identify when something is off-exchange, which means it is void, which means there isn't a contract, and then someone is held with a hedge contract that isn't going to be honored, but somehow to avoid that risk.

It appears from the recent rulings that we're moving in the right direction. We're very encouraged by that, and so we certainly want to be part of the dialogue to try to get to the point where we can put this behind us.

CHAIRMAN NEWSOME: Okay. Thank you, Tom.

Sharon, did you want to make a comment?

COMMISSIONER BROWN-HRUSKA: I thought I should make a few comments given what I had actually written about these particular contracts, and I actually would include sort of broadly the trade options and the hedge-to-arrive cases together in my thinking about this and going forward.

I think that these type of contracts really illustrate the challenge that we face when the promotion of market solutions and market innovation starts to rub up against our role of protecting the markets and protecting market users. How to reconcile these goals is the issue we face, even more in agriculture where efforts to protect participants sometimes extends into protecting participants from the markets that they created and that they use.

Walt's presentation made us aware of the positive changes that took place in financial markets beginning in the late 1990s when both Congress and the Commission recognized that such markets do not require the level of supervision traditional applied to the exchange-traded markets due to the sophistication or commercial expertise of the participants in these markets and took a number of actions to address this, culminating in the passage of the Commodity Futures Modernization Act of 2000.

Well, many of the positive changes wrought by the CFMA really--Pat actually mentioned this, have not been extended to the agricultural derivatives markets and the over-the-counter market. This is reflected in the in applicability of the relief provisions of the Act, including 2(h)3 and 2(g) to the agricultural commodities or transactions. It also extends in some cases--in these hedge-to-arrive cases in particular, it appears to me if you look back over the history of the CFTC in dealing with these cases, we sometimes acted to impede the introduction of innovative financial tools to the market, to agriculture.

Now, as Pat just outlined, the Commission last November issued three decisions involving the legality of innovative marketing tools in the ag sector, Grain Land Cooperative, Competitive Strategies, and Cargill. The issue in all three cases really concerned whether the contracts at issue were legal cash forward used for merchandizing purposes or whether they were illegal futures contract in the Grain Land and Competitive Strategies matters or illegal options in the Cargill matter. In separate opinions, I expressed my concern with the Commission's adherence to a legal approach for evaluating contracts that lacked clarity and legal certainty and thereby discouraged innovation in the ag market.

Now, I just want to explain what I mean. The standard that the Commission employs in these cases has its origins in some previous cases, the

1979 Stovall case and 1982 opinion in Co-Petro. What they rely upon historically is this kind of unpredictable interpretation of whether the parties contemplated delivering in their dealings with each other. To surmise whether the parties anticipated delivery at the time they entered into their hedge-to-arrive transactions, the Commission looks back to the future, that is we look backward and selectively count the deliveries that actually took place.

The problem with this approach, and this is something that the courts have recognized, and Judge Easterbrook in the Seventh Circuit reminded us that for contracting purposes, "it is essential to know beforehand whether a contract is a futures or a forward." Compounding that is our adherence to an approach that looks at an exhaustive catalog of futures conditions and actions that are present during these transaction. It is called the facts and circumstances approach or the totality of circumstances approach, as Pat mentioned.

I submit in my separate opinions that

that approach itself does little to clarify for the market what factors mattered the most and create the kind of undesirable uncertainty that gave rise to so many of the post-contractual lawsuits that we actually saw in the nineties in this area. My concern generally is that our application of this standard may result in formal forward contractual relationships being wrongly classified as futures and therefore discouraged.

I believe that the Commission's approach doesn't properly account for commercial reality. For example, in the Competitive Strategies decision, which I dissented on, a key innovation of the contracts offered by Great Plains enabled delivery to a third-party elevator at the option of the farmer. Well, the Commission insisted that the parties had to prove a connection between deliveries to third-party elevators to Great Plains contracts. My view is that this narrow interpretation of what constitutes delivery combined with the parties' failure to maintain adequate documentation led the Commission to dismiss the deliveries as merely coincidental and to declare the contracts illegal off-exchange futures contracts. The result is to legally discourage an innovative financial tool that allowed farmers to lock in a forward price while also enabling flexibility in delivery.

I believe that the Commission can take action to bring clarity to contracting practices in the ag market so that innovators understand where the boundaries are between what are legal cash forward contracts and what crosses the line into the Commission's jurisdiction. I strongly support the Commission taking another look at the ag trade option regulations to see whether a compromise can be reached that would balance producer concerns, the needs of the elevator industry, and the regulatory obligations of the Commission so that agricultural trade options could truly come to the market. I also believe that innovative forward contracts like that employed in Cargill's POC contract and Competitive Strategies' cross-country hedge-to-arrive contract should be encouraged by the kind of legal certainty that we have afforded to the financial industry. In my view, our goals of promotion and protection can be accomplished by providing clear guidance on where we will draw the line between futures and physical transactions and by adopting a less prescriptive approach.

I also would add that I firmly believe that education and disclosure can also make a significant contribution toward furthering our goals. For example, I believe that the requirements and the risks associated with these kinds of contracts have to be properly documented and accurately disclosed.   I suspect that when that does not occur, the Commission will initiate strong action, as we really have in the forex area. My making clear in our rule-makings and in our enforcement actions and in our adjudicatory decisions the lines of our determination of what constitutes an illegal contract, we provide importance guidance to the industry that will free it to innovate and provide the variety of contracts that will benefit farmers, merchants, and consumers.

Thank you, Chairman.

CHAIRMAN NEWSOME: Thank you, Sharon.

Again, I think it's obvious throughout this discussion that while everyone's goal is legal certainty or to provide as much legal certainty as possible, there continues to be differences of opinion on how to address that. I think the main point for members of this committee is that the Commission is open the addressing it and wants to address it, and those are areas in which we need your support and counsel, and we could probably spend two days in this room talking about these very topics, and that is why I suggested that those of you particularly who haven't thought about this topic in some time, go back, discuss it with your members, your boards, and submit thoughts to us in writing about how the Commission can properly move forward to provide the types of legal certainty that the markets and the businesses need.

Yes, sir.

MR. CASHDOLLAR: I think it would be

useful if we could get the papers on HTA. I don't think we have them in our folders.

CHAIRMAN NEWSOME: If they're not up there, we'll sure get them for you.

Neal.

MR. GILLEN: I just want to say I welcome the attitude I hear on this issue, and not to be a heretic, but I just want to advise that what we do in cotton, we don't have situations that you have in the grains where you have a lot of innovations. For example, I just had a call this morning. In our model contracts, we do not produce--we have delivery as a fixation on the futures exchange where you have delivery of the harvest. We do not permit a producer to roll over into the crop year. Basically, we protect the producer, and that is something that has to be considered.

So it seems very narrow-minded and what have you, but I found that we inserted this provision four or five years ago after there was an advisory issued by the Commission when the first hedge-to-arrive cases arrived, but I think it has been found to be very prudent on our part, because it produces a lot of money by facing the music when they should face it, not carrying it on into bankruptcy over and over into a new year.

CHAIRMAN NEWSOME: Thank you, Neal.

Any other comments or questions that anyone might have?

Well, thank you. Again, I would encourage you to get us your thoughts about how we can appropriately move forward. I can assure you that the Commission would like to do so, and even though I won't be there, I know Sharon and Walt very well. This topic is important to both, and so anything that we can do to provide certainty, certainly we want to do.

PRESENTATION BY ROSS DAVIDSON, USDA/RMA

CHAIRMAN NEWSOME: Next on our agenda, it's always good to have Ross Davidson, Administrator from the Risk Management Agency with us, and we've asked Ross to provide an update on the new livestock products.

Ross, we're glad to have you with us this afternoon.

MR. DAVIDSON: Thank you, Mr. Chairman.

I've been listening with a lot of interest to the discussion here and particularly your comments with regard to the innovative risk management tools, and certainly we've talked about these within a context, but there is a whole different context within which innovative risk management tools are being developed for agricultural producers, and that's in the crop insurance program.

And I will address the assigned topic, the livestock products, but I should mention also that we have a number of revenue products that reference their prices on the exchanges and provide innovative risk management tools such as crop revenue coverage and revenue insurance and others, and those products are in the process of evolution, but they've been very popular with agricultural producers and are providing some financial innovation outside of the exchanges.

There has been some quite a bit of interest in the Risk Management Agency's involvement in price risk protection with regard to livestock that emerged basically after Congress gave some authority to the agency to consider new products that the market might bring to us in the clothing of insurance. Two of those products that have come, livestock risk protection and livestock gross margin, basically reference off the exchange prices and cover a broad range of what might be called contracts, but we call them policies, for relatively similar time periods and relatively similar classes of livestock. Both of these products are not currently selling, although they were quite popular, and we found out why they were through BSE as well as an adverse margin movement that took place. We have suspended, but we are retooling those products and intend to have them reproduced sometime in the fall.

The livestock risk protection product uses futures contracts on the Chicago Mercantile Exchange to set rates, provides coverage for swine, fed and feeder cattle, and protects against a price decline, and no other peril is included. Typically, our insurance products include pretty much all natural perils. This is just price decline, and it will be available when reinstated in a number of states. The board of directors has approved it for swine in Illinois, Indiana, Iowa Kansas, Minnesota, and Nebraska, Oklahoma, Texas, Nevada, Utah, and Wyoming, as an example, and fed cattle for Illinois, Iowa, and Nebraska, and feeder cattle for Colorado, Iowa, Kansas, Nebraska, and a number of other states. And we've been advised that at our next board of directors meeting for Federal Crop Insurance Corporation that there will be a request to expand these even further in anticipation of these products being available in the fall.

The livestock gross margin is available for swine, and it references or uses futures contracts from the Chicago Board of Trade and the Chicago Mercantile Exchange, for the CBOT for corn and soybean meal, the CME for hogs, and it ensures the difference between swine price and feed costs. So there is a margin protection that's embedded in this product. It's sold monthly. It's only available in Iowa, but there is a move to expand that as well.

There has been some relative--quite a bit of interest for these products to have been as young a as they were, and several hundred contracts were sold in the early parts of their availability. We have been working with the submitter of these contracts to make some changes to them to deal with the exposures that we found. One of our requirements for these insurance products is that they be actuarially sounds, in other words, that the prices for the contracts be set in such a way that the corporation can basically recover whatever benefits may be paid out over a period of time and found that in the BSE incident, the market became so volatile and exposed some flaws, frankly, in the design of the program that it created some opportunities that shouldn't exist in the context of insurance.

So we're making some changes at the direction of our board of directors or having the submitter and the owner of this product make changes before they will be allowed to be reinsured again in the crop insurance program, things like adding language to prohibit offsetting positions, to permit suspension of products due to extraordinary events, such as BSE, a sales period limited to starting after the validation of price and rates on the last day of the price discovery period and ending on the following day at 9 a.m. central time. It was the stale pricing risk involved in the original design of these products that was exposed by the BSE, and then also instituting some limits on premium volumes, volatility.

As you know, as we all know here, the cattle and swine markets have been volatile, and RMA will continue to monitor these markets before allowing sales even when the products are allowed to be sold. We'll have certain market volatility limit, up and down, and controls on when the products will be available for sale. We also are very conscious of the potential for future market volatility resulting from some uncertainly with regard to cattle markets, particularly the BSE, testing also the soybean market and things of that nature. So we're trying to make sure that these programs are, as we call them, actuarially sound as they as they go forward.

I believe personally that it is really critical that we coordinate very carefully with these so that we don't criss-cross too much and particularly use your expert advice as these products evolve.

I hope that's useful.

CHAIRMAN NEWSOME: Thank you very much, Mr. Administrator. We're always glad to have you at the Commission, and, Alan, always good to have you back at the Commission as well.

CLOSING COMMENTS

CHAIRMAN NEWSOME: Before we adjourn, I thought I would ask my colleagues if they have any closing comments they would like to make and then give everyone else that same opportunity.

Walt.

COMMISSIONER LUKKEN: I would just note that all these discussion matters are pretty weighty issues that we're dealing with over a long-term period of time here at the Commission, and certainly as your organizations give thoughts on this, to please submit them to us, come in and talk to us. This was not as much to get answers today as to ask the big policy questions of you and to have you think thoroughly about these issues as we go into a reauthorization year.

Obviously, Congress is going to have some views on some of these subject matters we brought up. As I mentioned earlier, you know, 2000 occurred without them doing much in the area of legal certainty for cash forward and cash contracts and HTA cases. This might be an opportunity if, indeed, these groups are on the table and want to do something, to talk to us, talk to Congress about it, and provide us guidance in that area.

So I would encourage you all to do that.

I look forward to talking with you individually in the future, and thanks again for participating.

I would also like to note Andy Morton is in the audience from the Senate who suffered through the entire meeting without falling asleep, but we appreciate him, as always, coming down to visit.

CHAIRMAN NEWSOME: Commissioner Brown-Hruska.

COMMISSIONER BROWN-HRUSKA: Thank you so much.

I just wanted to second Walt's comment. I think one thing that we have here at this Commission, and it's been encouraged by Chairman Newsome, is robust discussion about these very important issues, and they're important to all of you for a variety of reasons, and we want feedback and we want your views on these issues going forward. Some of these issues, I think, you know, we can deal with getting that feedback ourself. I think we're committed to, if we get it from you at the Commission, we're committed to doing as much as we can about it here to get to resolution of some of these issues without necessarily carrying it to the level of Congressional deliberation.

So while I would agree that we encourage you to go to Congress if you have an issue with us, I'd also first encourage you to come to us and let us know what your concerns are, and we will do everything we can to resolve it without legislative intervention or action. I think we are responsive to you and to Capitol Hill, and we're more than happy to continue this dialogue and this interaction.

Thanks.

CHAIRMAN NEWSOME: Thank you, Sharon.

Any kind of closing comments or thoughts by any of the participants of the committee?

Seaver?

MR. SOWERS: Well, I again just thank you for having us. I really appreciate the opportunity to be here. I also, while the Administrator is here, just wanted to say on behalf of the banking community, you will probably not be surprised to find out that the livestock programs are very popular with the bankers. So we definitely look forward to seeing those programs come back on line.

Just a quick question, and I hope this isn't putting the cart before the horse, but assuming the program comes back on line in good shape and particularly with the livestock risk protection program, what is the process for going beyond the pilot program? Is it your board that makes that decision? Does Congress have to give you new authority or how does that work today?

MR. DAVIDSON: Well, our board of directors has the delegated responsibility from Congress to determine when a pilot is finished. Typically, we're allotted crop commodities. Pilot have taken about three years to run their course before we evaluate whether or not the pilot has validated the actuarial soundness of the program and whether or not it's meeting the producers' needs. These are a little different in that you have a lot of cycles taking place in one year as opposed to just one cycle for a commodity, and as a result of that, our board of directors has decided that in a year, we will take a look at these programs after they're reintroduced to determine whether or not they ought to be moved to national status.

I will say that the banks as well as the insurance companies and the reinsurance companies that are the capital market participant in this program, I think you'll find that they have a stronger interest after they take on some of these risks, particularly the insurance companies, that they'll be much more interested in purchasing commodity contracts to cover their risk. The aggregators of these risks, I think become very important customers.

CHAIRMAN NEWSOME: I think that's a good point, Ross.

I want to give credit where credit is due. I've had the opportunity to chair this meeting, but Commissioner Lukken and his staff are responsible for the development of the agenda and for scheduling everything as it has been today. I thought it was a very good meeting, and thank you, Walt and Erin and Dave and Elizabeth, all those involved in the meeting.

Any other comments by the group?

Yes, sir.

MR. METZ: I certainly want to thank you. I think this was an important meeting and important to hear what our colleagues have to say in this industry. The American Soybean Association does not have a position right now, but obviously after listening to comments, we'll go back along with industry partners and forward our comments. Again, for us, the primary issue is transparency in the market and price discovery liquidity in the market. As you know, almost half of the soybean are now raised in South America. This gives us great concern.

I was in Europe a couple of weeks ago visiting with some of the other oil seed countries around the world. They obviously don't feel that the Chicago Board of Trade is right now meeting their needs. So as those needs are met, we want to make sure that our markets remain very liquid, very transparent as well, and I think these are some of the issues that we look forward to visiting with you on.

The other issue, of course, would be someday when soybean rust does hit this country, that we're prepared for these market moves. They pretty much fluctuate in a large way with the possibility of a terrorist event upon our grain markets and to make sure that we have the proper things in place so that the markets don't fluctuate, and we look forward to further comment.

Thank you.

CHAIRMAN NEWSOME: Thank you, sir.

Any other comments?

Jim.

MR. MILLER: On a little lighter note, Jim, on behalf of my members, I just want to thank you for your leadership during your tenure with the Commission and particularly as chairman. You've been a great individual to work with. What you've brought to the job have allowed us all to have a little better understanding of the weighty issues that the Commission faces. That does raise one other issue though. I noticed your organizational chart is now going to have one more blank in it. We do have some pretty significant issues and not only the ones talked about today with reauthorization, and it seems to me that we're going to overload two other individuals greatly with your departure, and I'm just wondering if you have any perspective on that.

But certainly I want to wish you well in the future with your new opportunity.

CHAIRMAN NEWSOME: Well, thank you much, Jim, for those kind words. I would just say that Sharon and Walt are both workhorses. They're up to the load.

Seriously, the Commission has operated with two before and has done so successfully. That said, I think there's no question that the Commission operates best when all the seats are full, when you've got a dialogue of five commissioners that are all bringing different thoughts and ideas to the table, and I would subject that on behalf of your organizations, you know, you should encourage key members of the authorizing committee, the White House, that having these seats are important to you, and hopefully they can get together and agree upon nominees and move them forward as quickly as possible.

Yes, ma'am.

MR. GRABOWSKI: I'm with American Agri-Women. I've been pretty quiet, but I would like to thank you for including our organization among the representatives here. We are primarily a producer of all sorts of agricultural commodities, and while we do not have a position on this particular issue, we will discussing it and with all things, because we're a diverse membership. We may or may not be taking a position, but we thank you very having us.

CHAIRMAN NEWSOME: We welcome to the committee and certainly welcome the input that you and your organization may have.

MS. GRABOWSKI: Thank you.

CHAIRMAN NEWSOME: Anything else?

Well, I would simply say I think it's fitting that ag brought me to the table and my last public meeting is the Ag Advisory Committee. It seems that for some reason I continue to get further away from home and further away from my roots as an aggy. I think it is somewhat strange that the only exchange that doesn't trade any agricultural contracts is the one that I'm headed to, but obviously energy is very important to everyone sitting around this table and the industries that you represent. So please consider me your ag voice at the New York Mercantile Exchange, and as issues arise or you need an audience with regard to energy and/or metals, please feel free to call me just as you have over the last six years.

Anything else?

If not, this meeting of the Advisory Committee is adjourned.

[Whereupon, at 4:48 p.m., the meeting adjourned.]