COMMODITY FUTURES TRADING COMMISSION

AGRICULTURAL ADVISORY COMMITTEE

PUBLIC HEARING COMMITMENTS OF TRADERS REPORTS,

THINLY TRADED MARKETS, AND BASIS AND CONVERGENCE

IN THE GRAIN MARKETS

Washington, D.C.

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ANDY MORTON

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P R O C E E D I N G S

(9:37 a.m.)

COMMISSIONER DUNN: Good morning, ladies and gentlemen. I am Chairman of the Agricultural Advisory Committee, and I want to welcome you all to Washington, D.C., at the beginning of this most lovely and warm month. We have record triple-digit figures with the temperature today, so I appreciate you all getting here. It is air conditioned in here like the old movie theaters, so just plan on spending the day.

This is the thirty-first meeting of the Commodity Futures Trading Commission's Agricultural Advisory Committee. For many of you, it may be your first advisory meeting. It is certainly my first as Chairman, and I want to thank Chairman Jeffery and my fellow Commissioners for selecting me for the honor of Chairing this Committee.

For a little history, the Ag Advisory Committee was first formed in 1985, and has been the Commission's longest-standing advisory committee. It was created to advise the

Commission on issues affecting users of agricultural, commodity markets, and it is a valuable communications link between the Commission and the agricultural community.

Given the increased complexity and diversity of participants in agriculture markets, the Committee is an excellent venue to exchange information and discuss issues that affect the operations of agricultural commodity markets. During my tenure, with the blessing of the U.S. Senate and our President, hopefully beyond this particular meeting, I would like to find a way to make this Committee as relevant as possible for all of us.

For this meeting we originally planned to cover two issues, potential changes to the Commission's Commitments of Traders Reports, and the economic markets' implications of thinly traded price discovery markets. To this, after many inquiries from producers, we have added a brief discussion on the weak basis and lack of convergence that is occurring in some of the grain markets, particularly wheat. This marks a change in our agenda that was published in the Federal Register, and I wish to note that we will be covering it as a new item of business. The purpose will be to review the problem and engage the Committee's interest in pursuing it further.

We are here today to get your input and try to answer questions that you might have. Now I would like to recognize the Chairman of the CFTC Reuben Jeffery and my fellow Commissioners, Walt Lukken and Fred Hatfield.

COMMISSIONER JEFFERY: Thank you, Mike, and I assume in keeping with your movie theater theme with the air conditioning here, you will be serving the popcorn as well.

(Laughter)

COMMISSIONER JEFFERY: At the outset I would like to thank Mike and his staff for organizing this hearing, and most importantly, all of you for taking the time to be here today, considering particularly the elements and the fact that it is summer, and there are any number of other things we could all be doing.

The topics today here are extremely important to the work of the CFTC, and most importantly, to the agricultural community. As you are aware, the CFTC has a long-standing commitment to vibrant, sound, and reliable agricultural futures and options markets. I am equally sure you recognize the profound changes taking place, in the overall futures markets. These include new types of futures markets such as ethanol and South American soybean futures, the growth of electronic trading, including the launch of side-by-side trading, coincidentally, today in certain major historically agricultural product oriented exchanges, as well as changes in technology and government foreign policy. These changes raise issues for both the agricultural community and the CFTC.

Today, two principal issues are going to be addressed: the role of the CFTC's Commitments of Traders Report, about which we have heard from many of you prior to this hearing and whether or not, we should adopt changes to that report to reflect changes in the market; and second, the economic and policy implications of low-volume, less liquid markets and their effects on the price discovery function.

As we move forward to address these issues, I am hopeful that this Committee will live up to the advisory of its title in every way possible. We encourage your active participation in today's proceedings, and any follow-up comments you might have for the record will be welcome. The Agricultural Advisory Committee can play a key role as a forum for maintaining an ongoing dialogue between the agricultural community and the Commission.

I want to thank you again for your attendance, and I look forward to a productive and active discussion today. Thank you again. Commissioner Lukken?

COMMISSIONER LUKKEN: Good morning. I just wanted to join my fellow Commissioners in welcoming everybody here today for the Ag Advisory Committee meeting. I wanted to congratulate Mike Dunn for assuming the role of Chairman of that Committee. He is going to do a great job. I was happy to serve as Vice Chairman for a bit under Chairman Newsome, so I know the difficulties and how important this Committee can be in determining policy for the agricultural community as it relates to the futures markets, and I am certain Mike is going to do a great job in that role.

I want to give a special welcome to those who have had to travel here, and those in the ag community, some old friends, some new friends, so I am looking forward to hearing the spirited debate this afternoon and this morning.

I would say that in particular it is a great agenda. I am particularly interested in this morning's topic on the Commitments of Traders Reports. This has a long history at our agency as we will hear shortly. It is something though that has become an important transparency item for the marketplace itself and something that is deserving of review, something that has not been reviewed in a while,and we are going to take a look at it from top to bottom to make sure that it is working as intended.

So I look forward to the debate and hearing the presentations this morning. With that, I will turn it back over to the Chairman of the Ag Advisory Committee and let him introduce our next Commissioner.

COMMISSIONER DUNN: Just so you all know, they are all to the left of me because of the way the microphones work. They are not philosophically to my left.

(Laughter)

COMMISSIONER DUNN: Fred Hatfield, who came on board the same time I did. Fred?

COMMISSIONER HATIFLED: Thank you, Commissioner Dunn. I want to welcome you all here as well. I want to thank Commissioner Dunn and his staff for organizing and putting this hearing together. We like to call Commissioner Dunn "Farmer Mike" here at the CFTC. He has symbolically, I think, chosen today to have this hearing because, as Chairman Jeffery said, today in Chicago, Kansas City and Minneapolis we have side-by-side electronic trading with floor trading for the first time.

Having grown up in the Central Joaquin Valley of California, agriculture to me sure has gotten a lot more complicated than I recall it growing up. When I look at today's agenda, and we are talking about Commitments of Traders Reports, thinly traded markets, and basis and convergence in the grain markets, you have to have economists, counselors, and surveillance experts to figure that all out. But it is necessary I think not only because of the futures markets, also because just the sheer growth in the commodity markets.

Everything seems to be overshadowed by the talk about energy and the financial futures markets, but when you look at the ag commodity growth just in the last 5 years, ag commodity growth is up 60 percent, 25 percent in the last year alone. So the growth is phenomenal, and some of that growth is feeding some of the issues that we are here to talk about today. So I appreciate the fact that we have the expertise and the backgrounds of the people who are here to help us address these issues.

COMMISSIONER DUNN: Thank you very much. I would be remiss if I did not note the void we have in the Commission. This is the first public meeting we have had since the resignation of Commissioner Sharon Brown-Hruska, and when I came on and Fred came on she was the Acting Chair and was a great mentor for me and good friend, and we will miss her. This is the first time we are having a meeting without her, and you guys are a lot uglier.

A few logistics before we get to the introduction of the members of the Advisory Committee. Today's session is being recorded. A transcript will be made available to our website. The session is also being broadcast live via teleconference and via videoconference to CFTC

Regional Offices in a listen mode only.

You will notice that we have a roundtable session, but given the expansion of the Advisory Committee and the size of our room, we are having what we call a modified roundtable format here, and I appreciate you all working with this little handicap that we have.

When you come to the table to use the microphones or if you are speaking from the floor microphones, after you are recognized, I would like you to give your name and who you represent. We do have a court reporter here, as I have said, so it is important that you do identify yourselves every time before you speak. If the volume needs to be adjusted, we have technicians who will take care of that. Just speak directly into the microphone and I think you will be all right.

All questions and comments must be into the microphone. That will assist our court reporter and those listening via telephone and video conference. Questions and comments must be limited to 5 minutes or less, and we may shorten the time limit if it becomes necessary to ensure that everyone has the opportunity to speak and be heard.

I would like the members of the Advisory Committee to please stand and identify themselves as to who they are and who they represent, and I think we will start over here.

MR. ZERZAN: I am Greg Zerzan with the International Swaps and Derivatives Association.

MR. GAINE: Jack Gaine, President of the Managed Funds Association.

MR. GOULD: Eldon Gould, with the Risk Management Agency of the Department of Agriculture.

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

MR. STEVENSON: Randy Stevenson with R-Calf USA.

MR. BAIR: Jim Bair, North American Miller's Association.

MR. MARTIN: Good morning. Gary Martin with the North American Export Grain Association.

MR. VITALIANO: Peter Vitaliano with the National Milk Producers Federation.

MR. WATSON: I'm Leroy Watson with the National Grange.

MS. KINNAIRD: Jula Kinnard, National Grain Trade Council.

MR. CLARK: Good morning. I'm Fred Clark on behalf of the U.S. Rice Producers Association.

MS. SPURGAT: Jennifer Spurgat with the National Association of Wheat Growers.

MR. WESTON: Ryan Weston, American Sugar Alliance.

MR. RUTHERFORD: John Rutherford, International Dairy Foods Association.

COMMISSIONER DUNN: Are there other members of the Ag Advisory Committee?

MR. KIRCHHOFF: I'm Rick Kirchhoff, with the National Association of State Departments of Agriculture.

MR. JACKSON: Tony Jackson, with the Independent Bankers.

MS. PAUL: I am Beverly Paul, with the American Soybean Association.

MR. GILLEN: I am Neal Gillen, American Cotton Shippers Association.

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

MR. MITCHELL: Larry Mitchell, American Corn Growers Association.

MR. SHAEFFER: Larry Shaeffer, Renewable Fuels Association.

COMMISSIONER DUNN: Are there any other members?

MS. LUDLUM: Kelli Ludlum, American Farm Bureau Federation.

COMMISSIONER DUNN: We also have a couple of other special guests I would like to recognize. One is someone who had been previously a member of the Advisory Committee, the Honorable Dallas Tonsager who is on the Board of Directors of the Farm Credit Administration.

We have from the Hill representing the

Senate Agricultural Committee, Andy Morton. Is there anybody else from the Hill?

Fred had talked about the beginning of some exciting things happening in Kansas City, and we have two other special guests, the gentlemen who are responsible for running both the Kansas City and the Minneapolis Grain Exchanges. Jeff and Mark, if you will stand up and identify yourselves.

MR. BORCHARDT: I'm Jeff Borchardt, with the Kansas City Board of Trade.

MR. BAGAN: Mark Bagan, with the Minneapolis Grain Exchange.

COMMISSIONER DUNN: Thank you, gentlemen, for being here today.

Our first item on the agenda is the Commitments of Traders Reporting Program. The weekly Commitments of Traders Reports provides market participants, researchers, and the public valuable snapshots of each Tuesday's open interest of all futures and options markets in which 20 or more traders hold positions that meet or exceed

CFTC's Large Trader Reporting Level.

On June 21st, the Commission published in the Federal Register notice that it was undertaking a comprehensive review of the Commitments of Traders Program to see public comment and review. Chairman Jeffery in my opinion has done an outstanding job of trying to increase transparency in how we operate at the Commission with a number of public meetings and comments in the Federal Register. I do not know if he knows what he has opened, but I am told we have received a record 4,000 comments already on the Commitments of Traders, and we will be reading all 4,000 of them.

(Laughter)

COMMISSIONER DUNN: This period closes on August 21st for comment. As I noted earlier, a transcript of today's meeting regarding Commitments of Traders Reports will be included as part of the document for the review of the Commitments of Traders Reporting Program.

We will begin the discussion with a

presentation of the Federal Register's release from John Fenton and Don Heitman from the CFTC's Division of Market Oversight. John is in charge of our Commission's Market Surveillance Program, and Don is one of our senior legal and policy specialists for agricultural markets.

We will then have a series of 5-minute views from the field in which Dave Lehman of the Chicago Board of Trade, Dan Brophy on behalf of the National Grain Trade Council, Greg Zerzan of the International Swaps and Derivatives Association, Tom Coyle on behalf of the National Grain and Feed Association, and Fred Clark, on behalf of U.S. Rice Producers Association. I will not reintroduce these gentlemen when they come forward. Their bios are in the information that you have received.

Following that, we will open up the floor for a modified roundtable discussion from members of the Ag Advisory Committee, and then open it up for public comments for the members of the public who wish to talk on the subject matter.

Is Nicole McNair here? Nicole from my office is available for the public members who wish to speak on this. We would really like to find out who you are, so if you will sign up with Nicole, and we will schedule you to speak publicly.

With that I am going to turn it over to John and Don.

MR. FENTON: Thank you very much, Commissioner Dunn. I will give some background of our Large Trader Reporting Program which we use in our market surveillance, and it is the raw material that goes into our Commitments of Traders Reports. Don, who is the author of the Federal Register notice, and we have gotten a lot of favorable comments for how well-written it was, will go through the history of the evolution of the Commitments Report, how it has changed over time and how we have tried to keep it current and as timely as possible, and useful to market users.

I will start by explaining our Market Surveillance Program. That is in the first instance why we get large trader reports. The federal regulation of commodity markets started back in the 1920s. In 1921, the Grain Futures Act was passed, and I think it is fair to say the primary motivation of the passage of the Grain Futures Act was the sense that futures markets, the grain markets, were subject to manipulation. In fact, from available records during the 19th and early part of the 20th centuries, there were fairly numerous instances of manipulation. So the Grain Futures Act was passed, and within a very short time, I think within a year or two of the passage of the Act, there was some form of large trader reporting instituted. Don will go through this, but shortly thereafter there was an attempt by the agency to provide information on the users of the market.

Large trader reporting was motivated by the observation that to properly do surveillance on a market you need to know who has the large positions in the market and market power as a result of large positions, so that is why we get large trader reporting. We are looking for concentrations of positions that could pose a threat of squeeze or a corner, large relative to open interest, and large relative to potential deliverable supply.

We have market economists who are assigned to specific markets. Their jobs are to become experts in those markets. They get these daily reports, and I will explain in a bit how we get them, but they look at these reports every day to see who has positions in the markets and how they have changed over the previous day. They are comparing those positions to other factors in the market such as deliverable supply. They are looking at price relationships which can be an early indication that there is a problem developing in a market, basis relationships which we are going to talk about later today, and spread relationships tend to become distorted when there is evidence of a manipulation. Our economists also follow the fundamental factors in the market to understand what moves the market and what factors are at play in the market.

As the Commission knows, we present usually three or four markets at weekly surveillance meetings. They may be markets that we are concerned about, or they may be just markets for which there was some interesting development during the week that we want to keep the Commission apprised of.

If there is a problem in the market, we do a number of things. One, we are working with the exchange. Exchanges have a self-regulatory responsibility to police their own markets, so they are supposed to do surveillance. They are very close to the market. They have great access to expertise at the exchange, so we take full advantage of their knowledge and work with them.

Some of the things we do when there is a problem is we contact traders that we are concerned about and other traders who can provide us information to start what we call a jawboning process which is to talk to traders to find out what their intentions in the market are, to express concern of the Commission if in fact we have a concern, and just to sort of talk our way through what could be a problem or a congested expiration. If we are not satisfied with the results of that process, we can issue warning letters. It is a letter that more formally conveys to traders the concern of the Commission about an expiration and that they have a responsibility to make sure that their trading does not result in a manipulation of prices.

The Commission has broad emergency powers. We can intervene in a market. We are very loathe to do that. It is not by any means a tool that we use frequently. I think in the entire history of the Commission we have had four emergency actions, and I think only three of the four were related to market problems.

If at the end of an expiration we feel like there is evidence that a trader may have either attempted or actually manipulated the market, we will refer that to our Division of Enforcement and they will then proceed to investigate it and take appropriate legal action against the traders.

So the raw material of our Market Surveillance Program is the Large Trader Reporting System. Every day we get reports from the Futures Commission Merchants, the brokers in the industry, for all customers who have positions above reporting levels. Reporting levels can vary from as low as 25 contracts for some of the smaller markets, to as high as 3,000 contracts for the Eurodollar market. Just as an instance, in the ag market, corn's reporting level is 250.

The goal of setting the reporting level is to get all positions that we potentially would be concerned about during an expiration, and also to get coverage of around 70 to 90 percent of the total open interest in the market. That coverage is useful to us in surveillance, but it is also useful for information that we provide in the Commitments of Traders Reports.

The Commission has I think leveraged this information, the large trader reporting information, quite successfully beyond market surveillance. Market surveillance was the original reason we get it. I am a little biased here, I think it is still the number-one reason why we get it, but we have made other uses of it. It is now being used in our financial surveillance in markets to protect against the financial risks in the market. Our Division of Clearing and Intermediary Oversight is now drilling down below the Futures Commission merchants to look at the customers of the Futures Commission merchants who may potentially pose a financial threat to the Futures Commission merchant, and ultimately to the clearinghouse.

We also use the large trader data in research projects that our Office of the Chief Economist uses. A recent example was that Michael Haigh did a study of managed money traders and their impact and their role in energy markets, and that has received quite a bit of attention.

Finally, the large trader information provides the foundation for the Commitments of Traders Reports which is why we are here today, and the intent here is to provide transparency to show more than just the open interest in a market, to show broadly speaking who holds that open interest. We know that it is a report that people find very useful. It is the largest hit that we get on our website. We would actually like for the commentors to provide more information on how it actually is used and how it is useful to people.

One thing that I actually did not list as one of the uses, but I think it is very important, is that it gives us the information which we can use to talk to, for example, congressional committees with confidence that we are on top of the market and that we know what is happening. And it is just as important to know when there is not a problem, namely, in the absence of information you might assume that there was a problem, often times knowing who is in the market and knowing the size of positions and the composition gives you comfort that in fact there is not a problem and that we can explain what is happening. Commissioner Dunn introduced Andy Morton, and I have spoken to Andy and others on congressional staff many times on energy and ag issues, and I know recently Chairman Jeffery spoke about hedge funds, and Commissioner Lukken recently spoke about energy markets, and I think they were able to speak with confidence partly because of large trader information that we have.

Generally speaking, we break down the large trader information into two groups, commercials and noncommercials. Commercials are traders who are engaged in business activities that they use futures markets to hedge. It includes the traditional commercials, producers, farmers, farmers of corn, for example, manufacturers, processors of agricultural and other commodities, dealer merchants who are intermediaries in marketing the commodity.

Then there is a relatively new category that is really an important part of the discussion today which is swaps and derivatives dealers. They are engaged in OTC activities which creates risks for them and they use the futures markets to hedge those risks. In a world where you have two categories, commercials and noncommercials, we have felt they fit better in the commercial category. But we know there are people who feel that that has caused a problem with the commercials category, and that is at least one of the reasons why we are soliciting comments.

Noncommercials are speculators and includes the managed money traders, commodity trading advisers, commodity pool operators, hedge funds. It includes floor traders and floor brokers. Then just any other speculator who has a view of prices and trades accordingly. The difference between these two categories which historically was considered to be important is that commercials are offsetting risk, and noncommercials are assuming risk in order to make a profit, hopefully.

The way we actually get the information we use to make these classifications is from our Form 40 Report, which all reportable traders have to file when they first become reportable, and then have to refresh every 2 years. There is a question on this report which asks the trader if they are engaged in activity that they use futures markets to hedge. If they indicate yes to that question, then they are asked to identify the role that they play in the market; are they a producer or a manufacturer, a dealer merchant, a swap dealer or something other than that; to tell us what futures markets they are commercials in, what futures markets they use to hedge, and what their risks are. So if they are a producer of corn and they use the corn market to hedge that risk, they would indicate that.

Commissioner Dunn briefly described the Commitments of Traders Reports, so I will go through this rather quickly. It is a snapshot of the market every Tuesday at the close of business. We publish it for any market where there are 20 or more traders who hold reportable positions at the close of business. This last Friday we just did a calculation. We did commitments reports for about

100 different markets, and I think that that is probably typical, so every week we produce a commitments report for 100 markets or so. It is released at 3:30 in the afternoon. It is available in long or short format. The short format is just a subset of the information that is in the long format. It is also available in futures only and in futures and options combined forms. In futures only obviously we are only showing futures positions, and in futures and options combined we show the combined positions in a futures equivalent basis. So options positions are adjusted and put on a futures equivalent basis. The reportable positions are broken out between commercials and noncommercials, and then the residual are nonreportable traders who, being nonreportable we really do not know anything about.

I am sure this is going to be very difficult to see even if you have paper in front of you, but this is actually the Corn Report for last Friday. The first column shows the total open interest in the market, and then it breaks it out between the various reportable categories. For the noncommercials it shows the long and short. In this case, noncommercials held about 300,000 long contracts and 87,000 short contracts, and that is outright exposure for those traders, and then there is a spreading category. So if a trader is long one month and short another month, that is considered a spread position and reported in the spreading category. Also, a position that is long futures and short options or short futures and long options is considered a spread position, and that is shown in the spread category.

Then the commercial category breaks out between long and short. We do not have a spreading category here because we assume that the positions when they are long and short may not in fact be spreads as they are not trades that are based on expectations of changes in the spread relations. They may be commercial positions that are offsetting exposures that are based on different months, so we just report it as either long or short. As I said before, this would include both the traditional commercials and also what we call the nontraditional commercials, including swap and derivatives dealers.

Then the total is all of the traders that are reportable, and then to the extreme right there is a nonreporting column which is the residual. Then we break it out into the percentage that those positions represent, and you can see that for the total reportable longs, they had 88 percent of the open interest, so we are meeting the goal of having 70 to 90 percent, and the total short was around 81 percent. Then at the bottom we have concentration ratios which show what the top four traders and the top eight traders hold as a percent of the total open interest.

With that, I am going to turn it over to Don who will walk us through the origin of the Commitments Report and how it has changed over time.

MR. HEITMAN: What I am going to do is

walk everybody quickly through what is in the Federal Register notice, requesting comments on the COT reports. The first thing that we will do is to go through the history. The COT reports trace their antecedents all the way back to the Grain Futures Act of 1922 which established the Grain Futures Administration within USDA. Their objectives included "to obtain for the use of Congress and the enlightenment of the public, authentic and comprehensive information regarding trading in grain futures." To the end, they imposed reporting and record-keeping requirements on the exchanges. Using that information, the Grain Futures Administration starting publishing annual statistics. The first year they published was 1924, and the statistics showed hedging versus speculative transactions in grain futures. When the Commodity Exchange Act came along in 1936, it broadened the jurisdiction and created the Commodity Exchange Authority and added a bunch of new commodities such as cotton, butter, eggs, and potatoes, among others, which were included in these annual statistics.

Over the years as new agricultural commodities were traded for future delivery, these were added to the Commodity Exchange Act and added to the Commitments of Traders reports -- soybeans, soybean oil, soybean meal, frozen concentrated orange juice, and livestock futures, among others.

Eventually, we switched over from these annual statistics to monthly COT reports, which were first published in 1962. The Commodity Exchange Authority characterized that as a step forward in the policy of providing the public with current and basic data on futures markets operations. So these monthly reports were compiled at the end of the month and published on the eleventh or twelfth day of the following month. The first one was published on June 13, 1962. Since that date, the reports have been continually evolving and improving, we like to think.

In April 1975 after passage of the CFTC Act, the Commission succeeded the Commodity Exchange Authority and we continued monthly

Commitments of Traders reports, but added all the new commodities brought under CFTC regulation by the CFTC Act -- coffee, sugar, cocoa, metals, energy products, and financial products, among others.

The frequency of the reports was increased. In 1990, the reports went from monthly to twice monthly; in 1992, to every 2 weeks; and beginning in 2000, they were published weekly. The timeliness also improved. In 1990, publication moved to the sixth business day after the “as of” date, and in 1992, to the third business day after the “as of date”. And the amount of information published was also increased. In the 1970s, we added data on numbers of traders in each category, a crop year breakout, and concentration ratios, and in 1992 we added options data.

The distribution was also widened. In 1993, the reports were changed from a paid subscription-based mailing list, to fee-based electronic access, and in 1995, we just put it up on the website freely available to everybody.

As the reports have evolved, the market has also evolved, and it is the interaction between the markets and the reports that gave rise to this Federal Register notice. One of the issues contributing to this was the elimination of the Series '03 reports, which happened in 1982. This action was intended to remove a paperwork burden on large traders. Large traders had been required to file Series '03 reports, for every large trader in the market. The Commission eliminated the Series '03 reports in 1981. The Series '03 reports had required each reporting large trader to classify their positions as hedging or speculation, and that was the source of the data for the COT reports up until 1981.

When the Commission eliminated the Series '03 reports, they actually suspended the COT reports for 18 months to allow computer changes, and when they began publishing again, they based the COT data on a different series of reports -- on the Series '01 reports filed by FCMs (brokers) and the Form 40 Statement of Reporting Trader that John mentioned earlier. There is significant difference in this new reporting mechanism, and that is that the Series '03 reports had classified trades as “hedging” versus “speculation.” When the COT reports resumed, reportable positions were classified as “commercial” or “noncommercial” based on the declaration in that Form 40 Statement.

The public perception is, I think, that “commercial versus noncommercial” in the current reports is report is essentially the same as “hedging versus speculation” in the pre-1982 reports. However, the markets have evolved a lot since 1982, so we are faced with the question: do the commercial versus noncommercial categories of today's COT reports appropriately classify trading practices that were not contemplated when the hedging versus speculation category was removed in 1982?

Another thing that contributes to this uncertainty is the speculative limits and hedge exemption rules. The Act and CFTC regulations require the Commission and the exchanges to impose limits on the sizes of speculative positions in the futures markets. Bona fide hedges are exempt from these limits, and the test for what is a bona fide hedge is whether a position is "economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise." Again, you have the "commercial" label. Both the hedge exemption rules and the standards for classifying commitments of traders positions refer to "commercial" positions.

The question becomes, how do you deal with the entry of "nontraditional commercials" into the marketplace? John alluded to this when he spoke about swap dealers. Since the early 1990s, various nontraditional commercials have requested and received hedge exemptions. The best example is a swap dealer that enters an index-based over-the-counter swap with a large pension fund. The pension fund is seeking to diversify its portfolio to include physical commodity exposure. The swap dealer makes a swap with the pension fund for the index, and the swap dealer now is in effect short the index. Thus, it has a big short exposure in these physical commodities which it seeks to hedge in the futures market. The corn, soybeans, and wheat positions in the swap dealer's portfolio of long futures are granted a hedge exemption from federal speculative limits and reported as “commercial” for COT purposes.

The effect on the COT numbers is significant. Pre-1991, both the long and the sort side open interest in the Commitments of Traders reports represented traditional hedgers -- producers, processors, manufacturers, and merchants. Today, a significant proportion of long-side open interest in several major physical commodity futures contracts is held by nontraditional hedgers such as swap dealers. This has raised questions as to whether the Commitments of Traders report can reliably be used to assess futures hedging activity by persons hedging exposure in the underlying physical commodity markets.

To address this issue of whether the COT reports are accurately reflecting what is going on in the market, the alternatives we discussed were: we could adopt changes in the way the COT data are presented in the reports; or we could stop publishing the reports if data anomalies cannot be resolved or we find the reports provide no public benefit. We put that second option in because we felt, in order to get the broadest possible range of comments, we should list the broadest possible range of options. It led to, among other things, people calling me, because I am the Federal Register contact person, and saying very unkind things to me on the phone. Also, the Secretariat asked me a question that I had never encountered before, which was "are we required to post on the website the comments that have profanity in them?" and I said "yes -- for purposes of full disclosure. I think it is extremely unlikely that any children are going to be going through the Commitments of Traders comments." I would like to say to anybody who is listening or reporting this, as it says on the slide, "Relax, calm down and take a deep breath. We are not going to stop publishing the COT reports." We will find some way to address the data anomalies.

As Commissioner Dunn said, we have received over 4,000 comments and it did, I think, achieve the result of showing us there is a great deal of desire on the part of the trading public for the information that is in the COT reports.

Based on the issues I have described, we listed a bunch of questions that we are hoping to get answers to from the public commentors, and I am going to turn it back over to John to go through the questions.

MR. FENTON: Before I get to that, I just want to clarify a thing that is often times confused. There are two types of traders in futures markets whose trading is related to commodity index trading. One, as we have already mentioned, are swaps dealers who do OTC contracts related to a commodity index and then come into the futures markets to hedge that risk. Those traders are included, as we have said before, in the commercial category. However, commodity index funds trade directly in futures markets, such as, and I can disclose this because it is publicly known, Deutsche Bank has an ETF that is based on the Deutsche Bank Liquid Commodity Index and they take positions in the underlying futures of that index.

Those commodity index funds are reported as noncommercial traders. So that in and of itself seems like an anomalous situation where the ultimate purpose of that trading is very similar, and yet it reported in two separate categories in our report.

What we would like to find out both from commentors to the Federal Register Notice and from the members of the Ag Advisory Committee here today is to give us some helpful ideas on these as well as other questions. First of all, how is the Commitments of Traders report useful to people, just as background to us? Is the current classification system flawed? I am sure there are various opinions on that. If it is flawed, what changes should be made, and to what futures market? That second question I think gets to the issue of to a great extent this is all a function of the growth of commodity index trading, and that is a subset of all the markets. As I said, we do Commitments of Traders Reports on a hundred markets, and yet the underlying markets of commodity indices are 15 or 20 of the major markets. We would like input on whether changes should be made to all reports even though the real interest is in a subset of those reports. Along the same lines, would a periodic supplementary report with finer classifications be sufficient, rather than changing the current Commitments Report, we could put a periodic monthly or quarterly supplemental report that would provide the information that gives a finer breakdown?

To the extent this issue is motivated by commodity index trading, that trading is very stable. There are not a lot of changes from week to week. If we do put it out on a weekly basis, I think people will see that there really is not a whole lot happening from week to week, and so a monthly report might be sufficient.

Would a finer classification put traders at a competitive disadvantage? Would it disclose information that could be used to the disadvantage of traders? There are some traders whose trading activity is based on a number of different kinds of trading. It could be both physical hedging, and it can be swaps hedging, and right now that is reported to us as a single number and we currently do not have a way of breaking that trading out between the components. Either we would have to figure out a way to do that or we would decide which is the primary component and then report it all under that primary component.

Those are some of the questions that we hope to hear from folks today and also from commentors to the Federal Register Notice.

COMMISSIONER DUNN: Thank you very much, John and Don. It always amazes me that as the staff goes through these literally thousands of reports that come in that they are able to give us a meaningful presentation during our surveillance meeting.

With that, I would like to have our folks from the field, Dave Lehman, Dan Brophy, Greg Zerzan, Tom Coyle, and Fred Clark come forward.

Let me take this opportunity to introduce a couple of other people who have joined us. I am told Honorable Tom Erickson, former Commissioner, is here. There he is. Also Susan Keith, from the Senate Agriculture Committee has joined us.

I will go in the order that we have you on the agenda, if that is fine with everyone. With that, Dave, we will begin with you.

MR. LEHMAN: Thank you, Commissioner Dunn, Chairman Jeffery, Commissioners Lukken and Hatfield, for the opportunity to appear today at the CFTC's Ag Advisory Committee and provide comments on the Commitments of Traders review.

The Chicago Board of Trade commends the CFTC for its comprehensive review of the Commitments of Traders Report and for recognizing the significant role that index fund trading has assumed in the agricultural markets. While the CBOT is still developing its answers to the questions asked in the Federal Register Notice, I will provide preliminary answers to some of these questions.

However, before I do that, I would like to give a little background on the issue from the CBOT's perspective. During the fall of 2005, a number of market participants communicated to the CBOT their concern that CFTC's Commitments of Traders Report may need modification to properly account for the increasing participation in CBOT's agricultural futures markets by index fund traders. While these market participants welcomed the beneficial impact on market liquidity provided by index fund traders, they also expressed concern that many of these traders were being placed in the commercial category of the Commitments Report.

As we understand it, the commercial category of the Commitments Report historically reflected hedging transactions connected to the activities of producers, processors, and merchandizers of the underlying product. As index fund trading has increased in these markets, some of that trading is reported under the commercial category even though it represents a different type of customer base than that which was historically assumed to comprise that category.

In November 2005, CBOT and members of the National Grade Trade Council held a conference call with CFTC staff to discuss the feasibility of creating a new or subcategory of the Commitments of Traders Report that would include the positions of nontraditional hedgers. CFTC and CBOT market surveillance staff explained that some index funds have received hedge exemptions from speculative position limits in agricultural futures and are being reported in the commercial category on the COT report. In both cases, these hedge exemptions do not apply to positions held in the spot or delivery month.

In December 2005, CBOT wrote a letter to CFTC Chairman Reuben Jeffery expressing its support for a change in the Commitments of Traders Report that would place the positions of index funds and other nontraditional hedgers in a separate category or subcategory of the existing commercial category. The purpose of this change would be increased transparency of the Commitments of Traders Report in reflecting the positions of traditional commercial hedgers and index fund traders.

The CBOT has continued to work with the industry in a broad cross-section including the National Grade Trade Council and the National Grain and Feed Association to better understand the concerns of the industry over how nontraditional commercials are currently being reported in the Commitments of Traders Report.

The CBOT, as I said, intends to submit a comment letter and is still developing its final answers to those questions, but I will give our preliminary answers today. Based on the feedback we have received from market participants and on the number of comment letters that the CFTC has received on its website, the Commitments of Traders Report appears to be widely used throughout the trading community by both commercial and speculative traders. CBOT research staff utilized historical data from the Commitments of Traders Report to monitor trends in participation in our products among commercial and noncommercial traders.

We do not believe that the Commitments of Traders Report currently provides any category of trader with an unfair advantage over another category of trader. We support continued publication of the Commitments of Traders Report. We support a revision in the categories of traders in the Commitments of Traders Report to include a new category of nontraditional commercial. We believe that the CFTC should continue the current weekly frequency of distribution of the Commitments of Traders Report as improvements in computer technology have enhanced efficiency of data-handling procedures.

Again, thank you very much for the opportunity to appear today to speak on this important issue on behalf of the Board of Trade.

COMMISSIONER DUNN: Thank you very much. Dan?

MR. BROPHY: Thank you very much, Commissioners. I was going to thank you for the opportunity to get out of Chicago weather as well, and actually I think I should apologize for exporting our steam bath to Washington.

My name is Dan Brophy and I am Chairman of the Futures Committee of the National Grain Trade Council. The Grade Trade Council has worked on this issue since spring 2005 with CFTC staff. Our work includes work with the Chicago staff of the CFTC, letters to the Commissioners dated September 16, 2005, March 2006, and various meetings here in Washington, as well as with Chicago staff. We will be submitting a comment letter in mid-August to the Commitments of Traders issue.

In quick summary, we wish to point out that today's Commitments of Traders Report combines traditional grain hedgers, or appears to. Actually, I heard some new information that I was not aware of, but I think it is generally true from our perspective that the report combines traditional grain hedgers in the same commercial category as a large and very influential and active group of new traders that we call financial hedgers. These are primarily index funds, but from what we gather from trade sources, they comprise other new instruments as well.

According to our discussions with our trade sources, these flows of money into our markets are just immense. One of our sources said $7 billion was indexed in 2001, $40 billion in 2004. They estimated $100 billion currently. These do not include estimates for customized more narrowly based commodity index baskets or new ETFs, both of which probably add to the total I just mentioned.

Six to nine percent perhaps of this is thought to include U.S. grain futures, corn and soybeans at 3-week contracts, meal, and oil. The flow may have slowed somewhat recently, but the net growth will continue based on the historical performance of these indices relative to stocks, bonds, and other investment vehicles. Therefore, the influence of index hedging and financial hedgers will continue to grow in the grain markets.

They are completely legitimate hedges, and we are the first to recognize that. We are glad for their involvement in our markets. However, the character of these financial hedges is fundamentally different than the traditional grain hedge, and this is the point of our presentation. These positions, as has been stated in your own questionnaire and stated today, are typically long positions. We have not seen any competing reverse instruments developed. I suppose one day they will come. But they are typically long, they are typically rolled forward, they are not sold out. These are commodity price developments which are completely different than anything we have seen before because if you normally have a flow of buying into a market, it triggers activity in the part of traditional hedgers, producers, merchandizers, consumers in grain markets, et cetera, and it triggers a lot of activity, but the price movements trigger absolutely no response from the index hedgers.

In effect now, the grain markets have two distinctly different types of hedgers using our markets whose activity is captured in the commercial category in the COT report. The traditional hedgers, again, they are instantly responsive to price movements in the underlying commodity, and financial hedgers whose positions really are investment securities, these positions are not for sale or seldom for sale, they are not responsive to price movements in the underlying commodity, they are not responsive to supply-demand developments. This is a new and critical distinction, but it is missed entirely in the current COT reporting format.

What I want to emphasize to you today is that in our view the index and other commodity investment hedges have the characteristics of securities, not commodities futures. They are futures positions held for investment, not for trading, not for resale, so in effect, a component of the futures market open interest has been securitized as investment securities and is something we have never seen before.

The CFTC and the grain futures exchanges have the specific data, but our members believe that in some grain futures contracts, the index hedges now constitute a significant share of the open interest. The 3-day delayed release of COT information poses in our view absolutely no threat to the confidentiality of positions and can offer no advantage to any group of traders over another. As grain markets increasingly migrate off trading floors to screen trading, and it started today, trading will become completely anonymous, fewer information sources will be available, and, therefore, this will further guarantee the confidentiality of activity in positions and also make the COT report more valuable to the industry.

Regarding the convergence issue, we would simply like to say that the buying power and the staying power of the index hedgers has the potential to exceed the influence of traditional hedging. The nonresponsiveness to price movement and supply-demand development such as crop size in the physical commodity by these entities may make the relationship of some futures contracts to the underlying cash markets less predictable and more volatile. This increases risks to the traditional hedgers who rely on historical basis relationships. We would like to note, as you all know, that there is a multibillion-dollar domestic and global industry including storage, handling, processing, shipping and receiving facilities, banking credit lines, banking relationships for managing inventory and other price risks, exchange traded futures contracts, all of this network and all these enterprises have been built up over the last 150 years around the general reliability of the futures-to-cash-basis relationships. The hedge of this large industry needs to be promoted and protected.

We believe that traditional hedgers need disclosure of financial hedger commitment of traders data to assist them in determining the size of the nonprice responsive commercial open interest or other open interest that, as I said, I was not aware was not in the commercial category. We need assistance to determine the size of this nonprice responsive commercial and other open interest relative to total open interest.

More accurately constructed COT data will help traditional cash grain hedgers assess whether hedging risks and hedging effectiveness have changed or may change. Without this data, there is simply no way to know as a traditional commercial hedger if a hedging risk different from anything ever experienced in the history of our industry resides in the market this hedger is using for his daily management of price risks. Therefore, making available to the trading community more accurate, comprehensive data will improve market transparency and assist in efficient price discovery function of the grain markets which is definitely your objective, our objective, and beneficial to the public.

We are asking the CFTC to create either

a new and separate reporting category or a subcategory of the existing Commitments of Traders commercial category to capture open interest data for nontraditional financial hedges and distinguish this new and important component of open interest from the open interest held by traditional grain hedgers. Thank you.

COMMISSIONER DUNN: Thank you very much. Greg?

MR. ZERZAN: Thank you, Commissioner and the other Commissioners.

I am Greg Zerzan and I represent the International Swaps and Derivatives Association, or ISDA. As you know, ISDA is the world's largest financial-services trade association. We have nearly 750 members in countries all around the globe, and our members are as diverse as multinational banks, commodity firms, manufacturers, and consumer goods producers.

We are grateful for the opportunity to comment, and we would like to congratulate the Commission for your continued willingness to tackle changes and issues in the dynamic marketplace.

The members of ISDA would have some concerns with changes to the Commitments of Traders Report. We will be submitting our comments formally later, we are still in the process of formulating them, but in general we would note that to the extent a separate category was created which would apply to what we believe would potentially be a narrow subset of participants in this industry, we are concerned that opportunities would be created to disadvantage these participants, opportunities which would allow others to see their trading positions, deduce their strategies, and trade ahead of these participants. It is worth noting that this would be not simply to the detriment of this narrow community of swap dealers, but to the detriment of their ultimate customers who include pension funds, mutual funds, and other members of the public.

There is no reason to single out this

narrow community, and there is a danger of eliminating the key benefit of anonymity which is provided by the futures markets. There is also a danger that by separating out nontraditional commercials from commercials, you allow the commercials' positions to be exposed, and, similarly, the trading strategies to be more easily deduced.

ISDA is in support of continuing the Commitments of Traders Report. We believe it is useful and it has generally worked well. We feel, however, that if it is necessary to add a new category, that category be broad enough to include a wider community of nontraditional commercials so that swap dealers as a subset would not find themselves particularly exposed. We also would support limiting the frequency of the report as suggested in question 10 of the Federal Register Notice.

ISDA looks forward to continuing to work with the Commission and members of the community to reach a healthy resolution which does not expose swap dealers unnecessarily, but addresses larger concerns within the marketplace. Thank you.

COMMISSIONER DUNN: Thank you, Greg. I think we have on the agenda Tom Coyle next, and Tom is sitting in this particular position because he is using the computer to do a PowerPoint presentation for us, and so that is the reason why we have them in different places. Tom, if you will, please.

MR. COYLE: Good morning, Commissioner Dunn, and good morning other Commissioners.

My comments will focus primarily on the need for additional transparency in reporting of fund trading in the CFTC's weekly Commitments of Traders Report. I appreciate the opportunity to share of the views of the National Grain and Feed today. We will be submitting written comments to the Federal Register Notice shortly.

I thought since there had not been a meeting in some time that we would give an overview of NGFA and why we are here and why this issue is important. The National Grain and Feed Association has 900 members and over 6,000 facilities. Our members handle grain, process grain, and include millers and now includes ethanol producers as well. Our members work with farmers to provide marketing strategies, and to accomplish that and to provide effective hedging, we need to have as much market data timely and accurate as possible.

The Commitments of Traders Report has been a useful tool to provide insight on Commission participants. Speculators and hedgers have different economic interests for being in the market. Gauging the interests of these groups provide insight to value and to risk. Historically, it was fairly easy to identify the difference between a speculator and a hedger, because a hedger was traditionally a grain handler that was handling the physical commodity. Today that is not possible from the current reports.

The NGFA has supported the increasing position limits at the Chicago Board of Trade for years. We view that as positive for the industry, improves the foundation of the exchanges, and it enhances trade transparency particularly because it does allow swaps trades to show up in the Commitments of Traders Report. In April 2005 we again supported the significant increase in position limits, but at this time there was a genuine concern that this kind of trading could overwhelm the amount of actual hedging of physical commodities, so we made two requests at the time. One was that there would be more information and more details in the reports, and more transparency about who was trading the markets. Secondly, to the Board of Trade to make sure that the delivery process and the convergence was protected.

For an idea of the increase in position limits, the corn limit has been increased by 340 percent since 1999, soybeans 150 percent, and soft red wheat up over 100 percent, which are pretty significant increases. These increases in limits have achieved their goal which was to bring on more participation. What is particularly interesting and I think important to this discussion is the fact that it not only brought more participation, but it brought in new users and the new users who have different economic interest in the market, and it specifically increased the amount of various fund types. I don't even want to categorize them as one because there are so many different kinds of funds, and it is expected that we will continue to see growth in that, even more enhanced by the electronic trading.

In the same time frame, the Chicago Board of Trade volume is up over 80 percent as the charts show, and probably significant to the discussion later about wheat and the basis levels and some of the imbalances, let's say, is that the white open interest volume is up 150 percent. In fact, at one point in 2006, the open interest in wheat was actually larger than the production of soft red wheat. If you look historically, that typically does not exceed 40 percent, and is seldom over 30 percent. That is a key issue for some of the balances or imbalances that we are seeing in cash and futures. Soybeans have seen a similar growth, not quite as dramatic as we have seen in corn and in wheat.

The key issue for our participation today is that National Grain and Feed strongly believes that the report is more important today than it has been in the past particularly because the landscape has changed. We have new user groups. If you look back on the reason for having the report to begin with, it was to provide that kind of information on who was using the market and why. Everyone will have their reasons to analyze the data, but at least the data was there. It is our view that the increased open interest and the new user groups have actually reduced the utility of the report. The report needs to have more detail to affect proper analysis and market efficiency. We applaud the success of the regulated exchanges and we welcome the growing participation of the various funds. This represents a robust market. At the same time, we believe that the growth increases the need for more detail.

Commenting on the issue brought up earlier, and I will make it brief and add comments later particularly as it relates to wheat, is the fact the futures prices have been elevated by a new and significant buyer and, as Mr. Brophy had identified, tends to be one-sided. There are a number of things that impact the wheat market this year, the fact that you have crop problems in hard wheat and you have crop problems in spring wheat this summer, and we have not seen that in soft wheat. So as you see, the prices relative to these other issues, the soft wheat which is the most liquid market, actually, has tended to follow. Identifying exactly why that volume is up or what impact it is having is difficult because the report does not differentiate between who is buying in the market.

The other key issue is transportation costs. I can put in perspective that historically, wheat from Chicago to New Orleans would probably cost 25 cents a bushel, and today it is 85 cents a bushel. It is hard to say is it futures, is it transportation, is it new participants? Again, having more and better information about who is participating in the market may aid in that discussion, and I will answer any questions.

COMMISSIONER DUNN: Thank you, Tom. Fred?

MR. CLARK: Thank you, Commissioner Dunn and Chairman Jeffery, Commissioner Lukken and Commissioner Hatfield.

I am pleased to be here this morning on behalf of the U.S. Rice Producers Association. It is a trade association comprised primarily of producer organizations in Mississippi, Missouri, Texas, California, and Arkansas. I am pleased to offer what I would call our brief initial thoughts on the Commitments of Traders Reports and its important to individual producers and those who may do futures trading or marketing on their behalf.

The COT reports are a great asset to all users of agricultural markets, futures and options markets in particular. As indicated in your Federal Register release, the reports are one of the most visited areas of CFTC's website. We believe that this activity is indicative of the importance of the reports to all market users.

The reports are especially important to individual farmers or agricultural producers, and the easy availability of the information is one of the great levelers, we believe, of the market playing field between large and small market players. This is critical for individual farmers like rice farmers who do not have the time or the resources to follow futures markets and even the cash markets to the same extent that many commercial users or speculative traders might. Obviously, for these and other reasons we would oppose the elimination of the Commitments of Traders Reports.

First of all, I want to say thanks so much for having this hearing today because I know

I have learned a lot already about the context in which you are considering these changes, so this has been very helpful and is appreciated.

Generally speaking, I think producers feel as if those who actually deal in commodities in some way, in other words, those who actually produce them, market them, buy them, handle them, process them, sell them into the market, should be as a class somehow readily identifiable in the Commitments of Traders Reports. I know this is what we are talking about here this morning, but that is the goal, I think, because other participants in the markets can skew those results or cloud what is really happening in the market. So determining the positions and activities of what producers consider to be true hedgers or true commercials is a key in many respects to their ability to carry out their marketing plans and to operate profitably.

Producers tell us that they use the information from the reports to determine their own position relative to the market. For example, the higher that they believe the aggregate short position to be in the market, they would normally conclude that means there has been more selling perhaps done by sellers relative to buyers, and the opposite, of course, would be the same case. To the extent that information is clouded by information in the report that is not indicative of actual physical market participants, that makes that job more difficult for them.

As important as all this data is, I think it is also critical for producers to be able to readily see the change in all these market factors over time. So almost as important as what is reported is how often it is reported and that it is reported in a consistent way so they can see market movements, because that is critical to them. Like all other traders in these markets, farmers and others in agriculture, of course, have what could probably be characterized as an insatiable desire for market information, and we understand that sort of human inclination.

Having said that, we think one critical

difference is that individual producers are probably at a pronounced informational disadvantage compared to major market traders and commercials in the markets.  So to the extent the Commitments of Traders Reports can help to level that playing field, I think that is why producers think the reports are so important.

It is also important that producers be able to readily separate actual commercial market users or hedgers in their minds from other participants such as hedge funds, swap dealers, or pure speculators.  As was alluded to I think in our Federal Register release, the market behavior of each of these participants varies as has been discussed here a little bit today already, so the more information that producers have that can allow them to glean who is doing what to whom and why, to put it colloquially, the better off they will be and the more likely they will be able to separate out what they believe to be what I call real cash market effects and help them market their commodities against what they believe the real cash market to be. Each regarding each of these factors is important to be able to determine, of course, which factors are driving the changes I mentioned earlier, the changes in the market, and which ones may not be.

In addition to that what is important to producers is the basis in the futures relative to the cash, and that is important as well. Again, the basis may be clouded to some extent by nontraditional commercials in the market.

In a brief response to some of the other questions you raised in our Federal Register Notice, we do not believe that the Commitments of Traders Reports provide any particular segment of traders with any unfair advantage. In fact, we believe the existence of the reports acts as evidence of the need to make market information readily available to producers on a timely basis. Because the reports are publicly available to everyone who is concerned, we would argue that any unfair informational advantages will be reduced as the reports are published more frequently and with more information. Thus, we would urge that the reports be published more often and as close to a real-time basis as possible.

We intend to comment in writing on these and the other questions you raise in the Federal Register Notice soon, but I would sum up some of the views of our producers as follows. One, the Commitments of Traders Reports are one of the Commission's most useful tools in assisting producers to design and execute marketing plans. Two, of course, we oppose the elimination of the reports. Three, we believe the reports should be published as frequently as possible with as much readily accessible information and detail as possible. Four, daily reporting should be the goal to which the Commission should currently aspire in this regard. And five, the reports should be biased towards providing more market information and transparency whenever that is possible and practical. Thank you again or having this meeting today and for the opportunity to talk with you.

COMMISSIONER DUNN: Thank you all of the panel members. The way we will proceed here is we will allow the Commissioners to ask the panelists any questions they may have, and then I would open it up to the panelists to ask each other any questions that they may have. Then the Advisory Committee members if they want to ask the panel a question, please come forward and do that. Then we will open it up for any public members who are here today who would like to make a comment or ask a question. Also, Don and John will be available for questions as well.

First of all, I am delighted to hear a consensus that we ought to keep the Commitments of Traders Reports, and I think that bodes well for what the Commission has been doing in the past. It is a little frightening to let everyone know how we are watching you, and then suddenly find out that you are all watching us to see how we are watching you, and that I think is something that as a Commissioner I need to keep in mind.

Dan, I am paraphrasing you on this, and, Greg, I would like to get your reaction to this. You said that these open interests become securitized when the swap dealers and others get those, and then they are nonprice responsive. It seems like that could cut both ways, but, Greg, I would like to get your reaction to that.

MR. ZERZAN: Thank you, Commissioner. Before I would react, I would like to maybe hear a little bit more about what exactly Dan meant by that.

COMMISSIONER DUNN: Would you amplify, Dan?

MR. BROPHY: Yes. These are based on committee discussions, my discussions with my sources in the industry and other committee members, discussions with their sources in the industry, and admittedly, we are at something of a disadvantage because we do not have the data the Commission has, but what is happening is that these index instruments are becoming Wall Street instruments, or have become Wall Street instruments. They are sold to the public as investment instruments. They are not for resale. They are not something that Tom's company purchases or Cargill or ADM purchases to hedge an export sale or a sale to a domestic miller, for instance, and then resells when Tom's company or an exporter or domestic trader buys the grain from a farmer. Those are transactional futures instruments.

These have become investment instruments, and Greg's group of companies, ISDA, I am sure has more technical knowledge about this than I do, but there is simply no question that there is a huge component of the open interest in at least one commodity, perhaps two that I am positive about, that is not for sale. I understand some of these swaps or some of the index funds have run into tax problems with the IRS, I do not understand all those details, but they have gotten around the problem that was presented by the IRS's challenge to them when they were actually buying futures and warehousing those futures to back up their sales of the investment instrument. They have developed much more sophisticated swaps that solved the tax problem, but the element of open interest continues to exist that is not for sale.

I hope I am being clear about it, but I just do not think there is any question that some significant portion of open interest in some markets has become a security not for resale. We are not saying that is a bad thing, but we are saying, going back to my comment about the multibillion-dollar hedging industry and merchandizing, milling, processing, handling, exporting, domestic trading industry, all the bank relationships, banking, credit relationships for hedging, credit lines, all of those are built around the general reliability, there is no guarantee, but the general reliability of the cash futures relationship, i.e., basis predictability in hedging effectiveness.

So as a large and perhaps growing component of open interest in the grain markets becomes nonprice responsive and not for sale, that affects the hedging risk that the traditional hedger is looking at. Again, we are not saying that this is a bad thing, but the only way to get a sense of the size of that risk so the traditional hedger can assess whether or not he wants to participate or widen his basis parameters is to have some idea of the component of that relative to total open interest.

My suspicion is in corn there is a sizable index fund and financial hedge open interest, but that market is so much bigger than wheat that it has not had the effect that I think it is now having in wheat. Let me give you an example, and Tom Coyle brought up some of this. The open interest in wheat is one-third the size of the open interest in corn in futures in Chicago soft trade wheat. The size of the soft trade wheat crop this year is 3 percent of the corn crop, so it is a major new component that is a change, the likes of which the industry has never seen before. We are not opposed to it. We simply want some idea of what it is relative to total interest, and that would make the Commitments of Traders Report much more useful.

If I may, I do not see any risk of revealing anybody's position, CFTC would know this better than we do, but historically I do not think there have been any problems along these lines, and when the markets were much smaller and there was no financial hedge interest involved, the commercial open interest was thought to be traditional hedgers and there were no problems with that. I hope that answers.

MR. ZERZAN: I think Dan is restating the issue that the Commission is tackling, which is to say there are reflected in the commercial category persons who are not in all cases taking and dealing in the cash markets. Certainly, we are sympathetic to the idea that this may create issues for some cash market participants. However, our concern is how you break out the depiction of the so-called nontraditional commercials, because certainly in some markets we have indications that there are a very small group of persons who would fit within this nontraditional category. And if you are maintaining an index with published targeted levels of investment in different types of commodities and then you break out this same group and do a narrow subset which is able to be seen by the public in real time in Fred's world, then you have the very real opportunity for other persons to view this information to know where these people are in the markets and where they need to be, and, therefore to trade ahead, which, obviously nobody wants that.

So I think it is not really that there is a disagreement. I think the issue is how do we ensure that we protect nontraditionals and their end customers, being pension funds and mutual funds and other members of the retail public, to ensure that they are not disadvantaged and the markets as a whole are not disadvantaged by a level of exposure which allows other parties to take advantage of new information which heretofore did not exist. I think that is really the long and the short of it.

COMMISSIONER JEFFERY: I have one question for you, Greg. You talked about the swap dealer category and maybe expanding it. How would you break it up? Because one of the nice things about the simple categorizations we have is that while they may cover a lot that is not necessarily obvious in each of the two categories, it is real simple -- you are in one bucket or the other. So once you go beyond that and try to slice and parse this down more finely, are there any specific categories you would suggest that we consider?

MR. ZERZAN: Mister Chairman, as I am sure you frequently encounter, I have come to you with a suggestion that lacks any real specificity, hoping that you in your wisdom would be able to figure out what I mean.

(Laughter)

MR. ZERZAN: Frankly, as we wrestle with our submission, this is one of the things that we are trying to figure out, how you would parse this in a way that provided some information that was useful to the market but did not disadvantage the narrow subset people who are swap dealers.

I think part of the problem is, in some of these markets we are talking about perhaps four people who would fall into the category of swap dealer or nontraditional, and frankly, I could not tell you off the top of my head what other groups we would want to add to that, but I think we probably need to work creatively to figure out how we could make it a broader list than just in that instance those four entities.

COMMISSIONER JEFFERY: We are open to all suggestions.

COMMISSIONER LUKKEN: As a general statement, I would say that the addition of the nontraditional swap dealers and others who are coming into these markets, in my view, are a good thing, and we are trying to aggregate as much information into the marketplace as we can. If you don't believe me, go visit one some day and go up and see the weathermen, the economists and everybody who is going over all this information to try to bring this to the marketplace to their economic advantage, just as any processor or farmer might want to do himself. So as a general rule, I would say this is all a good thing. However, we have to balance the idea of transparency, as Dan had stated in his statement, with this idea of protecting confidentiality.

One thing I worry about in the electronic age is if we get this wrong, these swap dealers will vote with their feet and they will go somewhere else and we will not have any of those because none of it will be transparent. So we do not want that. But we are trying to find some balance in the middle where we are able to provide some additional transparency with some confidentiality so that we are not giving away proprietary information. That is the key and that is the sort of information that we are going to want from Greg, even though he does not want to give it up today, and others who might have thoughts about these issues, too. How can we provide some cover for these folks so that we are not giving away trading positions?

One thing I would like the panel to comment on is where the interests diverge between the nontraditional and the traditionals. As I think about this -- if they are long in the markets, both want the markets to go up, both are hedging interests, some have proprietary trading desks, but some people who are producing also do proprietary trading as well. So for policy reasons, try to tell us why this information would be useful. What are you going to gather if a swap dealer's positions are one versus the traditional commercials? What sort of information does that reflect to you to change trading strategies? To me, they are perfectly aligned. And if they are perfectly aligned, why are we further breaking them up? But I am sort of dumb in this area, so please enlighten me.

MR. COYLE: I would go back and give you an example of the past, and I will give you the current situation.

Let's assume that you are a farmer trying to decide whether or not you want to lock in a percentage of your price, you really do not have a sense of whether there is good demand or not. Everything is in arrears. You do not see the sales for a week or whatever. You see your crops, but you are trying to gauge whether or not there is real consumer demand. So you see a Commitments of Traders Report that shows the commercials and you believe the commercials to be Cargill, ADM, buying futures, you see the long side of that going up, so you draw the conclusion that there is good demand, it is confirmed again by an export sales report, you do not see the domestic sales which would be hedged that way, and so you make a decision that maybe the demand is better than you were expecting that you be a bit more patient in establishing your sales program. And remember, you are just weighing that against the other risks you have, that if you sell ahead and you have a crop problem, now you have sold too much of your crop, so you need that information.

Today you simply cannot make that judgment because the information is not available, and today the open interest is going up and up. Typically, that is the sign of a bullish market, that is a good thing. The farmer is happy about that. But may not quite recognize that that is not consumer demand led. Therefore, as the price goes up, you do a hedge to arrive contract and you sell next year's wheat at $4.50 a bushel and you are just planning out your vacation for next year, but you do not lock in the basis levels because you assume that that is an indication that basis levels should be strong as well. But when you get there, you realize that demand has not grown, which you probably should have known because export sales did not show any sales, and you get there and the basis is 60 under. You say I did not sell $4.50 a bushel like in my normal basis of 20 under, the basis is 60 under partly because of transportation, and partly because the futures market is doing more of the work than you would normally expect, and now you have that exposure.

Compound that by the number of farmers in a whole industry group, I'll tell you what, our members are the opposite, the hedge to arrive problem. People say now we are saying we ought to put risk disclosure on our contracts, and when you do a hedge to arrive, your risk isn't the futures, your risk is the basis, and when you did a White Paper in 1996 that said basis is not as much of a risk, the landscape has changed. So that would be an example for a farmer.

Let's give another example where your crops are really having a problem and you really are bullish. You really should not be selling, but you are seeing the markets weaken. Maybe it is weakening because at some point in time these long only index funds say it has been a 3-year horizon, my investment portfolio plan is to be 3 years, and now I am getting out, and the market is actually weakening while the crop is burning up. The farmer says, I must the wrong, the crops must be better somewhere else, mine are terrible, and so I had better go ahead and sell some of my crop now. Then when that phase ends and then the markets skyrocket, the farmer missed that.

Everyone is going to have to make judgments on the information. The fact is, today they do not have the information. And we certainly appreciate the fact that you would not want to be able to identify a specific grain company in the report, and you would not want to be able to identify a specific swaps dealer either, and the assumption is that the current rules of 20 participants would be enough to protect that, but there may be other ways to do that. Today, like you, Dan, I was a little bit surprised to realize that actually the index funds were in the noncommercial and the swaps were in the commercial. I thought it was the opposite. But if you put both of them in this new category, and swaps dealers do not just provide contracts for long-term investors, somebody like Perdue Farms or some other commercial may say I want some creative hedge, I want an average price for 2 years out because I am worried about ethanol and price of corn, so you buy the same thing from a swaps dealer, and maybe putting them all in one category covers that exposure, but the detailed information is important.

COMMISSIONER HATFIELD: I am struck by your testimony, Tom, about the growth in the wheat market saying at one point that earlier this year I believe that wheat futures were 105 percent of U.S. wheat crop, and normally from 1994 to 2004, it would be about 40 percent. Greg has indicated that his group of swap dealers are a very narrow subset, it may be a small group of people but it may be a large impact. So if any of the panelists have any further comments on the size of these subsets, whether it is swap dealers or what-not in these commodities, either collectively or individually, I would be interested in the impact that they make. Does anybody want to take a crack at that?

MR. COYLE: We have made some assumptions about the impact because we have seen the basis levels weaken, and, again, transportation changes as well, but we do not really know anything on the grain side about who the dealers are and how big they are, so I will pass it to someone else.

MR. CLARK: I would reiterate the same thing, we do not know. And again, we do not have any problem with these folks being in the market. We think it is a good thing. It provides some liquidity in some respects, but we do not know how big their positions are.

COMMISSIONER HATFIELD: Greg, do you know, and will you tell us?

MR. ZERZAN: As I said, in some markets we have indications that it is a very, very small group of participants. I think in general one of the things about the futures markets is that they afford a level of anonymity which is in general a good thing and that people support. So I do not think it is always possible to know.

But I think as Commissioner Lukken pointed out, in some respects it is irrelevant because someone who is long in corn is hoping the price goes up, and it does not matter if he is actually going to be selling corn at the market or if he is holding that position on behalf of investors. So there is an alignment of interests which in some ways negates the concern that I think is a side issue here, because I do not think the concern really is that the character of the market participant somehow bodes for a negative future market direction. I think it is that the character of the market participant might affect an end user's ability or a producer's ability to judge that subset of the market which is actually interested in the cash commodity. So I think there are some markets where this is a very small number, there are some markets where it is probably larger, and there are some markets where you simply could not tell.

COMMISSIONER HATFIELD: Let me ask you this also, Greg. In Tom's written testimony he mentions that they say we believe that the Commission's current rules restricting reporting aggregate positions of market segments containing less than 20 reportable participants is more than adequate protection. Do you agree with that?

MR. ZERZAN: I think it is dependent. I think it depends on the size of the overall market. The reality of it is, as Commissioner Lukken noted, there is a real danger that you will either, number one, exposing the positions both of the nontraditional and the traditional commercials. Secondly, you have the danger that you will force persons who prize anonymity and their ability to be sure that people will not trade ahead to move to over-the-counter positions and out of the exchanges. To draw a flat-line number 20 is I think probably not justifiable in terms of the broad variety of markets about which we are talking.

COMMISSIONER DUNN: As promised, now we will let the panelists each other questions, if you have any.

MR. BROPHY: May I respond to some other comment from a minute ago?

COMMISSIONER DUNN: Sure.

MR. BROPHY: The index fund managers who I have spoken to, one directly and one second hand, made it very clear to me they do not care if the market goes up or down. They happen to be long, but it does not make any difference. Their index fund investment is a security that has been sold to a public that wants commodity portfolio price exposure, and they recognize that sometimes that exposure will be profitable at the end of the month or at the quarter of the year, and other times it will not. But the one fellow's comment to me again and again was, You do not understand, they are not going to sell anything. And after a while, I did understand.

The second thing that I would like to say is that Greg has a concern about positions being revealed and front running and so forth, but actually my understanding of this is, and I have even seen some of the public announcements, that most funds publicly disclose the percentage of a given commodity that is in their fund. Sometimes they actually publicly disclose when they are going to buy, the GSCI is publicly disclosed when the roll takes place. There are firms that trade around that speculatively. I just do not see any risk of front running that is at all significant, and I do not see any concerns with positions being revealed because, as I said before, all these years the commercials' positions and in fact the large reporting speculators' positions which were assumed I think correctly to be the trend trading funds, those were all reported when these categories were pretty clean and nobody had any problem with it.

The other thing which will be in our comment letter is that I do not see any utility at all of the attempt to reconstruct somebody else's positions. I think a number of years ago the Commission was involved in a debate about whether there was such a thing as insider information in commodities trading, and I have learned from experience that there is no such thing. The markets are very volatile for a number of factors at any one moment, and I just do not see where anybody has any advantage over somebody else in a given moment knowing something.

COMMISSIONER LUKKEN: May I ask for a point of clarification, because there seems to be some confusion on whether these long-only commodity funds are categorized as noncommercials or commercials. I think of Goldman Sachs where they are a dealer and also have a fund. So I am trying to figure out exactly which direction are they. And am I the only one confused on this?

MR. FENTON: Most of what we see in the futures market related to commodity index trading, at least what we have identified, are swap dealers categorized as commercial. So the vast majority of commodity index positions in the futures markets have been included in the commercial long category.

A much smaller amount where the trading is directly in the futures market by commodity index funds is classified as noncommercial, that would end up in the long category there, but that is quite small in comparison to the other.

COMMISSIONER LUKKEN: But are the people on the commercial side hedging something, typically? Or are they just a dumb long fund that is just in for long?

MR. FENTON: The person in the futures market, the swap dealer, is hedging something. They are hedging the risk of their OTC position.

COMMISSIONER LUKKEN: Over-the-counter position.

MR. FENTON: So from their point of view it is a hedge, but it is not a hedge of physical exposure in the underlying corn market, for example.

COMMISSIONER LUKKEN: But these long-only, trend-following funds, they are on the noncommercial side, versus the swap dealer hedging folks who are on the commercial side?

MR. FENTON: Right.

COMMISSIONER LUKKEN: Thank you.

COMMISSIONER DUNN: John, does it in fact end up as Dan said, they are nonprice responsive open interest then?

MR. FENTON: I think that has been our experience. The pattern over time has been in terms of the total participation, it has been a gently upwardly sloping line, so it has grown. It does not have any of the in and out kind of characteristics that some of the either technical trading or speculative trading has, so it does appear to mostly be insensitive to price.

COMMISSIONER DUNN: Does that, in your opinion then, have an impact on the price discovery in the marketplace?

MR. FENTON: In my opinion it does.

MR. COYLE: Commissioner, we had our convention last March. I chaired a panel discussion and we had one of what you would call a traditional hedge fund, a trading fund, a manager of an ETF, and also one of these index funds. The message was very clear that the money that was going in their accounts had a horizon of 3 plus years, and if at the time the markets were breaking and the comment was as the market breaks, our money is going out, more people are investing and they are not looking at getting out, because of the time horizon. At some point you have to assume that you are going to get to that level of investment dollars that are in those funds, and then the investments will be--but today people are trying to get cash into that what they call space in their investment portfolio, and whether or not they are close to it or not, most people I talk to say not even close, but at some point they will get balanced and they just are not balanced today.

MR. ZERZAN: I think it is important to recognize that to the extent a swap dealer is serving as an intermediary, the swap dealer is hedged, and you are right, if he is doing his business correctly, he is really not concerned with the moment of the prices. But the important thing to remember is the underlying parties who are counting on him, the index funds and the investors in those funds, the pension funds, the mutual funds, et cetera, they are very price sensitive and they are very concerned about where the price is going, and they reflect supply and demand. So to say that there are participants in this market who are just riding the wave and they do not care one way or another, so, therefore, it affects price discovery, I think is to completely discount the reason they are in this market in the first place, which is that there are people who want commodity exposure but they do not want to ride commodity exposure down, they do not want to be reflecting declining demand, they want in fact to participate in the price movements in the market. So there is a reflection through the swap dealers, and it is not to say that you have this large group of individuals in there who are simply distorting supply and demand, they are in fact reflective of the underlying supply and demand.

COMMISSIONER DUNN: Are there members of the Ag Advisory Committee who would like to ask any questions or make any comments? Again, would you come up to the microphone and state your name, please?

MR. STEVENSON: Randy Stevenson with R-

Calf USA. This is my first meeting, and I have noticed one of the basic principles here is 3,500 years old, and that is transparency in the marketplace. Back then, all transactions were at the city gate in the light of day, so I would encourage you to impose as much realistic transparency to it because it is the ultimate self-regulating enforcer.

The other question that comes to mind when you are weighing some of the swaps versus the commercials, my question would be, when the futures were established, who was it designed to benefit initially, and does it still? Is that part of the mission? Thank you.

COMMISSIONER DUNN: Thank you, Randy. Are there any other members?

MR. GAINE: Good morning Commissioner Dunn and other members of the Commission.

COMMISSIONER DUNN: Jack, please identify yourself.

MR. GAINE: I am Jack Gaines, President

of the Managed Funds Association. August 1, 1977, I became General Counsel to the CFTC and I just want to comment favorably on the change in tone here, where back then in the 1970s and 1980s, the word speculator, the word fund, the words managed money, were not necessarily the most popular expressions among this group, and I have really enjoyed the discussion this morning where all of these activities are discussed and no one says there is too much speculation, there is this, that, and the other thing, and I think we are down to some issues that are raised here that we are going to follow this very, very closely, and I think drawing some of the distinctions between some of these motivations of traders, for example, someone suggested somebody is in there and price neutral. As a lawyer and in my economics training that I received here, that is what a hedger is supposed to be. In the perfect hedge, he should be neutral to price movement up or down. Of course, with basis and other changes, that probably is not exactly true, but being price neutral, that is, putting position on it seems to me without regard to whether it goes up or down may not be all bad.

But I just wanted to comment that it is a great area that you are looking at and we will follow it very closely. We do not have any answers, but I find this very illuminating this morning. Thanks.

COMMISSIONER DUNN: Are there any other members or public who would like to make a comment or ask questions?

If not, let me thank the panelists. This has been fantastic, and it really has for me been a tremendous source of information. Thank you very much.

This actually puts us about 10 or 15 minutes ahead of schedule, so what we will do now is break for lunch, and we will come back here then for the afternoon session at 1 o'clock.

(Whereupon, at 11:34 a.m., a luncheon recess was taken.)

A F T E R N O O N S E S S I O N

(1:06 p.m.)

COMMISSIONER DUNN: Ladies and gentlemen, could we please get seated, so we can get right into the afternoon session?

I thought this morning's session was just great, and I really, really thank the panelists that we had on. They did a fabulous job, and now it is a challenge to the folks who are up here now. I hope you all had a good lunch.

We are going to turn to the Thinly-Traded Market Price Discovery for this afternoon's session. While this subject of thinly traded markets is one that our economists worry about daily, I am told we have not previously discussed this at the Agricultural Advisory Committee, and so I think it is time for us to raise this subject. The purpose of today's session is to explore this issue to better understand what market users see along with potential problems CFTC staff worry about. We are particularly interested in learning more about the potential concerns of market users in this area and fostering discussion between market participants and regulators of the various parts of the price discovery chain.

In coming up with this particular topic, I talked with Dr. Ken Clayton who is the Deputy Administrator for Ag Marketing Service. We met at the Ag Outlook Conference, and we started talking about what is the relationship on price discovery between what goes on at the CFTC and what Ag Marketing Service does. So we kind of hatched the idea of having this particular session.

We will begin with an "Overview of the CFTC Authority over Cash, Futures, and Options Markets." Nanette Everson, our General Counsel, will make that presentation.

Then we will have an overview of "Thinly-Traded Markets in Dairy, Pork, and Beef" by Dave Kass, our Industry Economist in the Chicago office.

The "Role of Price Discovery Markets in USDA Programs," will be presented by Warren

Preston, Chief Economist, Livestock and Seed at USDA Ag Marketing Service. Warren and I knew each other in a past life when he was at Packers and Stockyards. I hope I remember what agency he is with now.

Then we are going to have Michael Haigh talk about "Price Discovery, Cost of Carry, and Trader Interactions in Commodity Markets." Michael is an Associate Chief Economist here.

We will have "Economic Issues in Thinly-Traded Price Discovery Markets" by Steve Turner who is the chair of the Department of Agricultural Economics at Mississippi State. Thank you very much for traveling up here, Steve, to participate.

It then calls for us to go to a break, but instead of going to the break because we only have one panelist on the "View from the Field", Gregg Doud, I am going to ask Gregg Doud to come up and do his "View from the Field" while the panelists are still here, and I think it will generate a better discussion.

With that, I would like to begin with Nanette.

MS. EVERSON: Thank you very much, Commissioner. I know you are all excited after lunch in the 100 degree heat to listen to a lecture on the law. So I will be speaking for an hour and a half. No, just kidding.

I am very honored to be here and want to thank Commissioner Dunn for all the hard work in terms of setting up this Agricultural Advisory Committee. It is a very important undertaking where we seek the viewpoints of scholarly people and thoughtful people in terms of input in our decision-making process, and it is a great honor to be here.

I would like to just make three points. The first one is that -- is this working okay?

MR. DUNN: It is working okay, and they will control it back there. So if you just get in a comfortable position and talk, they will pick it up.

MS. EVERSON: Okay, got it. The first

one is that our historical roots in the agricultural commodities area are enduring and significant, and they are very important to our legal authorities, and that is something you will see throughout the Act, and I will talk about that. The second one is that we have authority, not regulatory authority, but we have statutory authority over cash markets where there are underlying agricultural commodities, and this is very significant. It is focused primarily on manipulation. I will be talking about those statutory texts. The third one is that we are at essentially the zenith of our authority in terms of our full range of tools when we are talking about agricultural commodities, futures, and options on agricultural commodities that are traded on designated contract markets.

Looking at the first point, the historical significance of our roots in the agricultural field, this is a very important constituency for us, and I think you can see it primarily in an interesting statistic. Only about

7 percent, by volume of the contracts that trade on designated contract markets are agricultural. Nevertheless, a very large percentage of our surveillance resources that we allocate go to surveilling the agricultural commodities. So this is a very significant area. It derives from the fact that we have the underlying physical, and this is subject to potential manipulation.

I always learn a great deal when I hear John Fenton give his views and his testimony, and I think he really honed in on this, looking at the 1922 original Grain Futures Act, where he said that the evil that Congress sought to really address in that statute was manipulation and that there was evidence of that. So this is something that is extremely significant to us.

I noted that this morning the Commissioners were right on the money, and they knew that today was the first day of trading at the Chicago Board of Trade in terms of the side by side pit and electronic trading and also for Kansas City for its hard red wheat. You can tell

I am not a farmer, I am sure. What that shows you is that no matter how fancy things get and how things evolve and change in this very rapidly changing market, we are still focused on the fundamentals here which are looking for manipulation and to go after it whenever we find it.

Another example of the historical roots is something very significant which is that we have independent litigating authority, and that is really no small thing. In Section 6(c) of our Act, we can go directly into Federal District Court and commence an action. The reason for that, without getting the permission of the Attorney General, is that we need to nimble, we need to be able to move quickly in these physical markets, and we don't have to bypass but we may bypass. We don't have to go through the Attorney General which is an elaborate process. Very few agencies have this level of independent litigating authority, and it derives from 1974 when we were very much focused on the agricultural commodities. So this is very important in terms of our historical background. The bottom line is that this birth, shall we say, in this field has really given us the muscular authorities that we have, and it continues to be very significant to us.

The second point is we have no regulatory authority over physical commodity markets, but we do have very significant statutory authority. Again, we are going after manipulation here. What is interesting is you will see there are four texts. There is 6(c), 6(d), 9(a)(2), and 4(b). All of these have these key phrases in those texts. What they talk about is our power concerning "commodities in interstate commerce or for future delivery," and that "or", of course, sets up the contrast that we can focus on "commodities in interstate commerce." Again, you see sort of historical roots, like if you look at 9(a)(2), one of the specific texts that they talk about is false reporting concerning crop information. So this is very important. We have manipulation, attempted manipulation; we have corners, attempted corners. We look in kind of a mini squeeze situation for an impact on a regulated futures market. We are not talking, of course, about going into the forwards market. That is clearly excluded from our definition of a futures contract, but this is significant.

Again, you can see this in the allocation of our resources. I am advised that we have more full time employees or full time employee equivalents for surveilling the agricultural markets than the other markets, although energy recently has given us a good run for the money.

The third point I want to make is that regarding options, futures and options on futures where the underlying is agricultural commodities, we have the full zenith of our regulatory and statutory authority. So we use all of our levers and all of our bells and whistles. We do it to regulate the exchanges that trade the products, the traders who trade the products, the clearing organizations that clear the products, and those who solicit and offer the products. So we use all of our tools legally in terms of these important markets.

Just to close, whenever I get lost, which one is wont to do in the Byzantine complexities of the statute, I like to go back to Section 3 which is our Purposes and Findings, and I think that really kind of always puts us right back on focus in terms of what we are looking for. The Purposes, I think, were extremely well crafted by Congress, and they remain our guiding themes: to detect and deter price manipulation, to ensure financial integrity of transactions, protect market participants from fraud, and also after the CFMA, to promote responsible and creative innovation. We focus on these in the commodity markets in terms of our legal authorities, and we will continue to do so.

Thank you.

MR. DUNN: Thank you very much, Nanette. We will now go to Dave Kass. You are going to see the presenters kind of gravitate down to this end. They have to do that, or did they give them -- oh, they did. Okay, maybe they won't have to.

Dave, if you would, please.

MR. KASS: Thank you. I should preface my remarks that most of this will be factual. If an opinion or two happens to leak out of my own, it is my own and not necessarily the opinion of the Commission.

Also, to kind of echo what Nanette said, actually I have been here more than a few years. I go back to when 100 percent of regulated futures trading was agricultural futures trading, and it is about 8 to 9 percent now. As a member and a longstanding member of the surveillance activity, I can tell you that a disproportionate amount of Commission resources goes to the agriculturals compared to some of the financials. Something like Euro dollars, which is probably one of the largest markets traded in the United States, doesn't get near the sort of concern and use of resources that something much smaller does in the agricultural community.

I am going to present basically three market categories. They illustrate different issues about thin markets and how the thinness of markets has caused us surveillance issues and things that are done to address it. It certainly is not meant to indicate that these three markets are the thinnest of the markets we regulate by any means. They happen to be Chicago Mercantile Exchange markets, but for one, I am from the Chicago office. So it was going to probably be Chicago markets anyway. Those are the ones I am most familiar with. It just happens to be those markets. The Chicago Board of Trade and all the other organized exchanges have their share of thin markets, but these, I think, will illustrate a few points about thinness and some of the issues it causes.

Let us go forward. First of all, what is the requirement to even trade a market in the United States under our rules for a designated contract market? Again, as Nanette said, that is the one where we have zenith of our powers. If you are on a designated contract market, you come under the full brunt of our regulatory powers and authorities.

I apologize, you have sort of micro-copies of these in your package.  If I can find where this pointer is, did it come off the screen altogether?  Oh, there it is.

Basically, there is a core principle now and has been since the CFMA, the Commodities Futures Modernization Act, of the year 2000, and it basically says you can have a contract where they are not readily susceptible to manipulation. That is the broad language.  Then we have guidance on that.  As you all know, even in the agricultural community, there are two major types of markets:  The physical delivery where you actually deliver something, whether it is a foreign currency, a treasury note, or load of live cattle, and you actually deliver a product, and there is a change of title; versus a cash-settled market where you settle on the last day, and it is another mark-to-market, and you settle on the basis of some index.

We have guidance depending on which of those broad classes you fall into as to what we mean by not susceptible to manipulation. Basically it is, in the case of a physical delivery, your primary concern is deliverable supply, of course, and that the deliverable supply is then something that will not be conducive to price manipulation or distortion, and that the deliverable supply can reasonably be expected to be available to the shorts. If it is not available to a significant number of shorts, what good is it? So it is available to the shorts and saleable by the long. Any long trader who would happen to get this would have outlets for it, reasonable outlets for it. That is the basic guidance on physical delivery.

Then cash settled says that it should be settled at a price -- and this is key -- reflecting the underlying cash market, again not subject to manipulation or distortion, and that it is based on a series that is reliable, acceptable, and publicly available, and timely. So these are the conditions. I will leave it to the folks who come after and to the industry reps here today if they have suggestions in terms of to what extent, either for the physical delivery markets or for the cash settles, if they have an opinion about whether they are meeting these core requirements.

Let us start then with the CME dairy markets. They have a spot butter market that used to trade three days a week. It now trades all five days, but it trades for about 15 minutes or so in the late morning in an open outcry, pure auction market. Spot cheese similarly trades right before or after the spot butter market. Actually, this was already an agenda topic, but I am sure many of you are aware that just a few weeks ago, several Senators including Senator Feingold have asked GAO to investigate these markets to see whether they are susceptible to manipulation or not. So we will see what, if anything, come of that, but we have been looking at these markets for quite some time.

Also on the dairy side, well, there are actually a couple milk futures. There is the Class III which is settled on the USDA price. So that is a cash-settled. There are two butter futures contract. There is a physical delivery contract of 40,000 pounds and then more recently, they have side by side traded a half-size but it is cash- settled. So this is a case where the exchange decided, based on industry comment, to offer another product and kind of see which one would best serve the industry, which would be used and take off. The younger of the two, the cash-settled, looks like it is sort of winning the volume battle as we go forward.

Let me talk a little bit about the spot market, particularly since that is the one that is the smaller of the markets and it has come under this recent attention, but it has gotten quite a bit of attention over quite a few years. It was traded up in Green Bay in the National Cheese Exchange, and then it was moved ultimately to the Chicago Mercantile Exchange. This chart that you see is comparing the annual volume done on those markets, the spot markets again. These are not futures. These are actual physical trades of butter and cheese, what percent of total annual production, the annual trades on these markets do.

You can see butter recently over in this period here is running about, it looks like, 5 to 6 percent of total annual production of butter is traded on that market, again on an annual basis.

Cheese is much, much smaller. It is cheddar cheese that is traded. If you took it as a percentage of total cheddar cheese produced in this country, you are seeing about, let us say, 1.5 percent these last few years. If you took it as total cheese because it is the only cheese traded and, we understand from the industry folks, it only represents less than 1 percent of all cheese produced in the country. Yet, our understanding is that this cheese market, which is the one that is usually focused on, people use it as a formula or base to price something like 80 to 90 percent of all the cheese that is traded in the

United States. Clearly, it represents, let us say, a half a percent or so of total cheese production, and yet it is used to price a lot of stuff that moves through the dairy industry. Of course, that then works its way back into various dairy prices that the USDA puts out, and it is used ultimately to go back and price milk.

This little inserted table up here shows the average daily volume of these. So this is the volume. The lines are the volume in terms of production equivalent or what percent of production. You can spot butter -- again the numbers are probably are hard to read, so I will just go ahead and tell you -- was averaging about 10 loads a day, and that was pretty much when it was doing three days a week. Now that it is doing five days, I think actually the average per day is down, maybe because they took the three days and expanded it into five, so you are doing less per day. But spot cheese is quite low in 2005 at only about four contracts a day. So that means some days, obviously, there is zero volume, zero, one, two, something like that, and other days, there might be ten or fifteen on average. We are talking a very, very small number of loads.

In fact, this data is through 2005. We have half of this year in. If you projected that out for the full year, if we did the same, doubled the volume during this first half for the rest of the year, we are only operating at about a quarter of what you are seeing there in terms of the total. So far this year in cheese, we have traded 120 cash loads, so call it 240 for the year. In the last two years, we did about 1,000 loads. For the full year, we are projecting we may come in at about a fourth of what we have done the last two years. Butter is not quite as bad as that, but we are projecting based on the half year, a little under 500 loads perhaps this year. Last year, it was 1,500 --so about a third -- and two years ago, it was about 2,000. If anything, based on the first six months, these markets are getting even thinner, these spot markets.

We do have information. We did analyze

some data. Even though there is very little trading done and one might have issues with that in terms of defining this as thin, based again on conversations I have had personally with people in the industry and others and analysis of the participants, we do see a large share of the industry that takes time out of their day for that little 15-minute window each day. Business comes to a stop, and they have a major trader participate or at least on the phone with these brokers, ready to participate. It is the old you think the price is too low in the case of some or too high in the case of others, depending on which side of the user or producer you are, but if you don't like it and you think it is too low, you are free to buy it, or if you think it is too high, you are free to sell it. There is a lot of potential for participation in this market.

Let us move on to another commodity altogether, and that is feeder cattle futures. This represents a little bit different situation. It is one of the first, if not the first, to do cash-settled. Back in 1986, it converted from a physical delivery because of some chronic problems with feeder cattle live deliveries and went to cash-settled. Initially, when it first started as cash-settled, it was settled to a Cattle-Fax price that represented a 200-pound weight range, 600 to 800 pounds, and it represented 27 states. Essentially, every state that did feeder cattle business was represented in the index. Well, through a series of changes when it converted to a USDA-settled price in January of 1993, they reduced the range by half. It was only 700 to 799 pounds, so it cut that down quite a bit, and it reduced it to 12 states because, quite frankly, with having all those states and areas, they were getting lousy correlations for cash value. It couldn't be used as a very good hedge because by being such an expansive contract, it really wasn't serving the industry well.

Now it has evolved further. Now it has expanded from that original 600 to 800 back to 700 to 799. Then it went to 700 to 849 in year 2000.

It added another 50 pounds. Then just recently in August, 2005, it went to its current which you see on the graphic. Again we are back to a 200-pound range, although it is slightly different. It is a little heavier now, 650 to 849. So that shows kind of an evolution of trying to address this issue.

Otherwise, it is a seven-day moving average. One of the reasons for that is obviously the more days you involve, you can include more market feeder cattle. Most auction places only auction once certain times of year, maybe twice a week. With seven days, you are going to capture most of those auctions. So it designed around the characteristics of that market. You can see the speculative limit then is 300 contracts.

Looking then at how this turns out, this graphic -- you can see it is very seasonal -- shows the number of feeder cattle that are included in the index. The seven-day average index is published everyday by the exchange based on USDA data, and you can see a very pronounced seasonal issue. In January, it peaks and falls, and finally, October and November are sort of the valleys, as just the season when cattle are being marketed. You can see this in numbers. This table just goes back to the year 2000, and you can see highlighted in red are months where are average, there were fewer than 20,000 -- I am sorry.

This is the futures months. They traded January, March, and April, and they settle on a seven-day moving average. These are the number of head actually included when January settled in the year 2000, how many feeder cattle were in the index used to settle the contracts. You can see in that case, it was 37,000, and we have had as many as 44,000 in the index. The red are those that are below 20,000. There is no particular significance to 20,000 except when the MERC made their change in 1993 looking forward, that was the big change from the Cattle-Fax and the 27 states down to the 12 states, they said that we believe this change is likely to have well over 20,000 on any settlement index. Well, in the years since that happened, they are not all included here, but you can see here in the 1993 -- I am having trouble picking this up.

The last line is what the average was. You can see in the early months, we certainly get more than 20,000, but in some of the later seasonal months, we get well under. The average for the years 2000 to 2006 for November was only 10,000, actually slightly less than 10,000.

The encouraging thing is -- let me find out. Oh, there we are. It is pretty close to where I wanted it to be. It is kind of hard to find.

If you look at August, 2005 -- that is when one of these big changes occurred -- and you compare these numbers here to the ones above them before this most recent change, in every case, they are quite a bit larger. So that is encouraging that these changes that took place in August, 2005, are much larger than their corresponding months or the average. At least it looks like that was a change in the right direction with this expansion that added another 50 pounds and some grades and stuff.

We like to think of it, in market surveillance, as not just necessarily in terms of the number of head -- this number then is again these six years or better part of six years up through May of this year -- but of how many head are in the contract. I remember we saw something like 10,000 at its lowest. Convert that to contract units, the number of head in a futures contract, and you come up with the equivalents here of how many futures contracts are in the index. In January, for example, we had 563 contracts typically in the settlement of that contract, equivalent number of head of cattle. In October, you can see it is down to 236. In November, it was 151 on average.

Now the red numbers in this case are compared to the speculative position limit which in the spot month, it is 300 contracts. The significance of that, from a surveillance perspective, is somebody holding a spec limit sized position of 300 contracts would hold a position equivalent to more cattle than are actually used to settle the contract. You can see that in September, October, and November futures on average. The second line of data is the minimum we have ever seen over this period of time, and you can see sometimes it is way under 300 contracts. In fact, November, you can see at a minimum, the smallest contract we had in November actually only had 95 equivalents.

This one is kind of interesting because I believe that 191, we did bring charges of manipulation in that October, 2003 case. That is a case that is pending in Federal court right now.

That is the saga of the feeder cattle and some ways we look at thin markets there.

Let me conclude with the lean hog futures market which is also cash-settled and has its own kind of interesting comparisons. This is a 40,000-pound lean hog carcasses, and this is a two-day moving average. You can see some of the things. Again, this is settled to a USDA price.

The USDA puts out actually several different prices. One is producer-sold negotiated. This is a producer of hogs, going to the local packer and saying: Here is my load or truckloads. I am going to deliver them in the next 14 days. What will you give me for them? He gets their best price, and it is a pure spot market, what is the best price, arms-length trade.

The USDA also publishes -- included in the index -- something called the Swine or Pork Market Formula. This is that same or another producer bringing his hogs to market, but it is formula-priced. There was some formula agreed to, and it is priced on something that could be the negotiated price that day. They say, ours are better hogs, so we are going to get a dollar more or something like that, or it could be one of the other pork products price or something like that. The point is it is a formula price, and it is not negotiated that day. It is based on a negotiated differential to some swine or pork market price put out.

This is some data. This is USDA data, but it actually put together by a professor at the University of Missouri-Columbia, showing the trends. Now these two, remember, are the two that are used to settle the lean hogs future contract, and you don't have to know a whole lot about statistics and stuff to see a clear declining trend in the numbers of negotiated hogs that are just out there. This is the total hogs traded in the United States picked up by USDA, and you can see of all the hogs marketed, we went from 13-14 percent back in the 2002-2003, and now we are down to about 11 or 10 percent. Obviously, if this trend continues to get less and less negotiated hogs -- remember, this is the one that is pure spot, that is negotiated right there, hand to mouth, and the one that is most competitive in my opinion. I guess one of my opinions is sneaking out, sorry about that. The other included in this index is the swine and pork market formula. You can see also a decline there as well. Between the two components, we are seeing declines. This means the number of hogs included in this index is going to get less and less, particularly if this trend continues.

If those are declining, what is increasing? That is mostly these packer-sold or packer-owned which means a packer owned the hogs to begin with and either used them themselves or sold them to another packer. Obviously, the preponderance of that is the packers are using their own hogs.

This just illustrates the same point graphically. This top line is the producer-sold negotiated, and you can see, particularly recently, a clear sort of, in my view, down trend in those. More recently, just this year in fact, in the spring, the packer-sold went up quite a bit. I think that was due to, in the State of Iowa, they have some restrictions on packer ownership of hogs, and there were some reinterpretations between affiliates and that sort of thing. There was some reclassification of hogs in that case, and clearly, the reclassification went toward including more packer-sold, and those are not included in the index.

Then this is just another way of looking at the same thing. This is the negotiated sales as a percent of total sales that are included in the index. These are not of the U.S. total now. Those are included in the index at expiration, and these are the various expiration months going back a few years. You can see it has sort of flatlined here. It doesn't seem to be declining much, although it is clearly less now than it was.

Then again, doing the same sort of analysis that we did for feeder cattle, looking at it in terms of futures contract equivalents, you can see, based on this analysis that this line represents, for those who can't read it off the chart, 1,650 hogs included in that two-day moving average. Now the spot month spec limit is 950. In feeder cattle, of course, we saw sometimes and quite often, less than the spec limit. Of course, 950 would be down here off the chart somewhere.

The lowest ones now in terms of contract equivalent have been the last four expirations. This represents April, May, June, and July expiration. The four most recent expirations represent the lowest point. So from a surveillance point, again that would be a concern. It is about 1.5 times the spec limit, so it is not so bad that way. But again if this were a trend and start to get less and less of these negotiated hogs and that sort of thing, that would become a further concern.

Finally, let me end on this. For your consideration, these are some of the ways -- I think some of the feeder cattle rule changes illustrate this -- to minimize distortion because, remember, that is one of the criteria for a market. It has to be not susceptible to either manipulation or distortion which is a little broader term. You can clearly minimize, one, by increasing the product underlying the futures, physical delivery versus cash-settled. Of course, physical delivery, the more delivery points you add or the quality of whatever it is, whether we are talking grains or hogs or treasury notes, anything you add to delivery is going to make changes to the way that contract is priced. If there is one maxim in this industry where you have a choice to make a physical delivery, you are going to deliver whatever is cheapest. You would be nuts not to. If you add points at very undesirable locations or grades that are less desirable and you don't appropriately discount it or whatnot, the futures are going to price your least common denominator, your cheapest to deliver. So you have those issues.

Cash-settled, we saw feeder cattle. They started with 200-pound range in 27 states. They started huge, and over the years, at least decreased the number of states to 12. Adding more states and stuff doesn't necessarily -- there are tradeoffs in terms of basis pricing.

The second item then is, of course, you can somehow control, if you are faced with a thin market, by decreasing the speculative limits, particularly in the spot month and perhaps have different limits for different months. You saw clear differentiation in feeder cattle in some months versus others in terms of supply, so that would be a consideration. Talk about thin markets. For frozen pork bellies, the spec limit gets down to 10 contracts for this August future in the spot months. There is where the Exchange has obviously used a very tiny spec limit. It is down below our reporting level of 25 contracts.

In any event, from surveillance, we have to do a lot of this. We have to verify the transactions, take a look at it. If we know who the traders are in the cash, see if they have futures positions and it looks like they are doing something. That would be our concern if they are salting the cash index or putting out bids or offers or something in order to affect a futures position because they can have a lot of futures and may not take much cash, so that any loss they might take on a cash trade, they can more than make up for by having very large futures.

Of course, this other category is any other which I will leave to others to come up with ideas.

Again, these are thin markets. These are not necessarily the thinnest. They just sort of illustrate, I think, some of the issues that are our surveillance staff has to deal with and the creative ways, I think, in which the Exchanges have tried to address this.

That concludes my remarks.

MR. DUNN: Thank you, Dave. Warren, will you give us a little overview of the price discovery role in USDA's markets? I hope that is working for you there.

MR. PRESTON: Thank you, Commissioner Dunn, and thank you for inviting AMS to participate.

I will wait for the presentation to come up. Let me just preface my remarks by stating that I am in the Livestock and Seed Program, so my comments are geared toward the livestock industry, but I do mention some others.

We had the advantage of having Dr. Turner in town, and we had him give sort of an enhanced of his presentation yesterday. I will just note that there was a lot of interest. We put out the word to what is kind of a loose- knit USDA economist group, and we had economists there from AMS, from ERS, from Grade Inspection Packers and Stockyards, from the Farm Service Agency, Risk Management Agency, and the Cooperative State Research, Education and Extension Service. This issue of thin markets is one that seems to be generating a lot of interest.

Let me just give you a little background on AMS Market News. This year, actually, we celebrated our 90th year of publishing Market News information. Currently, we put out over 600 daily, monthly, and annual Federal and state and international reports. I know that those hit numbers aren't always a good indicator of usage, but we are getting about 50 million hits annually on the web site, so somebody is looking at it.

We have 125 Federal employees in our

Market News branches -- 80 reporters, and then the remainder is support staff. We have state reporters who work under our direction, and that is an area that I may touch on a little bit that is getting tougher and tougher for us as states have been cutting back their budgets and they are not supporting these positions as vigorously. One of the reasons we have to go from 27 states reported in an index to 12 states is that we don't have staff there and we just don't have enough market activity to justify having a Federal staff member in that state to pick up markets there.

Our basic economic theory is publicly provided market information increases market transparency. It is almost a tautology. It reduces search costs, and that means that participants in the market don't have to go out and expend their own resources to discover what prices are and what market conditions are. They can look at the market information that is provided publicly. It has that public good aspect that once the information is collected, the cost of disseminating it to one additional user is virtually zero. Anyone who has an internet connection these days can access our Market News information. That market information increases market efficiency in the technical efficiency sense that you can have better resource allocation -- allocate your resources to production and marketing activities as opposed to price discovery activities.

The theory is pretty simple. Economists typically posit that there is a demand schedule and a supply schedule. In a competitive market, the point where those two schedules intersect is where you end up with the equilibrium price and equilibrium quantity. But nobody can observe the demand schedule; nobody can observe the supply schedule. We can estimate those kind of things.

What can we observe? Well, what we get in practice is we get a bunch of transactions -- that is represented by the graph on the right -- that will be traded at some price, and there will be some quantity associated with each one of those transactions. We can aggregate those up and average them together and come up with a market average price. If we have enough of them, we can say something also about the market quantity that is clearing. We can also add in some information about the quality and the quality characteristics and the timing of the transactions and something about the price ranges. It is a very difficult process to go from that economic theory to getting that information in practice.

What has happened for Market News and AMS is that, while technological changes reduce the cost to us of disseminating market information, actually what is going on is the changing industry structure and organization of the agricultural and food industries has increased the difficulty of collecting and assembling the information. Back 90 years ago, we could go into a terminal market, and all the traders were there. All we needed to do was put a reporter in there, have that reporter collect all that information at one point, and then they could post it up. They would have chalkboards at the different Market News offices, and they could just get the calls in and the teletype in, and each market would report in what was going on. In that way, the industry had an excellent sense of what was happening nationally. Well, with the increased consolidation and, as David just pointed out, with the movement away from negotiated cash market trades and more formula pricing and more contracts in direct trade between two parties, it is not quite as easy for us to just put a Market News reporter out in every feed lot business office and collect those prices. So now we have that burden of trying to get that information together and assemble it into market intelligence or at least market information that is useful to the industry.

This is a type of graph that I am sure you have all seen. This is based on Packers and Stockyards programs' information. The Four Firm Concentration Ratio in Meat Packing from 1980 have increased quite dramatically for steers and heifers, increasing from about 30 percent up to about 80 percent; boxed beef, even a little bit higher;  And hogs, not quite as much but increasing from about 30 percent to about 60 percent.  The problem that this raises is two-fold.  One is that typically with fewer and larger traders, you just have fewer trades to report. The trades tend to be larger, and it kind of goes along with the whole consolidation and growth, not just on the packing side but also on the production side, fewer and larger farms, so that each transaction tends to be larger.  Then the other is we run into confidentiality issues.  When you start putting out a market price and you only have two or three or four players, then the question is are you starting to reveal information about prices being paid or being received by an individual player in the market and then what implications does that have for competition.

Some of the changes that we have had in the industry:  We have fewer and larger farms, handlers, and processors, so that results in fewer and larger transactions and confidentiality issues. We have private party negotiation rather than open market trade, and that makes it more difficult to assemble market data. We have increased use of marketing agreements, contracts, and formula pricing, so that means we have fewer negotiated transactions to report. Also increased product differentiation makes it more difficult to aggregate the data for homogeneous products. As David referred to, going from a 50-pound weight range to a 200-pound weight range also means that you have a bigger mix of qualities in those transactions.

Just to illustrate each of these points, this is an illustration, also from Packers and Stockyards programs' data, of purchases of livestock at public markets since 1980, and you can see that they have declined quite a bit. They were already relatively low, down in the 20 to 25 percent range for hogs, cattle, sheep, and lambs, but for all three of those classes of livestock, they have declined to the point where hogs is well below 5 percent, probably in about the 2 percent range, as the trade has moved to direct trade and contractual trade as opposed to going through markets.

One of the other changes I talked about in the organization of the industry is increased use of contracts. I would include marketing agreements and contracts both in this. The scale in terms of the years in this chart is a little bit misleading. It goes back to 1950, but it doesn't go each individual year. What I wanted to show was broilers which, in 1950, virtually everything was cash traded. There were no contracts. By the mid-1950s, that industry was basically fully integrated, and there was no more cash market trade to speak up in broilers, and it has stayed that way, up at 90 percent contract production, ever since.

Some of the other commodities: Wheat has stayed fairly small. That doesn't seem to be changing a lot. Corn and soybeans are just around 10 percent with just a small blip in 2003 which is the latest data that I have. We took this from an

ERS report. Cattle varies a little bit and hit up over 30 percent in 1999 and right now back up close to 30 percent. Cotton was increasing but seems to be leveled off around 50 percent. Then pork has increased quite a bit since the mid-1970s from virtually no contract production to now up around 60 percent. So this leaves fewer negotiated trades to report.

Product differentiation, I put this slide in for two purposes. One is just an unabashed plug for some of the programs that we do in AMS. We now have 44 USDA-certified beef programs, and these are specifications that go beyond the USDA grades like choice, select, prime but have additional specifications required. The issue here is then, when we are reporting boxed beef trade, it gets more difficult to assemble that information into homogeneous categories because now choice beef is not just choice beef. If you are looking at, for example, certified Angus beef, we are talking about the upper two-thirds of the category of choice beef plus other requirements. Then that product moves out of that choice beef category. We either put it in and have more noise in that category, or we take it out and then we end up with fewer transactions to report in that category. We see this happening in all of the livestock products, more and more product differentiation. It seems to be happening in the grains as well.

In terms of a little bit of economic ideas here -- I think you are going to hear these again from Steve Turner -- what is a thin market? We have talked a little bit about it, and we kind of have this vague idea of what a thin market is, but conceptually, what are we talking about? Hayenga, back in the late 1970s, said that a thin market was one with few negotiated transactions per time period. One of the key words here is negotiated. I think it really does fit in with the ideas that David talked about before. When you are looking at formulas and contracts, it is a little bit different than negotiated because I think people are interested in looking at the intersection of supply and demand as that commodity market unfolds in this given point in time, so that we can fix some information set that is available to everybody. When you start including contracts and you start including formula prices, that is fine, but what you have to realize you are doing is you are also including information that happened when that formula was negotiated three months ago or three years ago or even possibly 30 years ago. When that formula was first put together, that was the information set that was put together at that point in time.

You can really see this vividly on our swine reports. We have a prior day purchase number that we put out, and we have a prior day slaughter number -- the average price paid for the hogs that were slaughtered yesterday and the average price paid for the hogs that were bought yesterday -- and those prices are not the same. One reason for that is that the ones that were bought were bought over a period of time, some reflecting formulas and different kinds of contracts, and you kind of have this conglomeration of all different kinds of information sets.

Another concept then for a thin market is the number of transactions relative to total volume needed to estimate the true, yet unknown, price at a given level of precision. This was Bill Tomek's concept, and it is basically a statistical sampling concept of a thin market. The basic idea is that we have some sort of a distribution of a price that is unknown, and what we want to do is to estimate what that price is. That is a fine concept if the ideas of statistical sampling theory apply and you have that kind of randomization, so that if you pull in more volume, it is being pulled in through some sort of random sampling. But the problem is market news reporting is not a random statistical sampling process. NASS reports are because they do actually use sampling theory and they actually send out statistically valid samples, but when we are trying to report daily prices or twice daily price, we can't do statistical sampling.

And so, what happens is that the reported prices that we put out are going to be influenced by the volume of trades; they are going to be influenced by the timing of trades within a day; and they are going to be influenced by the location of those trades. Just increasing the number of trades reported alone doesn't necessarily bring you closer to that true, but unknown, price at this point in time. That is something that we need to be very careful about, and I think it fits very well with the idea of the increased surveillance of the transaction activity because we actually have an issue in the CME index where we have had reporting, kind of a select reporting from somebody who was not participating previously and then reporting in that market. The natural inclination is well, more information is better than less, but that information was maybe in one of the tails at the upper end or the lower end of that distribution, and it influences the reported average price. So we need to be very careful about applying this concept.

This is a little bit of a play on words: Public price reporting can't be done for peanuts. Basically, the illustration I am giving is actually peanuts, and what I mean is that it does take resources to be able to do the price reporting when you have these thin market situations. In the case of peanuts, there are few negotiated transactions at the producer/first handler level. Most of the crop is forward priced or there are contracts and marketing agreement entered into early in the season. When it comes time that the crop is being harvested, there is very little negotiated trade to be reported, and the transactions that do occur are diffused over time. There are few players. There really are two major purchasers of in-the-shell peanuts and then another fringe that makes up a very small portion of the remainder of that. A lot of these contracts contain non-disclosure agreements, so even if we did get the contract prices or even if somebody is willing to report it, they are not permitted through the contract to report it.

The problem that we have in terms of USDA programs is that these producer prices underpin program payments. The Farm Service Agency has difficulty in coming up with the national average price for peanuts because we cannot find the prices to report, but they have to create a price. Then the other point is that futures markets depend on having a cash market price.

The point of this slide is current price discovery really is necessary for futures market operation. If I look at the graph here which is just looking at prices over time, if I start at a known point here, I can engage in risk management strategies in the futures market and through futures and options to mitigate my risk as I am going forward. But we have had cases where we do not have good solid cash market information. Industry has said, well, let us put a futures market in place. You can't kind of take that information set in the future and bring it back if

I don't know where I am starting from. It is kind of like if I am building a house on quicksand, if I don't have a foundation to start with, where I am right now, I really have difficulty knowing where I should be in the future, given carrying costs, interest rates, and storage costs, and things like that. How do I know where I need to position myself in the future if I don't know what is happening right now.

One of the solutions that Congress proposed to some thin market price issues is livestock mandatory reporting. That was enacted in 1999. The first reports that we put out were in April of 2001. The Act expired for the first time on September 30th of 2004. It was extended until September 30th of 2005, and now we are operating that program on a voluntary basis, so we call it our voluntary mandatory reporting. The purpose of livestock mandatory reporting is to improve market transparency. One of the big changes that it created was it enabled us to report those non-cash transactions, those kind of formula pricing arrangements, forward contracts, marketing agreements, and packer feeding that we just didn't have information on before.

The challenge that we have with that is it is not a cure-all, and we do have difficulties. Probably the primary one, particularly when we first rolled this out, actually there are two of these. One is timeliness. There was a concern that the reporting was not coming out as timely. Basically, we have all the major packers reporting to us and within an hour, we need to assemble all that information into a Market News report. We have to clean up all the data, and of course, there typically will be errors in there, and we don't want to put out just meaningless noise. So that is an issue for us. Also, if trade breaks at a particular point in time, we really don't have a way to get that information out easily through mandatory alone.

Confidentiality was a big issue. We had to change our confidentiality rules because the law does say that we cannot release proprietary information. Of course, reporting burden is a concern that the packers have. It probably is the most efficient place to collect the information since there are relatively fewer packers and there are fewer reporting entities. Then compliance is an ongoing issue.

One of the hypotheses, at least that I have, or I guess I will raise the question, is whether livestock mandatory reporting stabilized the trend away from cash market transactions, at least in steers and heifers. Now on this graph, the dark blue portion is the negotiated cash trades; the light blue is negotiated grid. That is basically a formula. A grid is a formula, but the base is negotiated. The dark yellow is formula, and then the light yellow is the contract purchases. This goes back to 2002, the fourth quarter, up through 2004. What we are seeing is that trend away from the negotiated cash trade kind of stabilized. Now that may have been partly due to what was going on with cattle prices at that time, but it also may be due to the fact that we increased the transparency on what was going on with these formulas and contracts, and maybe people found out that there weren't some of these unknown sweetheart deals that were out there, and they thought maybe the negotiated market wasn't such a bad place to trade after all.

I do need to caution you on this. That negotiated grid is something that initially we had included in the formula purchases and we reinterpreted that. So we need to be a little bit careful about how we interpret that.

This is something that also the previous discussion touched on. The negotiated market is really the place where prices are set, even though we have all the formula trading going on. Part of the Livestock Mandatory Reporting Act was a swine contract library that the Grain Inspection Packers and Stockyards Administration runs. They haven't been able to keep that up to date since the Act expired, but the most recent data they have shows the contract terms. Ten of the contracts that they reported on used a plant price, an internal plant price, as the base, and 111 of those contracts used an AMS Market News price. So it is still that negotiated trade is far and away the driver of pricing, whether it is formula forward contract or negotiated itself.

Looking ahead, where are we going from here? In AMS, we clearly see the continuing changes in the organization of the supply chain are going to shift the locus of price discovery in agricultural commodity markets. We are going to have declining volumes of negotiated trades that are going to continue to challenge our traditional market reporting institutions. We are going to do our best to develop Market News programs that aid price discovery and improve market efficiency. As I said, it is a public good, and it is very easy for support for the program to kind of get lost amid the noise. We really, surprisingly, need to increase our resources in some ways to continue to collect and assemble this kind of information, even though we can disseminate very cheaply.

That concludes my remarks.

MR. DUNN: Thank you, Warren. We heard from CFTC and from USDA, and now Dr. Turner who is the Chair of the Department of Agriculture and Economics at Mississippi State University, who tells me that he would really rather be doing this than being an administrator, is going to try to bring this all together for us.

DR. TURNER: Thank you, Commissioner Dunn. Again, I am going to present a framework. Thin markets have been defined pretty well, so I am going to zip through that. I will try to get us back on schedule here a little bit.

What are thin markets? Again, markets with little trading volume, little liquidity, and we are concerned about anybody exerting undue influence on the market. In the simplest context, a thin market is one in which relatively few transactions establish prices. There are some real concerns about that.

One caveat -- I like that word, so I like to use it a lot -- just because you might have something called a thin market, every transaction is not equivalent with respect to the information that it has. So you could have thin markets, but the information that is coming out of them could be valid and reflective of a true market. I don't know what the probability of that is, but the probability is greater than zero. It is a lot less than zero, but again let us just remember that. The point is that price discovery mechanisms or market institutions might influence behavior and price results. This is the theme of my discussion: These matter.

Now again, I am going to zip through this because most of us have had Econ 101.

Here in our country and in our economic system, we know this. We kind of believe that whatever it is, there is a schedule, a demand schedule, a supply schedule. The key reminder is this is a snapshot at a particular point in time for a particular location for a particular commodity or good. This is a snapshot. We all know that life is a movie; it is not a snapshot. So we take lots of snapshots, and we put them together, and that is the movie, and, in economics, we call that a time series. That is going to be important.

The other thing is price discovery is a communication process, and we can put up barriers to communication or we can enhance communication. Basically, all price discovery is, is a way to get at those supply and demand schedules. It is the actual operational mechanism whereby buyers and sellers arrive at a specific price.

I am going to talk about an experiment that I was a part of. I want to put this up there. You can't see it very well, but do you see these little dots? Do you see the demand and the supply schedule and see these little dots? Those little dots are actual exchanges. So the little dots are price discovery.

All the buyers had, in this experiment, was their reservation price as. In other words, if I bought something, what could I resell it for? If I sold it, what could I get it bought for? In other words, they had reservation prices, but they only knew theirs for those particular three units they had. They went into this privately negotiated market and found another trader who took the opposite side and they made a trade. You notice that we have a series of trades. Then we go through time, and we get it where it converges to equilibrium price.

This is not unusual in experimental economics; this happens quite a bit. By the way, experimental economics is well known and well established. Again, this is an English auction, but the same kind of thing is happening, and I will come back to the private negotiation and the English auction and discuss that a little further.

Price discovery mechanisms -- you call them markets, you call them whatever you want to call them -- are the link between what we say is theory and this price discovery process. The important thing to remember here is there are institutions, structural arrangements, and communication tools that are conductive to this price discovery mechanism. I can't overemphasize how much we take this for granted. This is a great place to say that because we have 100 years or 160 years or however long that we have been trading futures contracts, and we come to expect that, that there are market institutions. If you travel in other places in the world that are trying to develop those kinds of institutional arrangements, you are made aware that a lot of the things we take for granted are not around in some places.

The bottom line is, though, how do you measure market performance? Usually it is done in several of these fashions. I am going to concentrate on pricing efficiency, but again you can look at price patterns, you can look at the volume that is traded, distribution aspects, market efficiency, pricing efficiency. There are basically five measures that are commonly talked about. Three of those measures have to do with price bias, and two of those measures have to do with price risk. The reason this is important is because when we evaluate a market, especially a thin market, one of the things we want to look at are these measures and are those markets achieving, let us say. Are they biased? Are they riskier?

The first one is the rate at which an expected price series approaches an asymptote. Again, you saw that in some of the slides, and I might go back to them. The difference between the asymptote and the competitive price equilibrium, again, a market reaches an asymptote. Is that asymptote where the competitive price equilibrium would be? Then the third one with respect to price bias is the difference between the overall price mean and the competitive equilibrium. That is going to be important. That is one that I looked at specifically in the experiment that I did.

Price risk has to do with the rate of change in price variability around the expected series. Then the last measurement would be the overall variability around the mean price.

One of the ways that we can test some of these things and get at market design and how a market operates is we can use experiments. Most of you are aware of Vernon Smith, a Nobel Prize winner. He won that Nobel Prize by being the father of experimental economics. He would probably say, well, I am not really the father, but I will take the prize anyway. This is a supplementary way of observing phenomena or verifying predictions made by theories with empirical content.

The nice thing about experiments is you can control things. You can create a thin market and then see what happens. It is very difficult, as Warren and David have mentioned, and it is getting more difficult to collect the data empirically in the markets. So can we do this in some other ways?

There are more than two but two of the biggest results of experimental economics are that institutions matter. The market environment or price discovery mechanism plays a fundamental role in determining outcomes. We can design a market that will give someone an advantage, or we can design a market that will not give someone an advantage. I was asked yesterday over at the Ag Marketing Service, well, just tell me about that. My response was you give me the contract, and I will do it. It is being done, but we are in the very embryonic stages of market design. Michael and I were talking about this earlier. It is still amazing to me that it is 2006 and we still don't have programs in market engineering and market design. Maybe there are a few, but there are not many.

The second fundamental result of experimental economics is that the treatment of information matters and having information matters. If you withhold information, certain things occur within that market. That market behaves in a different way. So information and transparency will matter.

I am moving along here, so I will try to stay on schedule. In three minutes, you will be on.

What are the consequences of thin markets? Well, you know, I am not too bright, so I will just start from zero and go to one. None to severe could be the consequence of a thin market. There could be no consequence and it wouldn't matter, or it could be that the consequence of a thin market is very, very severe. I am going to present two examples, one of each.

This is going to depend on, again, the price discovery mechanism, information use, and reporting. This gets back to what Warren was saying. If there is no reporting or the reports are not there, that could have a big impact.

How reliant are other markets on this thin market? This is where National Cheese is going to come into play.

None: We did a study and we published it back in 1995. Basically, we did an experiment where we tried to create a thin market and see what the price ramifications would be. We designed this thin market within a laboratory setting. If you are interested, I brought some papers. They are online, if you just go to that site. The Journal of Agriculture and Applied Economics is an online journal, at least that year is, ad you can get a copy of that and see the details. I am not going to cover the details of the experiment.

What basically we did is we compared price bias and variation from a thick private negotiated market to a thin auction market. The key there, when I look back on it, we are not exactly comparing apples and apples or oranges and oranges. The result we found was there was no systematic price bias in either market. The thin market, at least the way we designed it, and the thick private negotiated market, there was no price bias with respect to how we defined it, and I mentioned that earlier.

As far as the price variation, we found that to be lower in the thin auction market, and I attributed that to the market mechanism we used there. We used an English auction, and an English auction is much like a livestock auction where a good is put up for sale and the highest price gets the good. Again, those were my results in a fairly limited study, a fairly confined study. One of the things that can be done and I wanted to imply here is that we can design experiments to test certain things, certain hypotheses.

Severe: Thin markets can have severe consequences. This is a very good article, by the way. You might want to read it. It is in the Review of Industrial Organization by Willard Mueller, Bruce Marion and Sial. It has to do with the National Cheese Exchange, and that was mentioned earlier. This study examined and analyzed the motivation and trading behavior of the National Cheese Exchange from 1988 to 1993. Actually, they had data, and they looked at it from 1980 to 1993, but up until about 1986-1987, government price was above market price, so it wasn't really a big deal. When market price went above government price, this kicked in. It became a big deal.

The National Cheese Exchange was used to formula price 90 to 95 percent of bulk cheese sales. David touched on that with respect to the MERC. It is a different market but similar. It represented only two-tenths of a percent of all sales, so very, very little trading. I might add that two-tenths of a percent was total sales of volume of cheese. If we look at transactions, it was even less. I don't know. I don't want to speculate there.

Results indicated that the dominant seller who was a buyer in the cash market had exerted downward price pressure while buyers had no impact on price. Let me repeat that. There was a buyer in the cash market. Buyers like what? Low prices. So this buyer went in the market and sold and became pretty much an exclusive seller and would do that for price advantage.

When we talk about what are the ramifications, we look at resource allocation here. This was quoted in the article: "For every cent per pound reduction in the National Cheese Exchange price" -- I only mention Kraft because it was in the paper -- "Kraft's raw material procurement cost by over $10 million annually." You can imagine what the ramifications of this were when it was published, both with Kraft and with the other players in that market.

How did this occur? Well, prices on the National Cheese Exchange were typically 90 percent based on unfilled bids and uncovered offers. So there weren't actually transactions. On one occasion, prices changed over a 25 consecutive weeks' period without a single trade. Of the 313 trading session of 1988 to 1993, no barrels were traded in 53 percent of the sessions and no blocks in 62 percent of the sessions.

In conclusion, formula pricing off thin markets can be a major allocative problem. I have kind of brought to you the most severe case that I have seen. I want to also mention, back to my caveat, a thin market can be an efficient market, I believe -- that is my hypothesis -- if the institutions, structural arrangements, and communication tools are conductive to trading that reflects current market conditions and situations.

Thank you.

MR. DUNN: Thank you. Michael?

MR. HAIGH: Commissioner Dunn, fellow Commissioners, I am going to fully hedge my exposure here by pointing out my disclaimer in just saying right out, these are my opinions.

I am going to talk about four things today: Thin markets, cost of carry, price discovery, and trader interactions in agricultural futures markets. That sounds like a lot of information, but hopefully you will see that the four things that I am going to be talking about are closely connected together.

As everybody in this room is fully aware, the futures markets serve two purposes primarily, price discovery and risk transfer. Researchers have conjectured that thin markets affect both of these things. However, there is mixed evidence as to whether a thinly-traded market actually provides a good price discovery mechanism or risk management opportunities. Most people who study these two things study them independently and not jointly, and usually when they find that a market has potential for price discovery, they infer that it has good risk management possibilities. There are problems with that, and I will get through that later.

The crux of price discovery rests in the notion of cost of carry or the carrying costs, as it is known, of carrying a good forward in time -- the more stable the cost of carry, the most stable the pricing relationship between the underlying commodity price and the futures price. Types of carrying costs might include storage costs, insurance, transportation, financing, or the so-called convenience yield. In a world where there are no arbitrage opportunities remaining, we should find is the futures price should be roughly equal to the spot price once you have taken into account the cost of carrying it forward in time. If that relationship breaks down, there are arbitrage opportunities.

Unfortunately, we don't live in a textbook economics world, and we do have imperfections in the cost of carry models. For instance, the relationship between cash and futures markets may not be as tight if we have transactions costs, unequal borrowing and lending rates, margins and restrictions on short-selling, limitations to storage, or low supplies of the commodity, making arbitrate difficult.

I just returned from Asia and wanted to tell you a quick story about something that surprised me in South Korea. The development of the Kospi 200 futures contract, which is the contract that is linked to the 200 stock index, had a miserable time when it first started trading. Short- selling was just not allowed. If short-selling is not allowed, arbitrage will break down, making this relationship incredibly messy. The reason I am telling you this is that this is an extreme example in the imperfection in the cost of carry relationship, and it has implications for price discovery and risk management.

Other imperfections in cost of carry are limitations to storage. Arbitrage conditions have to be ultra-dependent on storage. Some things just can't be stored, and that restricts the possibility of being able to create a futures contract. Non-storable commodities are things like live cattle and hogs. Even though there is an inventory of livestock related to the animals on feed, no fixed storable supply exists, unlike grains, for instance. This affects the cost of carry relationship.

An example of a commodity that has a very strong cost of carry relationship that ties the underlying spot market to the futures market is precious metals, for instance, where arbitrage strategies are very effective, short-selling is very possible, and there is a large supply of the underlying asset which means that the futures and the spot prices are very closely connected.

This chart I have here, reflects a

couple of the elements that affect the cost of carry relationship on each of the axes -- supplies across the top, and storability going north/south.

If you think of it in two ways, in the top right hand corner, where we have plenty of supplies and the ability to store, we find a market like precious metals. That market is usually at full carry, meaning the spot and futures markets are very tightly linked through predictable relationships. As you find imperfections in the cost of carry relationship -- low storability, low supplies -- we see departures in the cost of carry relationship, for instance, livestock or orange juice. Everything else in the middle, you sometimes see departures.

Turning our attention now to studies of effective risk management and price discovery in so-called thin markets, there have been a number of attempts, academic studies that have looked at the cheddar cheese futures contract. There have been a couple of studies that have looked at that, one study by Fortenberry and Zapata on the fertilizer futures market, shrimp futures, ocean freight futures, and a recent study on Brazilian coffee, live cattle, and sugar futures. I will give you a rundown essentially of what these studies have found in just a second.

Before I do that, I just wanted to show you the longevity of these thinly-traded contracts. Now bear in mind, as far as I know, all of these were open outcry, so their lifetime, as you can see in that second to last column, varies -- 5.67 years for the black tiger shrimp, 7 years for the white shrimp. The far right hand column gives the highest volume year in terms of the number of contracts. By all accounts, these are very, very thinly-traded markets. Compare these markets to, say, the lean hog contract at CME which has a volume, I believe, in 2005, of about four million contracts. So when we talk about lean hogs being thin, these markets are really thin.

Researchers usually find a positive relationship between price discovery and effective risk management. The closer the markets are linked -- by that, I mean the cash and the futures markets -- the more effective the risk management opportunities. For example, in the shrimp study, there was found to be no relationship between the cash and the futures market which, in turn, led to very poor risk transfer. For the cheese market, it was found in the early days of training, there was no relationship between cash and futures, but as time went by, the relationship strengthened and risk management possibilities opened up. In the fertilizer markets, they found a very strong relationship between cash and futures in the very beginning.

For ocean freight, this is an unusual one because even though volume decreased over time, price discovery actually improved, which you may think would lead to better risk management possibilities. I am very familiar with this study because I actually did this one, but what people often neglect to say is that even though price discovery improves in the market, meaning the cash and futures become tighter linked, you might think that there are better risk management possibilities. Less volume means a wider bid or spread, essentially. This market had such a wide bid or spread, that you could have steered one of the big ships through it in this case. The markets were better for price discovery but certainly not for managing risk.

For Brazilian contracts, which is the most recent study, a tight link was found between cash and futures, but effective hedging was only found in some of the markets that they had studied there.

So, hopefully, what we have established so far is that price discovery is different in different markets, depending on the underlying characteristic of the market, and in some markets, there is not a tight link. If the cost of carry relationship does not hold, price discovery fails and researchers generally find that risk management opportunities will diminish.

What I want to show you now are some

graphs of commercials and non-commercials -- here, I call them hedgers and speculators -- in different markets.

Why I am showing you this is that despite the differences between the markets that I am going to show you, fundamentally, we still observe the same types of trading patterns. The first graph that I am showing you here -- I really like these graphs because this is about as close to textbook economics as you get -- is the relationship between the non-commercial and the commercial traders over a period of time in the Commitment of Trader categories. So this information is released to the general public.

Here, you can see that this is a very tight relationship between the trading activity for a financial product.

Here, we have the S & P Index. It is not quite as tight, but most of the periods of time, you see the opposite positions by the commercials and non-commercials.

Let us move to the corn futures contract which, if you remember that matrix of storability versus supply, it was sort of in the middle in terms of the full carry sometimes holds, sometimes it doesn't. Despite the fact that it doesn't always hold, we still see the same sort of strong relationship between the commercials and non-commercials in that market. So these are commercial and non-commercial traders.

As John Fenton pointed out earlier on today, we are able to look at specific types of traders, and one particular type that people seem to be interested in are the managed money traders which are collectively the Commodity Pool Operators, Commodity Trading Advisors, and Associated Persons, and then anybody else who manages money.

What I want to show you here is not an output from someone's heart report but a link between managed money traders and the largest commercial traders which are the livestock feeders. You can see here an incredibly tight relationship. It looks like they are spiking at exactly the same period of time. The reason why we see these spikes is because both of these traders are getting out of their contracts at the same time and are not particularly interested in taking delivery.

In conclusion, what I want you to take away from here is that researchers usually find a positive relationship between price discovery and risk management -- the closer the markets are linked, the more effective the risk management opportunities.

Between price discovery and cost of carry, even if a market is heavily traded, relatively, the price discovery function may not be perfect due to the characteristics of the market's storability, storage, et cetera. Despite the difference in volume and despite differences in price discovery in the futures market, the strong relationship between hedgers and speculators or commercials and non-commercials still holds.

Given the seriousness of this topic and

its importance, I am going to focus on the right hand side of this PowerPoint slide and say thank you very much and open up for questions.

MR. DUNN: Thank you very much, Michael.

COMMISSIONER DUNN: From what you were saying, Dr. Turner, about changes in the structure of the market, what is the impact of e-trading going to have on thinly traded markets?

DR. TURNER: Theoretically, they should hang around longer. If an exchange is in the business of successful contacts, previously, if a contract had no volume they would discontinue the contract. The cost of carrying contracts now would be low with etrading, and unless you are concerned about reputation or something else, or branding, you could keep it on longer as far as in the cost world.

COMMISSIONER LUKKEN: I have a related question. I was struck by this morning's conversation in which we were talking about too much liquidity in certain markets and the type of liquidity that was being brought, and then this afternoon where we do not have enough liquidity. It made me think also today, being the initiation of electronic trading in ag products, and related to Mike's question, how do we encourage some of that managed money liquidity that is brought into these marketplaces to come into these illiquid markets? I think of the ICE/NYMEX situation that is going on now. When ICE started listing this contract, a huge amount of demand appeared out of nowhere. It was not stolen away from NYMEX, it came from out of the blue, and I wonder if there is pent-up demand out there either because of electronic or failure to have somebody on the floor of the exchange that these contracts might be able to get some demand from electronic trading or other means that encourage managed money to come to these illiquid markets. I am not sure if anybody has views on that.

MR. HAIGH: I would imagine that a lot of this managed money is attracted to volatility for the first part, but also there has to be some liquidity there in the first instance for them to get going, so which comes first, the chicken or the egg, and there has to be growth in the market before it is attracted there.

COMMISSIONER LUKKEN: And you think it is up to the exchanges to provide dealers in the marketplace to get that seed growth going and try and encourage folks to come in?

MR. HAIGH: We certainly observe that. When a new market is developed, they provide incentives for market makers, so that is one approach I would expect.

MR. KASS: Actually, the Chicago Mercantile Exchange had its second annual dairy forum a week ago today, and the spot butter and cheese were the focus of the full day, butter in the morning and cheese in the afternoon. One question arose is whether they should put the spot markets up electronically, and the consensus was no, that it is counterintuitive. It is cheap for the exchange to do that, but the rationale was now there is public information out there of what brokers are executing the trades. Everybody knows there are probably 15 brokers standing around and they can make guesstimates about who their clients are based on past practices and they know trades have been executed on behalf of certain physical clients. If you put it up electronically, you lose some information, and they thought that made more transparency if you have the physical market traded in the pit where you could see the broker as opposed to electronically where you would not necessarily see that.

Of course, then the counterargument was, perhaps if there were more anonymity, so these are some of the tradeoffs. An interesting sort of debate, but that was a matter of debate at these meetings.

COMMISSIONER LUKKEN: Are there funds out there that want to be anonymous, as Greg brought up this morning?

COMMISSIONER DUNN: Fred?

COMMISSIONER HATFIELD: Yes, I was wondering if some of you could put this into historical perspective for us. It seems like there have been thinly traded markets around for almost as long as there have been markets, and

Dave talked about fewer and fewer negotiated trades, and I think Dr. Turner said that it was harder to gather the data. Can you guys maybe take a crack at where are we on this? Is it something that is just going to be more and more of an issue? Have we been able maybe from a surveillance perspective to keep up with this? I would like to get your take on it maybe in an historical perspective, if that makes any sense.

MR. KASS: I think Dr. Turner makes a good point. It is very cheap. It used to be you had to allocate pit space and you have a certain number of bodies there and desks and things like that, so if a market was not going to trade a certain amount of minimum volume that you were going to capture some money back, there are representatives here from the exchanges, obviously this is what they know, that it is a revenue issue.

Now with electronic trading, there is a proliferation and that it is very cheap to list another contract. Merc is talking about relisting a dry whey contract. That is obviously not a huge market, but it is very cheap to list it, and they would list it probably electronically. In answer to your question, Commissioner, I would think if anything we probably are going to see with etrading, my opinion is that you might see more thin markets because, as Dr. Turner said, you can keep them on board longer and foster them. Obviously, the hope is that they would generate more and more volume, but you can stick with them longer.

DR. TURNER: My standard reply is that is an empirical issue.

(Laughter)

DR. TURNER: This issue, it is interesting, back in the late 1970s it became a very analyzed topic. Then from about 1980 something it just dropped off the kind of research map, and it is interesting now that in 2006 it has boomeranged back. We are in a lot different environment than we were in 1978-1979, but those of you who are old enough remember what was happening back in 1978-1979, the economy was not the greatest back the.

The electronics now are much more advanced than they have been and cost is a crucial factor. There is also institutional resistance, and I call it market lethargy. I was an egg producer, my father was, and we priced, formula priced off earner an Urner Barry quote, and we knew that the Urner Barry quote could be subject to whatever, but it was so simple to formula price. And we knew that if were formula pricing, other people were formula pricing, so we just got used to it.

So I think there is that inertia, too, so until there is something that prompts change, and the National Cheese Exchange is a great example. That went on for quite a long time. So that is my take on it.

COMMISSIONER DUNN: For Warren and David, do you see a need for a role for greater collaboration between USDA and CFTC, between the spot cash market and futures markets?

MR. PRESTON: I think it is clearly an issue, particularly for these kind of cash-settled contracts, and we do work with CFTC and the exchanges in trying to establish to what markets should we report and how should we go about assembling that information and provide that as a public service. It is an issue that we do need to work together to make sure that we fully understand what is going into these different price series, what are the quality differences, what kinds of things are happening.

While electronic trading, in response to Commissioner Hatfield's question, is becoming easier, it seems like from our perspective we are still seeing fewer and fewer negotiated cash market trades. I do not know that those are going to take place on exchanges, but that seems to be the best place to get that information as far as having the information sets of all the market participants and what is happening right now and you pull it all together, it seems to me that current negotiated market still is a desirable price series to have. This is my own personal opinion. I do not see the industry gravitating toward more negotiated cash market trade, it is going to be more formula-based, and the question for us is where can we aid the price discovery process. Is it going to take place at the wholesale level, is it going to take at the farm first handler level, is it going to be at the retail level and formulas will be derived off of retail reported prices? That is where we are looking. So I see the negotiated trades continuing to get fewer and fewer.

MR. KASS: I think your question about cooperation between not just AMS but others, USDA, I would say that within the last 3 years because of that October Feeder Cattle which was a case we brought in a cash-settled contract which derived from the USDA price, since then we have done a lot more work with USDA particularly in these livestock areas. Our learning curve is just leaps and bounds of where it was prior to that October

2003 situation across the board, and we have had excellent cooperation in terms of them telling us about their surveillance activities in cash and our surveillance activities, but with these trends of fewer and fewer negotiated trades, unless other things change, it requires more and more vigilance on both parts and more cooperation between the two, and we have been pretty happy with the cooperation.

COMMISSIONER DUNN: I am going to use the Chairman's prerogative here because we did get behind. We were scheduled for a break, but I see people have been on the honor system taking their own as they needed them. I would like to ask Gregg Doud to come forward to do his presentation on what they see from the field. I know Dr. Turner has to go catch an airplane pretty quickly, so if Gregg can go, we will push through and have a rolling break.

MR. DOUD: Thank you, Commissioner Dunn. I apologize, I just got home from Kansas at about 1 o'clock this morning after a bunch of airplane trips, it finally got me. I have a pretty bad cold, so I am going to make my comments pretty short and try to get through them here.

I really appreciate all the dialogue that as taken place today. There are a couple of things I would like to point out from the conversations that we have had in the cattle industry. Number one, these markets have changed. I well remember where I looked at these markets every day from the time that I was with the Kansas Farm Bureau in the late 1980s. In those days we did not have index funds, we were barely learning about fund managers, and the nontraditional hedger was not a term we were familiar with. But we are today, and I think the point I would like to make is our reports need to change with changing times.

In the private-sector it has changed dramatically, and one of things we have a lot of difficulty with today is separating out is who is a hedger and who is a speculator. In particular, I would like to raise the discussion of the index funds. I am just a farm boy from Kansas, but for the life of me, I cannot figure out how those guys are hedging anything. Those guys are making a play on inflation, and to me that is a speculative play, but that is probably a discussion for another day.

The only thing that concerns me from time to time is, and I have talked with the CFTC and your staff about this, we get caught in this trap of “this is the way we have always done it.” I think that would be the one caution I would give you today as we work through this. With all the changes that we have seen, we have gotten more volatility in basis, and we are very concerned, particularly in the Feeder Cattle Index of decreasing the Merc's ability or our ability to use the CME feeder cattle as a risk management tool.

Just 3 weeks ago one of your staff people from Chicago, Bill Konkitis, joined Dan Basse of Ag Resource in Chicago to give a presentation at our Summer Conference. Actually, it was two presentations and a kind of round-table format there. There were pretty interesting observations coming out of that. Number one is we had some of the biggest risk managers in the cattle business sitting in on those sessions. And I say sessions, it was the same session that they sat in twice to give you a feel for how important they thought this issue of the funds was in their everyday risk management process.

They were actually interested in some of the Bill's comments, and mostly the comment about the fact that the CFTC is aware of everything that is going on and they are on top of it. I think that was a very important point that you folks need to make: that we have the data, we are on top of this, everything is on the up and up. I think the reaction of most of the folks in the room was, Why can't they share some of this data? Why can't there be some sort of give and take and continuing dialogue just like we had with Bill today, it was outstanding, and in a way put everybody on a level footing to understand what is occurring in this business today. I think that was a very, very important item that even Bill took away from the discussion.

Lastly, I would like to make a couple comments about the Feeder Cattle Index. We are going to add calves to that in March of next year. We have had a great dialogue here. Early this year, letters went back and forth between the CME and a group of NCBA folks that are working at looking at the Feeder Index trying to ultimately make it a better risk management tool. You have seen the numbers as far as the seasonality of what we are running into there. I think there is a tremendous amount of effort going on now with the CME, with USDA, and with us, to try to sit down and go through this data as best as possible and figure out how we can make a better risk management tool, whether it is adding an auction barn here or there or adding more direct trade or adding more value enhanced trade: without diminishing the value of the risk management tool. And I think everybody is very aware of the changes that have been made, how well it has worked. How do we tweak this thing just a little bit to make it better without going back to having 27 states involved and something that is unwieldy and you cannot deal with?

I guess the key word here is change. I do a lot of speaking and recently was up in Canada talking to a group of farmers that farm 29,000 acres in two different countries. They did not know what the Golden Rule was, and I was shocked that these guys are massive users of risk management tools in this country and elsewhere, and there are key parts of this environment, and maybe there is part of this reporting process as well that we can use to help folks understand the forks in the creeks that are hauling water to cattle in 102 degree heat and they listen to the radio and they see what is going on with their crops and they do not see the market reacting the way they think it should, they need help in understanding why that is.

In that context I guess my last point would be we have seen a lot of this involvement in my opinion based on an inflation hedge in recent years based on what is going on in energy and other places. Markets go up and markets go down, and if we do not have the ability to inoculate the guy at the fork at the creek on what is going on in this industry, when the cattle cycle does turn one of these days and this thing heads in the other direction, they are going to begin to ask a lot of questions that they are not necessarily interested in asking today. And if we do not inoculate these folks just like we did 3 weeks ago at our meeting in helping them understand some of the new realities in this marketplace, we are not necessarily doing our job, at least my job in my role with my trade association and elsewhere.

COMMISSIONER DUNN: Thank you, Gregg. The key point I am taking away from your presentation is that we are in a dynamic industry and it is changing and we have got to be prepared to change along with it, all of us.

This is the point where I will open it

up for the panelists and for Gregg to ask any of them questions, or they can ask each other questions.

We will now open it up to the members of the Advisory Committee. Does anyone on the Advisory Committee have any comments or questions? Again, please state your name.

MR. STEVENSON: Randy Stevenson, R-Calf USA, and mostly directed to the Professor over here. As the cash markets diminish, and I notice several of you pointing out the intersection of supply and demand, in the formula markets a lot of that supply is tied up or committed, so you have the variability that is condensed into that remaining supply. Does that show up with as increased variability and increased risk there in the remaining cash market, do we see that transfer over into the futures market, and possibly what can we do about it?

MR. HAIGH: I will take a theoretical answer to that any reduction in the supply of a commodity is going to relax the strong relationship between cash and the futures market, and that is sort of the gist of what I was going through there, you will get a reduction in the full carry making it harder to effectively price and also to manage risk. So I would say the answer in short is, yes, it would affect the relationship the less the supply of the commodity.

DR. TURNER: I would concur with that. Again, as far as the volatility issue, my initial hypothesis would be, yes, that the potential would be there for more volatility, but, again, I would like to see some empirical analysis of it.

COMMISSIONER DUNN: What kind of impact does that have on USDA and CFTC then as we try to do surveillance and monitoring?

MR. PRESTON: I guess I take a little different tack on it in terms of the theoretical impact because also when you take away that supply, you are also taking away the demand side, because if that you have supply tied up, then the demand curve moves down as well.

Theoretically, you do not need a lot of

information to discover prices, it is the marginal trades. That is the issue that we are grappling with, is the negotiated market reflecting those marginal trades when somebody runs short of supply or somebody is long on supply and they get into that negotiated market, either if they have too much product, they will have to put it on the market, if they do not have enough product, to buy it. Is it an effective mechanism to discover prices, or is it that we are ending up with the residual market? It is really a different product and a different characteristics set that we are really looking at? That is really the issue, I think, that is of concern to us, is it the market indicator in a case that is still helping us discover prices, the cash market, the negotiated market, or is it ending up being a residual market for those suppliers who are not already engaged in formulas and what-not?

I do think we need to be careful that formulas do not necessarily mean that that supply is tied up. That just means that there is already an agreed to pricing mechanism, and that does not necessarily that it is tied up. And that is one of the reasons we moved that negotiated grid into a negotiated category. We had it in formula because it is a formula price, but the base itself is negotiated. In my view, everything is negotiated, it is just when it was negotiated. Was it negotiated today or was it negotiated some time prior? And either side is typically free to move away from that contract or that agreement at least within some limits.

MR. KASS: I think a smaller number of negotiated trades, if it is good information, it is good information, but from my point of view in surveillance, we are always concerned about market power. When you get a smaller number of trades, it increases the likelihood somebody at least might try to do the math, could I exercise enough market power in the physical market particularly for cash and a certain is involved and how does it compare to the gain I might get in futures, we do not want people even doing that math. That is dangerous. So the smaller the market, the more people might pencil it out and see if that is something that they could do. So from a surveillance point of view, obviously that raises very deep concerns for us.

MR. COYLE: I don't know much about these smaller markets, but just an observation. If I am hearing it right, there are markets that are thinly traded and it appears that there is more of this direct trade maybe because of more consolidation in industries or various industry groups. And while it would appear then that you would not have that much information about these either formula trades or these negotiated trades or settlements, it would seem to me as more and more of that grows, again, this is just an observation, you would want to learn more and more about exactly how those prices are made because that may then adjust how you want to look at your pricing mechanisms.

MR. DOUD: I would also make a comment. Theoretically, if you are beginning to see that happen, your basis would get more volatile as well. One of the key questions then is, if you have a problem in a thinly traded market or not, are you getting convergence at the end, and at least so far we are. So you cannot really measure what is going on out over time, but we still seem to be getting pretty convergence in all this.

COMMISSIONER DUNN: Not to fast, Gregg, we have yet another session.

(Laughter)

COMMISSIONER DUNN: Are there other comments from the members?

MR. VITALIANO: I have a question for you, David Kass. I think by these structural measures, thin markets are here to stay and they are probably going to become more and more of the total percentage of production that is traded in open negotiation. That is just the way the markets are going. So, I think in terms of surveillance, more and more emphasis has to be placed on what Steve Turner talked about, are these markets performing from the point of view of pricing efficiency? In the Commission's surveillance work, how much of your attention and activities are devoted toward elaborating and looking, analyzing direct price performance, however you might be able to do that, to see whether those markets are indeed performing despite their obvious structural imperfections, or even by looking at some what I might call creative structural measures? I think you mentioned a good one rather anecdotally in the CME cheese trading, a small percentage of production is traded, but if you look at how the industry reacts to those market, in a sense there seems to be a lot of potential volume that makes that market perhaps more contestable than the pure trading volume numbers would suggest. Could you tell us a little bit more about how you are looking at developing surveillance tools in a world in which thin markets are pretty much a given?

MR. KASS: Actually, in the next session I am going to throw up some slides that show exactly where we have identified some issues. If we see a lack of convergence, futures and cash coming together, clearly, in a cash settled market they are going to converge, so that is not an issue. It is settled to the settlement price, so there you have to look beneath the surface quite a bit more to see what went into that cash index to make sure that was not influenced.

But I can tell you firsthand, for example, just over the last or year an a half, I have had a number of conversations with milk producers up in the Northeast who either email or write into the Commission, and we do our own independent analysis, but we hear a lot from producers, whether you're talking dairy, you're talking grain -- all throughout the industry they are not hesitant to let us know when they seen an anomaly and want an explanation. Hopefully, if we are doing our jobs we can explain it on the fly because we have done the research, we have seen the same anomaly. Occasionally, they will point out an aspect that maybe we had not considered and we will go back and take a look at it and get back to them. But I have answered a number where people are usually pretty impressed that a federal agency——and obviously we are a relatively small agency——that they will get a personal phone call back, often it is me because I cover a lot of markets, and we will sit on the phone with them and hear what they have to say, they will hear our explanation. They may still be unhappy with the low price of milk or wheat or whatever it is, but I think they come away usually understanding how we do surveillance and our concerns and how we look at these markets. So some of it is triggered internally, some of it is triggered by I am sure by some of your members, for example, who I have had conversations with.

COMMISSIONER DUNN: Do we have other members of the Advisory Committee?

MR. HAIGH: I might add something to something you had brought up earlier, Commissioner Lukken, about attracting managed money into thinly traded markets. This is more of a statement than a question, but I have heard anecdotally that some potential participants have said that they are not willing to enter these kinds of markets at this point for fear of unintentionally showing power. So it really is a situation where they have to have enough liquidity to be able to do what they need to do in these markets before they are even going to come into them. I have heard this on a couple of different occasions why they will not use the futures markets.

COMMISSIONER DUNN: John Bunting had indicated that he would like to speak.

MR. BUNTING: I am John Bunting. I am a dairy farmer in Delaware County, New York, and have really appreciated the opportunity to be here today and have learned quite a few things that you don't tend to think beyond dairy and milk and so forth. But I thought it was very interesting that Dr. Turner brought in the Willard Mueller/Bruce Marion study. There was a legal case on that which fell into trouble in the courts because milk pricing and all the things surrounding milk are essentially so complex, they are like religion in the Middle Ages.

So the attorney, Tom Dobson, tried to explain to the court every nuance of milk pricing. The judge did not get it, and Kraft in defense said how can we set the price of milk? The government sets the price of milk, and they used case law, and the judge said, yes, I can understand that so they did not win.

Let's go back. We have seen several things here in which we see the intersection of supply and demand, and in dairy I don't think that you can honestly get that demand equation with as much precision as you can the supply level because we track very closely the production of milk in this country.

If you go back to the days of parity where the Secretary had the opportunity to readily adjust the parity level, you see a fairly strong, not extremely strong, correlation between the production of milk in this country and the price of milk in this country, and as you move on further and further, there becomes less of a relationship. If you look at a 5-year period from 2000 through 2004, the relationship of price to milk production is -.09, in other words, there is none. Then if you look at where milk is being produced in this country and you take the same time period, what you find is that 30 states did not produce more milk, that only four states in that 5-year period produced more milk. When you look at the driving force behind that, what you see is that it is California real estate money and IRS Tax Code 1031 that is really driving the supply of milk in this country because the dairy farmer can sell his farm in Riverside or San Bernardino County for $400,000 or $500,000 an acre and 1031 lets them keep all of that providing he becomes a yet larger dairy farmer.

So the four states, California, Texas, New Mexico, and Idaho, all have significant increase in milk production, and yet with all of what has happened since 1996, the United States has been a net importer of dairy products. We do not produce a surplus of dairy products.

So you have to look at this price mechanism which everybody does, and as Mr. Kass said, farmers call him and complain about it. But in fact, the suggestion is that we set up milk pricing based on futures, and while I think most people who have delved into milk know that milk is one of the thin markets in which the cash market determines the futures prices. So then if you go back, and you do not have to go back very far, to late 2004 or 2005, and I think those who are familiar with the milk market know that there was one trader who went in and bought futures and then went into cash market and ran them up, and the rumor is that he built an $8 million house and had $20 million left over, that is a matter pretty much of who did it and is of record, whether he made $28 million, I do not know.

Then you go back to the Mueller/Marion report, and what they suggested there was that Kraft was interested in increasing their profit because of their relationship with Philip Morris. At the beginning of October of last year, the price of cheese on the Cheese Exchange began to drop and to fall, and I had been told that this was going to be happening by way of some brokers in late September, and sure enough, it happen. I thought Kraft is just going in to lower their cost for their February, March, April buying period.

But then more recently I began to look at it, and it is strictly a theory, and as Bruce Marion would say, they have the motivation and they have the opportunity to do it. At this point, Altria is going to spin off Kraft, and if you look at the difference in the share value of Kraft from the beginning of October to the present time and you realize that there are 1.66 billion shares of Kraft stock that Altria owns 88 percent of, the difference in that share price which was very tightly tracked over the time they have had it to farm milk prices is something like $3.5 billion.

So I would suggest that there is continuing opportunity for manipulation within the market and that we really should change some of that, and this is not strictly a CFTC question, but we should not put 100 percent of farm milk pricing in the hands of a few powerful people. What we need to do is give them their due, which might be 30 percent of the value of farm milk pricing. That would make your job a lot easier, the policing of it, the volatility would disappear, and the oversight would be a simpler problem. So that is just my suggestion, and thanks for your time.

COMMISSIONER DUNN: Thank you, John. As John points out, a lot of that also has to do with the USDA and the milk marketing orders and producers. We will have an opportunity in the upcoming Farm Bill to address those particular issues. Another person who had asked to address the group is Kathy Ozer, and I see Kathy just came in.

MS. OZER: I am Kathy Ozer, and I am the Executive Director of the National Family Farm Coalition, and many of the issues that John Bunting just raised are issues that our coalition has been very concerned about. We have an active Dairy Subcommittee that represents dairy farmers who work on their farms but are very concerned about what is happening in Chicago at the CME. We have been involved in meetings with them. A couple of us came and spoke with Mike Dunn last year and with staff and really see the role and the importance of there being real oversight and a real involvement and engagement in this process.

I think what we saw almost 2 weeks ago with the Senate Agriculture Committee doing their oversight hearing on dairy is that there is a real need for both legislative change, but also regulatory oversight at whatever levels that currently exist in law, but also support for changes so that we will have a system that truly works for farmers and for consumers.

We appreciate the opportunity for this meeting being held today and that there is an opportunity for public participation of family farm and rural advocacy groups in that process. I am not going to go over all the issues that John just did, but just reinforce the importance of this process and hopefully over this next year an opportunity for there to be further discussions about what is happening at this point as opposed to some of the historical perspectives of what has happened in the past, and I appreciate the work that is being done to explore this issue more publicly. Thank you.

COMMISSIONER DUNN: Thank you, Kathy. Commissioners, do you have any wrap-up for this group that you might have?

Let me thank you all. I feel like I have gone through Economics 101, 201, 301, and 401. I might have even gotten to a 5 level, but I really appreciate it. You have done an excellent job in exploring an issue that has a great deal of concern as you have heard from our public participants today, and I appreciate it very much.

That is a good segue for us to get into another issue that we have heard a great deal about. All of you can leave except for Dave Kass.

(Laughter)

COMMISSIONER DUNN: As Dave said, he is always open to talk to folks, and in that particular capacity he has had opportunity to meet with a group from the Illinois Farm Bureau who came in to talk to him with concerns about a weak basis and the convergence on the basis. Dave has prepared, just for informational purposes for the Advisory Group and for the Commission, some of what is happening here which is something that we need to probably be aware of and keep our eyes on. Dave, if you will, please.

MR. KASS: Thank you, Commissioner. I will preface with if an opinion happens to leak out, it is my opinion, and not necessarily that of the Commission.

This group that the Commissioner refers to, they came in and arranged for about an hour and a half and we had figured what we could do in about 45 minutes and leave 45 minutes for discussion and that sort of thing. It ended up that they were there for about 3-1/2 hours including through lunch, and I think we got some pizza for them and this and that, and they kept at it. They started out with the 25 cent tour of our surveillance system and ended up with the $5 tour, and they kept asking questions. I made two or three trips back to my office to get additional materials and slides to show that, yes, there was more beneath even what we had started, but we did not think initially we were going to have enough time to present it.

Let's go forward. This is sort of equal time. My earlier presentation was mostly Chicago Mercantile Exchange products just by happenstance. This happens to be Chicago Board of Trade, but it is an issue that has been raised quite seriously very recently, there has been a lot said about it, and it is of concern and I do not think we have quite all the answers yet.

This first graphic shows for the most recent future that went off the board, for corn is the red, soybeans is the green, and wheat is the blue, where we ended up in the last 30 days of trading. So here is your thirtieth day, twentyninth, all the way down to the last trading day in the July futures contract, what the cash basis was over that 30 business day period. You can see that zero isn't even on here, so we obviously did not get anywhere close to a zero basis. We do not usually quite get to zero, there are reasons for that, but usually several cents one way or the other would be considered pretty reasonable.

You can see in the case of corn, for example, we were pretty stable at around a basis of cash 25 cents under futures, soybeans a bit worse at 35 cents under, and here is wheat is, and this is based on cash in Toledo where the biggest delivery facilities are, essentially off the map at 65, and I think it ended up near the end at around looks like 57 cents. Clearly, not a model of convergence.

So we set off to try to figure out what is going on here. One thing we looked at then for each of these markets was how the basis compared. Let me just give you a description of this graphic. The zero line represents cash zero basis. This bar represents the range of basis we have seen, and this is over a period of 1996 through 2004, the range of basis we saw. This is for the fourth week of July, so this would be like just last week. This is current data, but going back in history all the way back to 1996, so this would be the range of bases we have seen in the fourth week of July going that far back.

The red X, it is a little hard to see, but here is one, for example, represents the median over that time period. The blue box, and you can see these blue boxes here, and this is going to be the same for the next three charts, represents where the basis was a year ago, so that is the 2005 basis. Finally, and sometimes, unfortunately, it overlaps and you cannot quite see it, but there is kind of a yellow-green star, and I will show you where they are. This one is down here, and that is this year, so that is what the basis was just last week. And the green star is up here, and it is a little hard to see.

These are at various major trading

points, Chicago, Toledo, Ohio, which is undoubtedly interior Ohio, St. Louis, obviously on the river, Decatur, upper Illinois River which is of course the delivery point on this, and the bean contract, and of course a big setter or value across the grain complex, and that is the Gulf. Note for example this difference here, and you can see this year's basis at about 30 under at the upper Illinois River. Meanwhile, the basis at the Gulf last week looks like about 45 over. That is a 75-cent difference, and as I go forward, I think you will see the reason for that. But nonetheless, each of this year's basis is just at the low or near low end, and certainly well below the median, in virtually every case except for at the Gulf.

Since I just described all that for corn, you should figure this out. This is soybeans, the same concept, a few different locations, perhaps. No, I guess it is the same. So it's the same deal, it is the basis last week over a long period of time, the median, last year's basis, and this year's basis, and here in soybeans you see it quite a bit weaker. You have at least these three that are well below. At St. Louis, Decatur, and note for example, soybeans, well below this year's basis, quite a bit below. Last year and well outside the range you did not see quite as bad as that in corn. And again, at the Gulf of Mexico you are seeing, for example, now upper Illinois River versus the Gulf of Mexico, that spread is about 80 cents. So you go from about 30 under upriver here near Chicago, to 50 over, so you get an 80-cent difference. Remember that, and you will see that again as we go forward.

Now let's look at one that has already been described here as probably the worst-case example, and this is wheat. Again, the same deal, wheat at various locations historically, and then what the median is and this year. Chicago, clearly below what we had seen. But with Toledo, we had to redraw the scale on this thing. Normally, you would see the median at Toledo for this time of year looks like about 7 cents under. It is a little hard to see up here. I'm sorry, Toledo would be about 16 under. It's right here. The median last year was right on top of that. So it looked pretty good last year. We were right on top of the median. This year all of a sudden instead of being something like 16 cents under, even worst-case scenario over this whole period going back to 1996, we were at about let's call it about 44 under, here you can essentially double that and we are just like off the reservation in terms of how weak this wheat basis is.

This other one is kind of an odd point. You didn't see it on the other one, this Blytheville, Arkansas, that is a point down near the Missouri/Arkansas border, and we illustrated that because Missouri and Arkansas congressional folks inquired about this and what is going on here, and you see there is also a very, very weak basis historically.

One thing about wheat, though, look at a year ago. We went from, at St. Louis, for example, right on the bottom this year, but look where we were last year. We were right at the top of this historical range. In fact, if you look at the blue boxes, generally last year we were in pretty good shape. We were at the medians, and at least in these two cases at the Gulf and St. Louis well above the medians. So what has happened in the interim?

One observation I would like to make is that in wheat we saw, was it Dave Lehman or Tom Coyle presented some volume figures, and wheat volume and open interest is just remarkably higher, tremendous growth in the amount of volume and open interest. But a lot has been said about commodity index funds and it is easy to attribute perhaps high prices, which is of course high relative to cash, to commodity index funds. And there have been vague terms used about the participation of commodity index funds, and, frankly, it is probably illegal for me to give you the numbers, and we do have the numbers in terms of participation, but I can tell you last year when we had a very, very strong basis, the percentage held by commodity index funds was greater than it is this year. That is counterintuitive if you want to jump to the easy conclusion that it is commodity index funds causing the problem, they had a higher percentage of open wheat contracts a year ago than they did this year, so that is not a simple answer to this situation we are facing.

What is some of the rationale here? Look at U.S. diesel prices. Virtually everything that moves in commerce is diesel-truck, rail, barge, whatever. This is last year's diesel prices, and, again, this is similar to what you saw except the median is this red line. This is the range of diesel prices from 1994 to 2004, an 11-year range, and look at last year. At the time it looked incredible, but now look at this year. What seemed to be incredible last year, people wished they had those prices this year, we are near $3 a gallon, and these are monthly prices. When you consider the top of the range was $1.75 prior to last year and the median was down here at about

$1.20, that explains a lot about the cost of moving stuff from interior points to collection, and then finally to export points.

More specifically, this is the same type of chart for barge rates. This is the Illinois River, and the reason for that of course is that is where you deliver in this case corn along the upper Illinois River. This is barge rates up through July of last year, this is end of month, so this spike here, I think we all know what caused that, I will just say K, that is Katrina, caused that huge spike in barge rates, we saw it continue up, and it looked like it was starting to come down, as we got into the months past Katrina things started to get in better order, and coming into this year in January, the green, it spiked up again and these are essentially record levels for barge rates for this time of year. You can see seasonally you get your highest barge rates later in the fall. But right now this is what we are looking at as barge rates.

Remember those differences between corn

and beans? I think one was 80 cents or so. Look at the cost to move it from the upper Illinois River down to the Gulf, and this is not magic and not by coincidence, it is about 75 cents. This is corn, and they are a little bit different depending on which commodity you happen to be moving. This is not by coincidence that the barge rate is going to be the difference in the basis between collecting something at the Illinois River and at the Gulf.

So these are the issues. Clearly, in corn and beans, I think we have a pretty good handle on some of that stuff. We are at full carry, so you have a little disconnect. Longs can take delivery all day long because they can hedge it and carry it forward if they get delivery and make a return. Shorts, on the other hand can deliver, but they are not having to bid in the cash market in order to deliver because you are delivering certificates and it is a promise to deliver. If you get called on a shipping certificate, of course you have to make delivery.

But with the economics of freight, it is unlikely it is going to get called. So you do not have a free hand to make delivery, there are certain requirements, that would explain some of the disconnect clearly between the corn and soybeans basis because longs are looking at one thing and shorts are looking at the other.

Wheat is a little different because that is a physical delivery market and there are some issues, and I think Tom Coyle talked about some of that when he talked about this issue in this morning's session.

I am just raising this as an issue. This is what I think the Commission is faced with. What is causing this wide basis and lack of convergence? Clearly, from the Commission's perspective we would like to know is this a one-time phenomena or is it likely to persist. If it is a short-term or one-time special circumstance, how long is this likely to last, and can and should anything be done to help the situation? If the market is going to cure itself, obviously, it might be a mistake to do something.

If, on the other hand, this problem is likely to persist in one or more of these markets, what can or should be done to address it longer-term knowing, for example, that if you say let's change the contract, a change in a term or condition of an ongoing grain contract could very well take 2 years to implement if you change it today because you cannot generally change it for contracts with existing open interest.

Then, obviously, as important I think for the Commission is beyond providing this forum for discussion which is of value in and of itself, what role should the Commission play in order to facilitate a solution if one is in fact necessary? I will throw those questions out there for anybody. There are some folks here who deal with this every day, these bases, convergence, and I will leave it to the Commissioner to decide where we want to go from here.

COMMISSIONER DUNN: Let's ask the Advisory Committee for any comments or questions.

Tom, I see you are already.

MR. COYLE: I can help you at bit with some of the numbers. I would point out just a few things so you can see the differences. Go back to the one you just had. You can see the big basis difference clearly on that. This is corn.

What I want you to notice here first of all, and this will identify the difference between corn, beans, and wheat, is that wheat is an odd situation this year. You will see here the basis here in Illinois and you see the basis in New Orleans up here, you will actually notice that the basis level in New Orleans has gone up quite a bit this year, and the basis level in the interior has gone down quite a bit. In this case, you can see the transportation values as having an impact on the basis in New Orleans as well as in the interior. It is important if you go to the same chart for wheat, a couple of things you will note.

MR. KASS: We do not show the upper Illinois River here, but we show Chicago.

MR. COYLE: You can show Chicago where

we would load grain today. This is actually our bid today, but if we were buying grain today from a farmer at that basis and load it out in a barge, it would lose 40 cents a bushel. And that goes to your comments, Mike, on the chart that you showed and some of your assumptions about an effective market and whether or not storage is an issue.

But what I wanted to point out here is the fact that you actually have a lower basis in New Orleans in wheat this year despite the fact that barge trade is significantly higher, and that is a reflection on the fact that there is not demand at the export point for the wheat. Typically what happens if freight goes up is the first thing that has to happen is the export basis has to go up and the end consumer has to pay it. Some of it will work its way back down to the interior. When that does not happen, it tells you that there are other supplies of wheat around the world that are more competitive, and so the consumer will not be able to buy grain from the Gulf. That is an important issue.

Then you want to ask yourself the next question, Why does that happen? I will make some observations and I just wanted to add from that, that this year's scenario is much different than anything else we have ever had. We have record carry-outs in all commodities, corn, beans, and wheat, so one of the reasons why you have this dislocation, or I would say disconnect that you see right now in corn and beans, is the fact that you have a big carry-out, you have high transportation values, and commercial storage is full.

In the case of wheat, you have a different situation and that gets to Mike's point earlier about storage. At some point elevators will operate effectively. Today we are loading out soybeans below delivery values, and buying wheat significantly cheaper, but at some point you cannot fill your elevator with wheat because then you cannot handle corn or soybeans. I will give you an example this week of an elevator in Milwaukee where we are full of soybeans and wheat, it is wheat harvest, and we have corn boats all week. The plant manager says, Tom, stop. We cannot take wheat anymore. And that is the reason why you see probably the basis in Toledo so low on wheat. So it does get to be a storage issue and it is unusual.

Typically, what happens then is the price gets low enough to stop the farmer from selling wheat, the farmers typically sell wheat out of the field, they do not store it. They use a half a bin for wheat because they use it for corn and beans later, but at 90 cents a bushel in Toledo a farmer may decide I am going to store wheat on the farm or I am going to do something else, and you will find unconventional storage capacity. We are bringing a boat from Duluth that has not had grain in it in 22 years, and we are going to store wheat for a year. This will not happen very often. This is unusual.

In any case, I just wanted to highlight why that is. It really ends up being a storage issue. You made the comment which surprised me about the make-up of the market and whether it is funds or whatever. You might ask yourself the next question, what was the futures price a year ago on wheat and what is it this year? I think what you might identify is that the price of wheat is significantly higher. And because the wheat price is significantly higher, the basis has had to go down because it is not driven by consumption. Part of the reason why the wheat price is so high is because you had a drought in hard wheat, and now you have a drought in spring wheat. We have ideal conditions in soft wheat, record yields, and farmers took advantage of the price that they saw last year to put in more acres. So we really have a situation right now where there is a lot of wheat that wants to move, and it has to find a home. Over time these things work out, and you may have a systemic issue in the issue that we have said earlier, part of it is related to the price, and the price is related to the fact that you have some long activity in the market where people do not sell out that long because the price realizes a dollar a bushel because they are not looking at the basis.

COMMISSIONER DUNN: Thank you. Are there any other comments or questions?

MR. GOULD: My name is Eldon Gould. I am currently the Administrator of the Risk Management Agency of the Department of Agriculture, but until last November I was a real live working farmer from northern Illinois, and so I have witnessed all of this first-hand, the basis problem that started a year ago with the capital K, Katrina, and as a producer you hope this thing was going to come and go pretty quickly, but obviously it did not, it has persisted, so I would say roughly in northern Illinois we typically would deliver on the upper Illinois River and the basis has stayed twice as wide as it normally would.

And then 2 weeks ago this past weekend I was back in Illinois and we were in the midst of wheat harvest at the time, soft red winter wheat with that basis there where you had to realign the chart to make it fit on there. At that time the basis was exactly 90 cents, so most farmers in the area that I am aware of put that wheat into storage because of the temperatures that weekend were very similar to what it is here in Washington today, and those of you who have stored grain know that grain that is at 90 or 100 degrees does not store very well, so we let the elevator take the risk and that is what happened.

As was mentioned, that grain now has to move out of storage from the elevator before soybean harvest starts which in our part of the world is toward the end of September.

I do not have anything to add except from the producer's perspective the frustration of it all, and the fact that I guess the real question is, is this a 1-year problem or are we changing paradigms with the problem with the river system of fewer barges and low water? In Illinois there have been a number of rail loaders go in that are shipping grain to the Southwest, and of course the number of ethanol plants. So it is kind of interesting dynamics in the grain trade.

COMMISSIONER DUNN: Thank you, Eldon. Would anyone else like to comment or have questions?

MR. BROPHY: I am Dan Brophy with the National Grain Trade Council.

I agree with what Tom said. He brought up some good points about the unique situation that we are facing in the wheat market this year. I would say that the statistics that Dave pointed out are something the likes of which I have never seen, and I think I reference that without saying that my remarks were in relation to wheat. I reference that in my remarks to you gentlemen earlier today.

I have not seen anything like this. Dave Lehman has an explanation, Tom has an explanation, they are both closer to all the data in the cash market than I am, but I think the point that can be drawn from this is that the industry needs some confidence that it does not have now. I think the first step toward restoring confidence in the general predictability of basis relationships is for the hedger, in particular, the short hedger, to have some idea of the magnitude of the index or financial hedge nonprice responsive long that is in the market at the moment. So I think if there actually is a contract problem as some people have said today there might be, it is too early to know, but the only thing that we can do is let time play out and get accurate data.

I hope that you will assist in the reconstruction of the Commitments of Traders Report to restore its former utility to the industry. Thank you.

COMMISSIONER DUNN: Are there any other comments from our general audience? If not, I would like to ask the Commissioners for a wrap-up. Fred, we will start with you.

COMMISSIONER HATFIELD: Thank you, Mike. Commission Dunn, I would like to thank you and your staff very much for what I think was an excellent get-together today. I thought all three of the discussions were extremely educational, and you know you have had a good conference when two people who I consider to be experts say that they learned something. I heard that twice today, and that is when I think you know that you have done a good job.

I want to thank all of our guests for being here. I also would like to say I am impressed every day, but it is nice to be able to say this in public, that we have a phenomenal staff at the CFTC. These people do the work day in and day out, they are very smart people, and I am glad to work with them.

Dave Kass reminds me of John Madden with that pen. He is the John Madden of the CFTC.

(Laughter)

COMMISSIONER HATFIELD: I want to thank everybody very much. It was great. Thank you, Mike.

COMMISSIONER LUKKEN: I want to congratulate Mike, too, for putting on a great program with his staff. They were working late last night, putting together pamphlets and programs, so they did an excellent job of organizing this.

I would also like to take the opportunity to pat our staff on the back. Something that Gregg Doud brought up, part of today's program was to educate what we do here and to try to bring confidence, as Dan had mentioned, to the people who utilize our markets that we are sufficiently overseeing this marketplace. And I think after you have heard John Fenton, Dave Kass and Michael Haigh and others speak today from our staff, you get the feeling that we are on top of these markets, and we certainly are. We see this every day on a real-time basis. The Commission is briefed every Friday on these things. So it is important to know that you have confidence in us and that we are doing the public's mission.

I would like to again thank Chairman Dunn for putting this together, and the Chairman of the CFTC also for allowing us to do this.

COMMISSIONER JEFFERY: I can only underscore Walt and Fred's comments. I will not repeat them. Again, I thank all of you for being here and the feedback we received today is extraordinarily helpful as we take particularly the Commitments of Traders Report to the next level and consolidate and assess all the feedback we have received today and any follow-on comments you or your colleagues want to send in to us, and try to adapt the report to all of the changes that we are also aware of and were discussed today so that we can make it something that continues to have relevance to all of you and the community at large in their day-to-day trading and producing activities.

Again, as to the staff at the CFTC, it is one of the great blessings of having the opportunity to work here as an outsider, and we have an extraordinary group of professionals -- many of whom who have been at the agency if not since inception, since the inception of their careers, who have put heart and soul into the work of the Commission. I think you have seen it today, and you see it day in and day out. You do not see it most of the time, but you know it is there and you should be comforted at the quality and the caliber of the work that they do.  This kind of session, I think, is not only informative to all of us, but it is also motivational to those of us who work here, and particularly the staff, in that it is real contact with the outside world, it is real visibility on the significance and import of the work that they so ably carry out throughout the various branches of the CFTC around the country.

Again, thank you all, and we look forward to continue to work together and continuing this important dialogue.

COMMISSIONER DUNN:  Thank you, Mister Chairman.  I echo all the thanks that my colleagues have mentioned.  But I would also really like to thank the Advisory Committee, the folks on the Hill, all of the people that we went out to to ask about what should be on the agenda for this particular Advisory Committee.  You obviously gave us good direction and pointed us in the right direction of where to go based upon the participation and liveliness of the debates and the conversations that we have had.

I would be remiss if I did not hold out my particular staff that has worked so hard. First, Eric Juzenas. Eric, if you will stand up. Eric did all of the background, all of the leg work in contacting the folks. Jason Gizzarelli assisted him when he was not out delivering his first born. And the person who really has done a tremendous amount of work, Nicole McNair. Nicole, if you will stand up. I came in Sunday, there was no air conditioning in the building, Nicole, bless her heart, had thrust her husband Joseph into coming and working with us, and they were putting together all of the material that we got together for today, and I want to thank all of you for that. And then the group that put everything together, the CFTC staff, Mister Chairman, you can be very, very proud of the support staff we have here, and I am not going to begin mentioning names for fear I would miss someone.

But finally, as to our professional

staff, it is nice to be able to showcase them, what Dave Kass has said, and John, Don and others, they are willing to listen to you, listen to the public when they give a call. It is tremendous. It is not what people think of when they think about federal service. They do an outstanding job, and I appreciate it. And my final thanks, again, to the Advisory Committee and all of you who have agreed to serve. We will be getting back to you to find out what further directions and other issues that you would like to have, when and where we might have our next meeting. We were thinking about trying to take it to the field, maybe get out to Chicago, New York, Kansas City, or Minneapolis to actually visit some of the exchanges to give some of you a firsthand look who have not been on the floor of those. It is a little logistics problem for all of us, but I would like to hear from you on what you would like to do. It is your Advisory Committee to the Commission. Thank you all.

(Whereupon, at 3:48 p.m., the PROCEEDINGS were adjourned)

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