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COMMODITY FUTURES TRADING COMMISSION

AGRICULTURAL ADVISORY COMMITTEE MEETING

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Chairman, Agricultural Advisory Committee

CHAIRMAN GARY GENSLER
CFTC

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P R O C E E D I N G S

(9:10 a.m.)

COMMISSIONER DUNN: Good morning, ladies and gentlemen, and welcome to the 33rd meeting of the Agricultural Advisory Committee. And as we begin to get started, what I would like to do is begin by adding introduction of the members of the AAC, so I will ask you to go around the table, identify who you are and who you are representing. And Bob, if I could start with you.

MR. DINNEEN: Hi. I'm Bob Dinneen with the Renewable Fuels Association.

MR. BAIR: Jim Bair, North American Millers Association.

MR. COPPOCK: Daren Coppock, National Association of Wheat Growers.

MR. CRYON: Roger Cryon, National Milk Producers Federation.

MR. BRUNS: Matt Bruns, National Grain and Feed.

MR. PEPPLER: Kent Peppler, National Farmers Union.

MR. NATZ: Kavin Natz, National Council of Farmer Cooperatives.

MR. WILLETT: Sam Willett, National Corn Growers Association, and I'm joined this morning by Gary Niemeyer, a member of the Board of Directors for National Corn Growers Association.

MR. BURLET: I'm Chad Burlet, Burlet Trading, but I am not a member of the AAC.

COMMISSIONER DUNN: But you are a panelist today.

MR. LEHMAN: Good morning. Dave Lehman, CME Group.

MR. WORTHEY: Good morning. I'm Mark Worthey. I'm an employee of Flowers Foods, representing American Bakers Association today.

MR. BLANCHFIELD: John Blanchfield, American Bankers Association.

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

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

MR. BOONE: Robbie Boone, Farm Credit

Council.

MS. JOHANNES: Mary Johannes, International Swaps and Derivatives Association.

COMMISSIONER DUNN: Well, thank you very much. I wish to welcome you all to the Agricultural Advisory Committee, to the Commodity Futures Trading Commission. As I said, this is the 33rd meeting of this Advisory Committee.

The subject of today's meeting is convergence in the wheat futures contract and the proposal to implement variable storage rates on this contract. On April 22nd of 2008, the CFTC held an agricultural forum to address concerns about the volatility of the agricultural markets in the fall of 2007.

At that forum, I asked who was responsible for fixing the problems that were identified. I stated, "I don't think there's a silver bullet or a single solution for what ails the marketplace. And certainly the solutions that come up cannot be implemented overnight, but I firmly believe that the market participants are the best qualified to come up with solutions that will ensure that we have a viable, fair agricultural futures market that will provide a fair price discovery and for risk mitigation."

This morning you will see a chronology of how the market participants have worked to address wheat convergence concerns. As I predicted, solutions did not come overnight.

However, there has been a continued commitment by the industry to work together to seek resolution of the convergence concerns in the Chicago wheat futures contract. I commend all of those dedicated folks that have been working on this effort.

Today we will meet to discuss a variable storage rate proposal that mostly everyone agrees is the next step in this multi-year effort to solve the convergence issue. As with everything, including the variable storage rate proposal, the devil is in the details, and the implementation of this proposal has been a point of contention between the exchange that owns the contract and some of the users who rely on it.

I look forward to hearing from both sides on this debate today. I am hopeful that the discussion will help guide the AAC -- the Ag Advisory Committee -- and the Commission as it moves forward to resolve the convergence problem.

As you all are aware, the CFTC has this latest proposal out for comment in the Federal Register. This is a material change to the contract and, as such, requires a vote of the Commission. The intent today is not to vote on that but to hear from the subcommittee on its recommendations and hear the response to that by the Agricultural Advisory Committee.

The transcript of this meeting will become part of the comment record of the proposal, and I encourage everyone to submit their views on this subject as soon as possible. I want to thank all of the AAC members and the presenters for their time, effort, and advice in these matters.

I particularly would like to thank everyone who volunteered and was chosen to serve on the AAC Subcommittee on Convergence which will present its report and recommendations today. The subcommittee's report should be viewed as a precursor to Commission action, but it will be used as an important source of information on the convergence issue.

My commitment is to listen to you with an open mind to your thoughts on everything we discuss today, and again I want to thank all of you for your participation. I will turn it over to the Chairman of the Commission for his opening remarks.

CHAIRMAN GENSLER: Good morning. Thank you, Commissioner Dunn, for chairing today's meeting of the Agricultural Advisory Committee.

I also want to welcome Commissioner Scott O'Malia to the CFTC. I note the importance of having a full Commission, all five of us, in place at this critical time in our nation's history and as we try to recover from the worst financial crisis in 80 years.

I also want to thank the President for

nominating and the Senate for confirming not only Commissioner O'Malia, but now Commissioner Sommers and Commissioner Chilton. We now have our full Commission, and I think the next one of us up might even be Commissioner Dunn in 2011, so we've got a while that we are all together, the five of us, which is just terrific.

I also want to join with Commissioner Dunn in welcoming this full committee and its members, and wish to thank you for the advice and contributions that you've given in the past, and certainly on this critical issue that we're facing today.

The agricultural futures markets remain at the forefront of our regulatory agenda. The markets provide critical price discovery function for many sectors throughout our economy, and not only affect the growers and farmers and merchants, but every American as they go to the food store and sit down for dinner at night. The Commission and the staff make policing these markets against fraud, manipulation and other abuses a top priority.

Now, as I sit here today, and I hope I am able to join you for the full meeting -- I know there were some bets on how long I was going to last here -- there are three things that I would like to just listen to. One, of course, is this wheat convergence issue that is the main topic.

But also I would like to hear from people their thoughts on this critical thing we're doing right now with Congress to bring reform to the over-the-counter derivatives marketplace, how it affects the products and markets that you know most about in agriculture, but just as you have been watching this great debate go on, it would be terrific to hear your thoughts.

Secondly, as you know, we are seriously considering imposing position limits in the energy markets which, along with the exchanges we actually had in place through just eight years ago, 2001. It would be terrific, as we do have position limits in the agricultural market, to hear what works, what doesn't work, and just observations in the agricultural markets as we consider this in the energy markets.

And then of course third, as we look to your advice in this wheat convergence issue, that's the main topic and the meat of the meeting, but it would be terrific to hear your thoughts on some of these other things as well. More particularly, convergence in the wheat market, the Commission has been very concerned about the lack of convergence in soft red winter wheat, the contract that we're chatting about.

At the height of the poor convergence last year, you all know the figures better than I, if I mistakenly remember them, but in the Toledo cash market I think it was always hovering between $1.30, $1.15, and it even popped out to a $2.00 problem at some point. It has recently been brought in, in July and September, in the.60 to.75 range, but it is still, at least in my mind set, not satisfactory. At the core of these markets it has to be far tighter than that, and more predictable.

In April the Chairman of the Agricultural Advisory Committee, Commissioner Dunn, brought together stakeholders affected by the lack of convergence, formed a subcommittee, which I applaud him for. And over the last several months members of that committee have been working to identify causes of the poor convergence, provide recommendations to the full committee, and I look forward to hearing them today.

But, if I might, particularly I would like to understand from your point of view what continue to be the causes of the lack of convergence. For instance, is it the design of the contract? If so, what issues? Two, is it just the nature of the market's in full carry and it's been in full carry for such a time? Or, as many people have observed, is it the role of index investors and the significant portion of the market that's held by index investing?

To the extent it is contract design, of course, there's a recommendation in front of us from the Chicago Mercantile Exchange with regard to variable storage rate, and it would be helpful to understand whether that will address whatever contract design problems there are. Or are there other contract design issues? It would be helpful to know.

To the extent that you are supportive of this variable storage rate, of course the timing of its implementation is so critical, and I know that's in front of you, and all the work that Commissioner Dunn has done. So I thank you again, chairman of this committee, Commissioner Dunn, for hosting this meeting.

COMMISSIONER DUNN: Thank you, Mr. Chairman. We will now turn to Commissioner Sommers.

COMMISSIONER SOMMERS: Thank you. Good morning, and thank you all for being here to discuss the important issues in front of the Agricultural Advisory Committee.

I want to particularly thank Commissioner Dunn for his leadership on all of these issues, and those of you who have participated in the Subcommittee on Convergence. I appreciate your service to the Commission, and I look forward to your report and recommendation today.

I also appreciate the Chicago Board of Trade's proactive efforts to try to find a solution to this problem, and our Commission staff who have worked very hard to help us better understand this complex issue. Over many months we have devoted significant time and effort to examining poor convergence between cash and futures prices in certain agricultural futures markets, particularly the CBOT soft red winter wheat contract.

The CBOT's recent rule changes that provided for seasonal storage rate, added delivery locations and other changes have narrowed the basis, but the contract continues to exhibit a lack of convergence problem, particularly when the futures market is near or exceeds full carry. This issue is core to our mission at CFTC, and I want to make sure that it is accurately discovering prices and is providing an opportunity for producers and commercial entities to hedge price risk.

Many market participants have expressed concern about the continued usefulness of this contract, which is troublesome.

I think we must attempt to restore the confidence that our markets operate efficiently and effectively, and to strengthen market integrity. Public confidence in the markets is crucial.

I am hopeful that through the dialogue today, we can come to an agreement on appropriate next steps that will allow us to finally move towards resolution. I appreciate all of your input over the past several months, as well as the time and effort you all have devoted to finding these workable solutions, and I look forward to hearing the discussion today.

COMMISSIONER DUNN: Thank you, Commissioner Sommers. Commissioner Chilton?

COMMISSIONER CHILTON: Thank you, Mr. Chairman, and I thank the Chairman of the Commission for his tireless work on all these issues, and congratulate Commissioner O'Malia in particular but also Commissioner Sommers.

I don't know if people remember back in the nineties there was this catch phrase, "Not." You know, you would make some declarative statement and then you would say, "Not." "Nice tie. Not."

I want to echo what Commissioner Dunn and the Chairman were saying. This meeting is not about taking an action on the wheat contract. We're not going to take a vote here today.

It's only to get your input. And the reason we want it in particular is because of this convergence issue. That has been adequately explained. But I am concerned that we had some market-moving event the last time the subcommittee met on the conference call, and so I just want to make sure that people understand what we are not doing here today.

I do appreciate, Dave, CME coming forward with a proposal, and I want to make sure that folks understand the lay of the land. When they provide a proposal to us, we have 45 days in which to act. In order to disprove what they have proposed on their contract, we actually have to show that it's a violation of the Commodity Exchange Act. that it violates the law. If we can't show that, we don't have a legal basis for disproving it. That 45 days, by the way, is up on November 13th, I believe. November 13th.

We can proactively, as the chairman of the committee said, approve it. We could also, by default, just do nothing, and it would take effect. So the other option in our little state of play here is that CME, if they believed that perhaps, given market circumstances, they might be able to do this in a more expeditious fashion -- because I think a lot of people agree with the general constructs of what they have outlined, although we will find out more today, but there are some issues on the date, too -- and so it's possible that they could withdraw what they have before us and say that maybe it would be in May or maybe it would be in June, but that's CME's call.

So I look forward to hearing people's discussion, look forward to hearing Dave's presentation, also.

The other topic I wanted to mention that's related, while this issue may be dealt with -- and maybe the market will take care of it. I mean, maybe this will all be resolved before we would get to sort of the remedy, just by market forces. But I notice in our commitment of traders report that we released, the three-year totals, that there is a heavy proportion of index traders that are -- you know, these are what I have called "massive passives."

These "massive passives" are large, they are long, they are price-insensitive. They're not really trading in the market much. Not in wheat, but in some of the other contracts that are fairly small and illiquid, like cotton, and there are some others, you know, having this large group of "massive passives" who don't trade, I get concerned that maybe that would exacerbate a circumstance like we're having today. I'm not saying it is. I'm saying it's something that me, personally, that I'm thinking about, and so I think in the future we need to be aware of that dynamic and try to come to grips with what, if anything, we should do.

And then the last thing is, I didn't want this meeting to go by without saying that it was about a year and a half ago when we sat here and we heard from this committee about the cotton contract, the end of February, the beginning of March 2008. We've had an investigation going. We announced it in June.

Earlier this month we received a letter from Senator Chambliss and eleven others, Senator Lincoln and nine other Senators, and they have urged us to ensure that we provide as much information as possible. And I can tell people that our enforcement folks have worked very hard on that report, that investigation, and that I'm really hopeful that we'll get that out soon, and that we will give as much information, more in general than we do on these sorts of enforcement actions, in the future.

So I look forward to hearing what you're going to say and asking questions. I'd tell you I have five other points but then I'd have to say, "Not." So thank you, Mr. Chairman.

COMMISSIONER DUNN: Thank you, Commissioner Chilton. It gives me a great deal of pleasure to say this.

Commissioner O'Malia?

COMMISSIONER O'MALIA: Thank you. Good morning, Mr. Chairman. Thank you for the warm welcome. I greatly appreciate being here and having the nomination through. Congratulations to Commissioners Chilton and Sommers, as well, for their swearing in.

Commissioner Dunn, I appreciate you chairing this hearing to take testimony on the corrective measures identified to remedy fundamental problems with the wheat contract. It is so refreshing, in my second week, to take a nice easy issue that is so cut-and-dried.

But I am fully aware of the importance this product has on world food prices and the commercial implications to farmers, storage operators, and shippers, as well as those with significant investment in futures contracts.

Although I am in my second week, I am impressed with the body of work that the committee has produced on the fundamental flaws of this contract, and I compliment Commissioner Dunn as well as the Commission staff and the subcommittee participants who have worked very hard to develop a range of options for us to consider. I am very interested to hear the testimony of our expert witnesses, and I greatly appreciate everyone's participation here today. Thank you.

COMMISSIONER DUNN: Thank you very much, Commissioner O'Malia.

Let me give a little outline of what's going to take place for the remainder of the meeting. We have two members of the first panel on to give us the market fundamentals and a historic overview, and after they have made their presentation, then it's incumbent upon the Ag Advisory Committee to have any questions that you might have of them, of what went on, what transpired, what the history is and what the market fundamentals are. So they will make a presentation and the AAC will be able to question them on that.

Then the second panel, we will have a report of the recommendation from the AAC subcommittee, and then we will have a presentation of CME Group's proposal to implement a variable storage rate on that.

And then we are going to kind of take a break, so that everybody can kind of digest what they had heard so far, and then we're going to come back and we have a couple of reactors.

Matt Bruns and Chad Burlet are going to talk about their reactions to what they had heard on this.

And then I will open it up for any other public comments that they have on the proposals that are there, and then go back to the Ag Advisory Committee. It is your show, your opportunity to get the questions in that you need in helping you decide what area we might want to recommend.

I am going to be working from a consensus of what we hear from the various members. We're not going to have a vote per se, but what we are going to be doing as Commissioners is to listen to the tone and tenor of what the Ag Advisory Committee have to say in their statements and in their questions in this arena.

So let's start off, then, with that first panel, and we have two members of the CFTC staff: Dave Kass, who is with the Division of Market Oversight in Chicago.

When I first became Chairman of the Ag Advisory Committee back in August of 2006, we had our first meeting, and prior to that meeting Dave called me and he said, "Commissioner, I've just had a meeting with a group of the Illinois Farm

Bureau wheat producers, and they have a real concern about convergence. Let me show you some things." So as an ad hoc to that first meeting, we invited Dave to come in to talk about convergence, and he is our man with the history on this.

The second panelist that we have on there is Christa Lockenmayr, who is a member of the Division of Market Oversight, and she is going to give us a background of what has taken place, a historical overview. She has got a chronology that she has put in there, that I think you will all find very, very interesting.

So, Dave, if you will, please.

MR. KASS: Good morning, and thank you. Christa and I are going to essentially present sort of a factual underlayment.

Hopefully, no opinions will sneak in. If one or two does, it will be of course my opinions, not necessarily those of the Commission.

But I'm going to talk a little bit about just sort of the history of basis and convergence in the wheat contract.

This first graphic -- and as an economist, of course you lose your license if you don't present a whole lot of graphics and tables and charts, so I'll be doing that -- this just shows absolute prices of wheat going back to January '04, so the better part of six years. And the red represents the difference with the cash price at Toledo, the Toledo bid, so where you see lots of red, that shows weakness, that the cash price was below the futures price.

And interesting to note, at prices more or less above oh, let's say, $9.00 or so, which of course were historically high prices that we reached predominantly last spring, we had awfully good convergence, very little where you see red with cash prices well below the futures prices. But also when you had prices from, say, $7.00 to $9.00, which historically would be very, very high wheat prices, there were also periods of time that you had bad convergence, or a weak basis, rather. This doesn't necessarily show convergence, because convergence is a very specialized basis at or around the time of futures expiration. This is basis over a longer period of time.

Now, this isolates on just the basis, goes back further in time, actually. This goes all the way back to January of 1996, and shows the Toledo truck basis, the major delivery point on the wheat futures contract, on the soft red contract.

And again you can see that this is not, although the problem got exaggerated, it's not by any means a recent problem. We had, all the way back in this area here, in the late nineties, we had what would have been considered a very, very weak basis historically.

Then we had -- the yellow parameter here represents plus or minus.10 of the nearby futures price, so that would be considered a more or less reasonable convergence period, so that's what the yellow represents.

And you can see that the history of this -- and of course basis, weak basis, sometimes you get weak basis for lots of reasons, and basis is related to a lot of things, not just what's going on with the futures expiration but what's going on in the fundamental market, things like barge rates and lots of other things. But this is just the history of it.

Obviously we had that meeting in August 2006 that Commissioner Dunn related to, and at that time we saw very, very high basis in that, leading up to that meeting, and it was presented at that meeting as a terrible problem with wheat basis and poor convergence. But then of course that was -- we saw improvement, actually, for a period of time, and we got down to where we got some reasonably good convergence in late '07 and into '08, but then we all know what happened subsequently to that.

This is kind of the current situation for wheat basis at selected locations, just to kind of set this up. The boxes that range from top to bottom of each of these little rectangles represents the historical range in basis at these points. And this is all for the fourth week of October, and you can see then where we were historically.

The red triangle represents the median of that, and then you've got a green box and a blue diamond. The blue diamond represents where we were a year ago in basis, in 2008, fourth week of October. And then the green box represents where we are pretty much current, at least as of last week, in terms of basis.

And you can see, for example, at Toledo, which again is the one historically people look at in terms of basis and convergence for this contract, because it has been the major delivery point. Last year at this time we were about $1.50 below futures. This year we're in the area of about.90. But of course the median period of time is closer to the.15 to.20 range, so even though.90 or so represents a substantial improvement on where we were a year ago, when you consider the median was in the area of.15 to.20, we've still got a long way to go.

Moreover, at this point in time in October, we're not talking so much about convergence at this point in time, because convergence applies as you approach the delivery month.

And of course first notice day on the next futures contract is November 30th, so we've got about five weeks prior to first notice day, so you really wouldn't expect tight convergence at this point in time.

This is just a summary, and I'm not going to go through this whole thing, but it's sort of what are the classic market forces in periods of time when you have a negative basis? This is only for a period of time where futures price exceeds the cash price as you approach the delivery month.

Then you have sort of the classic situation that would apply. Holders of long futures products obviously would want to not get delivery and pay an expensive futures price for something they could get more cheaply in the cash;

or if they were getting it and then had to liquidate that cash, they would obviously suffer a loss because they would be liquidating at the much lower cash price. So they would tend to sell futures.

If you needed the product and you were long futures, you would certainly want to get rid of your futures and buy it in the cash market. Traders with delivery capacity can obviously profit in this situation from selling futures for delivery, buying the cash, perhaps, and then issuing delivery notices and profit from that difference. So all of these things help convergence, all these acts by players in the market during sort of a classic.

What happens if market is at full carry is quite different, at least for the first group, the long futures that really don't need product. They no longer have the threat of delivery because they're looking more at full carry. They can earn a positive return on invested dollars by taking delivery now and carrying it into the deferred contract, whether the next deferred or some further out, so they don't need to sell their futures contracts. They may buy futures, they may not, but in any event they're not helping convergence at this point in time.

The middle group there, the long futures that need product, they'll act pretty much the same. Again, they're going to sell their futures and buy it cheaper in the cash market, to the extent they need the cash.

The other group that's affected tremendously by a full carry are those with delivery capacity, the delivery facilities. You might think they would be more than willing to make delivery at wide basis, where we were seeing $1.00, $1.50 basis at times in delivery period, but they would be reluctant many times to make delivery because anything they deliver out on the street, if it's going to be carried month after month after month, it's going to tie up their facility.

Most of the delivery facilities are not

pure warehousemen; they are merchandisers. They want and need their facility for throughput, so their ability to sell futures and buy cash or deliver cash they already own can be very limited.

They would do it up to a certain point of comfort, but once they reach that comfort level they're not going to do it anymore.

And if these things are carried over month after month after month, they may have reached their comfort level.

So increasing delivery capacity, which of course we saw this past summer, may not have much effect on delivery capacity in the short run in a full carry market, for that very reason. They may deliver a small amount up to their comfort level, but once that amount is sticky in terms of staying in their facility, that's it. You're not going to see a lot more capacity coming out of that.

So that's the problems and sort of the disconnect that you'll find in a full carry market situation. There's a lot of other nuances to that, but that's just a quick overview.

This, now, up to this point I've been talking about sort of basis over time. Now we're going to talk more about the convergence, which is the specialized basis at or around the delivery period. The blue bars here represent basis on first notice day of futures contracts going back through March '98, so quite a long period of time.

And this is the scale on the right-hand side, so you can see the zero line which would be cash equals futures, and then you see it falling below that at points. I have a little trouble picking this thing out. There it is.

And obviously, again, you see this dramatic basis here, looking at the blue, where we got down on first notice day, even, basis approaching $2.00. It was well over, looks like about $1.90 at its worst point in September of '08. And going back historically, you can see there were other periods, even as early as back in the late nineties and into 2000, where we had what at the time looked like pretty poor basis relationships. It only looks not as bad now.

I'm going to be showing this same graphic, this blue part, in a later slide, so it's important to note what this is and what it represents. One thing it does represent, during this period back here we were seeing, you know, month-to-month, future-to-future, improvement in basis.

But of course if you thought, "Gee, the problem is over," then all of a sudden you had bad basis. But then again in late '06 we ha, again, a month-to-month improvement in basis, and one might have thought, "Well, if we weren't out of the woods back in 2000, we're out of the woods now. The problem is fixed." And, of course, "not," as the Commissioner said.

And you'll see now recently basis has improved again, month-to-month, from September '08 through this past September of '09. Is that finally on the right track and we're going to get there eventually? Well, history would say maybe not.

The red lines, by the way, represent the numbers of deliveries just on first notice day, so these would be initial deliveries, and you can see clearly where you have weak basis, you do tend to get heavy deliveries, of course. But apparently not heavy enough, because here recently you can see in the last half dozen or so futures contracts, all the way here on the right, we had the heaviest deliveries we've ever seen and yet we still had poor convergence, so heavy deliveries doesn't even necessarily get you there.

That one outlier there, May of '09, the very largest one, was coincident also with a Board of Trade rule change where they restricted the number of receipts that could be carried over, so that was an unusually heavy delivery period because by the end of that month noncommercials could no longer carry as many as they had in the past, so that's one of the reasons that one is particularly heavy.

Now let's look at spread. I mentioned in full carry and spread. Let's look at spread.

This goes back to March -- this, by the way, I'll give full credit, this slide and the next one, to the University of Illinois that has been doing a lot of work on this as well -- this now represents the spread on the first delivery day between the nearby future, the expiring future, and the next deferred future.

The red line just sort of arbitrarily represents 80 percent or more of full carry, and you can see then going back, more often than not we are above the full carry situation.

CHAIRMAN GENSLER: Could I just interrupt? Just one quick question on this full carry chart.

Is this full carry as the CME proposal is LIBOR plus 200 basis points, or is this some other measure of full carry, if you could, Mr. Kass?

MR. KASS: I believe they used LIBOR, and of course it's 80 percent, and I think the Board of Trade's proposals represent 85. Actually, given current interest rates so low, I'm not sure that the interest rates might move this a little bit, but it's not going to make enough to throw you out of a full carry into a non-carry, depending on what the interest rate --

CHAIRMAN GENSLER: Would it not make a big difference if you add 200 basis points or not? Because that does really address what full carry is.

MR. KASS: Well, I think I'll let the Board of Trade --

CHAIRMAN GENSLER: No, no. I was just asking what the arithmetic of this chart is.

MR. KASS: The arithmetic on this is LIBOR.

CHAIRMAN GENSLER: Thank you.

MR. KASS: And the higher the interest rate, of course, the more it would take you to get to full carry.

So this just shows, demonstrates, that we have been at or above 80 percent of full carry pretty much throughout history. There are a few here and there where we weren't.

And, finally, my final graphic shows that Toledo wheat basis which I showed you before, the little bars falling below the zero line, so that's the same, and in overlays now using the right-hand scale, at what percent we were of full carry during these periods of time. So the red represents the percent of full carry, and the line, there's essentially a line drawn at the 80 percent. It's the zero line for basis, but it's the 80 percent line for purposes of what is full carry. And again you see a pretty good correspondence between when you had periods above 80 percent of full carry tend to be associated with the times where we had the worst convergence, and periods where we fell well below 80 percent of full carry, those downward peaks or I guess valleys on the red line, typically you had much better convergence when you weren't at full carry. It's not perfect. There's a period of time you see back in about the, between the Sep '03 - May '04, where we were actually above 80 percent of full carry, looking at the red line, but we had very good convergence.

So, like most economic relationships, it looks like it sort of generally applies but it's not a perfect relationship, and we seldom get those sorts of things. So there's a lot of confluence of events that go into these, but carry does seem, particularly when you get above 80 percent, does seem to have a good relationship here with the lack of convergence.

So, with that, I will turn it over to Christa.

MR. LEHMAN: Commissioner Dunn, could I just ask a clarifying question of Dave?

COMMISSIONER DUNN: Sure.

MR. LEHMAN: Dave, the basis data that you presented, is that from USDA?

MR. KASS: The basis? I think it's a private source, Hollander and --

MR. LEHMAN: Oh, from Hollander and Feuerhaken?

MR. KASS: Yes.

MR. LEHMAN: Okay. And those are bids,

correct?

MR. KASS: Right.

MR. LEHMAN: So they're not prices which --

MR. KASS: They're elevator bids at the location.

MR. LEHMAN: A public bid but not a transaction price?

MR. KASS: Yes.

Mr. LEHMAN: Thank you.

MS. LACKENMAYR: Good morning. Thank you very much. I'd like to just set this up with a brief history of the convergence issue in the wheat contract, specifically relating to two sets of contract changes and the lead up to those up until the present point.

First of all, in this chart -- it starts in 2007 -- in blue you'll see the delivery months below, and then the bar represents where the basis was at that point. You can see the peak period is in December, and it's been gradually improving since then.

I believe Commissioner Dunn discussed the Special Agricultural Forum that led off this issue in his first meeting in 2006, and then that was followed by another Agricultural Advisory Committee meeting, which you know.

And in August of that year the CBOT sort of unveiled their first set of changes to the industry, followed quickly by the submission of the changes and their approval in December.

Those changes were basically to expand the delivery territory, to reduce the vomitoxin levels, and also to institute the seasonal storage rate.

And then, as Dave mentioned, the second set of changes was to put a limit on the number of certificates that can be held for noncommercial purposes. And you also see that the University of Illinois has done some exceptional research on this topic, and that we have had other government institutions involved. The Permanent Subcommittee on Investigations issued a wheat convergence report, and our chairman testified at that hearing, and then also there were research reports by the USDA.

At the time when the proposals were submitted, the CBOT advised us that the proposed new delivery territories would foster convergence by expanding deliverable supplies, meaning that an increase in capacity would lead to an increase in supplies, and that the higher storage charges would improve convergence by allowing spreads to widen and the nearby contract to fall relative to cash values.

So the alternative to that would be that the deferred price would go up, and we haven't been able to really see that the nearby has dropped or that the deferred has increased. And also that a reduction in the amount of vomitoxin would enhance convergence, as it would reflect milling quality grade.

So you see for the first change -- I believe the slides in your packet may be a little bit different than what I have but the information is essentially the same -- you'll see from when the changes were instituted to essentially the present, there has been a huge increase in capacity, over a 115 percent increase. The unused capacity there is not empty. Essentially it's capacity that the regular facilities can use to issue shipping certificates.

You also see that there is a considerable number of new players, some cooperatives that are able to deliver, and then in the table in the bottom left you'll see that despite the increase in capacity, the registered receipts level has actually gone down, so it hasn't been exactly as anticipated.

You will also see here from this map that the new delivery territory is essentially coincident with a vomitoxin outbreak along the Ohio River here in the northeast of the map, and essentially along the Mississippi River, so that may have resulted in wheat that was not of deliverable grade when the new changes were instituted.

And then this brings us back to the

basis chart. We haven't seen the improvement. We have seen an improvement, but not the one to convergence that we were hoping for. And so at the time when we approved, when the Commission approved the changes, there was some concern among staff and in the industry that they would not achieve convergence.

And so what we did was refer the matter to the Subcommittee on Convergence and suggested some topics for them to look at, which is modified compelled load out; restrictions on cash-and-carry, which is essentially the contract change in January that limited the number of shipping certificates that could be held; further increases in storage rates; cash settlement; and also restrictions on hedge exemptions. And at the time we also noted that the CBOT was very cooperative in discussing new changes, and that's where this dynamic storage rate came from.

COMMISSIONER DUNN: Thank you very much, Christa. I would now like to open it up for questions, and usually we allow the Commissioners to ask first, but since this is the AAC meeting, we're going to let the AAC members question first and then the Commissioners on any follow-ups that they might have. So if you have a question or a comment about the presentation of the first panel, please just raise your hand and we'll call on you.

No questions or comments? Pretty much history, and everyone says that's correct? Very well, then. Let's go into the second panel, if we will, and we have Andrei Kirilenko, who is with the Office of the Chief Economist, who was the staff person for the subcommittee for the Advisory Committee, and he will go through an overview of what they looked at and their proposal. And then we will have Mr. David Lehman from the CME Group talk about what the actual proposal was from the CME Group.

And please keep in mind that in essence everybody is agreeing on what the next step ought to be. It's the timing aspect of it. So, Andrei, if you will, please.

MR. KIRILENKO: Mr. Chairman, Chairman

Dunn, Commissioners, members of the committee, I would like to organize my remarks not around charts necessarily but around sort of the principles and the philosophy that we had to go in and try to address this issue.

Once it became clear over time that this issue of convergence is beyond day-to-day surveillance and not necessarily entirely the matter of enforcement, we moved and tried to understand this issue, researched this issue and tried to understand this issue better, collect a body of knowledge so that we could then work with the industry and the exchange on solving it.

So to lay out the basic principles that we have in mind, what are the key issues? The contract, this contract, is the property of the exchange. That's a fact. However, a persistent lack of convergence inhibits this contract's ability to deliver on its key public attributes.

And so there is a consensus that over time developed in the industry that the problem is imbedded somewhere in the aspects of the design of this contract. That has to do with where it's delivered, how are deliveries scheduled, what are the rates associated with the delivery or nondelivery.

And we also know that there are some incentives that are sort of aligned on the two sides of the contract. Some participants benefit from a lack of convergence and others lose.

So there is, in principle, an inefficiency that has to be addressed.

However, those who know how to solve these technical contract design issues are often the beneficiaries of the design, so there was a feeling that the regulatory intervention, regulation or at least study, is justified.

So we first look at how we have dealt with issues of this sort in the past, and there is a history of involvement of both the precursor of the CFTC and the CFTC itself with both the wheat contract and the grains contract. You see that this is not a new issue. This issue goes back to a long time ago, even before the CFTC was formed.

I could give you a quote from 1926. The FTC at the time suggested to Congress that "the Chicago Board of Trade be requested to permit delivery of grain on futures contracts at other important markets." So there was that whole report underlying that.

In March 1979 the CFTC stepped in and ordered the termination of trading in the expiring March wheat futures contract at Chicago, and that's a pretty significant action.

And among some of the reasons for the termination was a perceived distortion of price relationship.

In December 1996 the Commission issued a notification to the Chicago Board of Trade that the delivery terms on the corn and soybean futures contracts did not satisfy the objectives of the Act, and this action resulted in the creation of the Illinois Waterway delivery system for corn and soybeans, which many industry participants feel works very well for these two contracts.

So the initial involvement in the most

current episode of convergence and contract design was to study the issue, to bring together industry, academics, regulators, together, and we held a number of roundtables, conferences on the issues. And numerous proposals emerged to solve the convergence in grins and oilseeds, and wheat in particular.

Three major types of proposals: One is to address the structural issues, in particular in the wheat contract, and the structural issue here is that the production of wheat has moved west to Minnesota and North Dakota, but the delivery areas remained along the Chicago, Illinois waterway area.

Another set of proposals is to address the carry, to limit the -- to move away from full carry, effectively, to limit speculative ownership of certificates, to limit market participation of index funds, to increase storage rates, to do something that would make carry more expensive, basically.

And the third one is to address the

decoupling of cash and futures markets in some more drastic way, to just basically separate the two markets, that is, through compelled load out, modified compelled load out, or cash settlement.

So that was the initial involvement, and then the subsequent involvement, as these problems, we noticed from the charts that they sort of were not being solved, the CFTC formed the Subcommittee on Convergence as a subcommittee of this Agricultural Advisory Committee. Eighteen members of the subcommittee were selected from 36 candidates who submitted their -- the candidates. And sort of the principle that we're following in working on this issue is to introduce greater transparency and to induce collaboration, to elicit collaboration among those who are in the market, dealing with this contract -- the exchange, the regulators, and others.

So the work of the subcommittee was done, the formation and the work was done in a full transparent fashion.

All the meetings were announced. The

public was able to listen in to all of the meetings, and the subcommittee discussed ways to address contract design issues among the ones that I showed you before. Basically, there were five different types of options: To introduce new par delivery area for wheat; to increase storage rates; to put penalties on ownership of certificates; to compel the load out; and to look into a cash settlement of this contract.

The full report of the subcommittee is in your binders. The main recommendation that emerged in the last conference call in September 2009 is that the subcommittee recommended to the CFTC's Agricultural Advisory Committee that the CME Group adopts a variable storage rate mechanism for the CBOT wheat contract starting with the December '09 contract. At that point, Dave Lehman, representative of the CME Group on the subcommittee, objected to this recommendation.

The rest of the report, the underlying, the background, the summary, and who is on the subcommittee, is, as I said, in your binders. The subcommittee during that conference call also decided that it will remain as an ad hoc body to monitor progress with this, with the wheat contract and other agricultural contracts, and to see how it could be of further assistance.

Thank you.

COMMISSIONER DUNN: Thank you, Andrei. David?

MR. LEHMAN: Thank you, Commissioner Dunn. Thanks for bringing the Ag Advisory Committee together, the experts in the industry, to discuss this issue. I think we're finally there, and there's no "Not" after that statement because I think the variable storage rate is a very innovative concept. It's one that addresses the fundamental cause that the research has shown behind the lack of convergence, and that is spreads reaching full carry and not being able to expand further because of the fixed storage rate.

I just wanted to clarify. Andrei's last comment was that he noted that I did not support the subcommittee recommendation, and that's not correct. As I think everyone that's involved with the subcommittee knows, the variable storage rate proposal came from CME Group. We developed it in the fall of 2008 and presented that to the subcommittee. What I objected to was the implementation date, the December implementation date.

So what I want to do today is go through what the variable storage rate proposal is, and we submitted this to CFTC, as Commissioner Dunn noted, in late September, September 29th, to be exact. It's under a 45-day review. And what the proposal or what the mechanism essentially does is introduce a transparent, market-driven formula that would allow storage rates to expand at every expiration or following every expiration.

So today we have a seasonal storage rate in place that expands twice a year, or expands once a year and then retracts. It expands in July, stays in effect through mid-December when the storage demand is greatest and storage costs are higher, and then it reverts back to 5 cents per bushel per month in December.

The variable rate is a mechanism that will allow the rate to increase by that same amount, by 3 cents per bushel per month, at each expiration, if the spread as a percentage of financial full carry is 85 percent or greater. If the spread, conversely, is 50 percent of full carry or less, the storage rate would decrease by the same amount, by 3 cents per bushel per month.

So the two variables in the calculation are full carry, and that's what this first chart or slide shows, and that's a straightforward calculation. We do use the 3-month LIBOR rate plus 200 basis points --

CHAIRMAN GENSLER: Yes. I just, for the record, think that that's more than full carry, but we could ask the committee.

How many of you finance at LIBOR plus 200? I'd be interested, as we go around the table, how many of you finance at LIBOR plus 200, how many finance at something else.

MR. LEHMAN: Yes, right now it's 2.28

percent. So if you have a cost of money that's less than 2.28 percent, then your full carry calculation would be a little different. Not everyone in the market has the same cost of funds. We know that for a fact. Different entities have capital available at different rates. We did a survey, a broad survey of the marketplace on this particular question, and the survey responses were very strongly in favor that 200 basis points over LIBOR is an appropriate cost of capital.

The next variable in the calculation is just a number of days, and that is typically either 60 or 61 or 62 in a two-month spread, or 90 or 91 or 92 in a three-month spread. And then, obviously, the futures price of the nearby contract and the daily storage premium are the other variables in the calculation.

So how we implement this is, the spread is calculated every day beginning on the 18th calendar day of the month prior to the delivery month, and then it's compared to this full carry calculation, that period from the 18th calendar day through option expiration day, so that's roughly 35-40 days. We do the calculation and calculate the average.

And if over that 35 or 40-day period the average is percent of full carry of greater, then on the 18th calendar day of the delivery month, after deliveries have taken place, we increase the storage rate by 3 cents per month. That then stays in effect until the next calculation period. We start calculating for the following delivery month right away, on the next calendar day, do the same calculation through option expiration day prior to the next futures month expiration, average it, and have the same announcement.

And we'll publish this on our web site every day. It will be transparent for the market to observe what our calculation is. If someone has a different rate of interest and their calculation is a little different, they'll be able to see what we're publishing, anyway.

And so this will be a running mechanism that continues throughout the crop year. If, as I said, that calculation results in a ratio that's 50 percent or less of full carry, the storage rate will come down by 3 cents per bushel per month.

But it will never fall below 5 cents per bushel per month or the 16.5/100ths of a cent per bushel per day. That will be a floor.

So in our view it's a very market-oriented way to allow the spreads to expand, and as the spreads expand and are better able to represent the cost of carry in the cash market, we expect the front end of the futures curve to come down and meet the cash market.

As I said, the components of the calculation, 3-month LIBOR plus 200. Market feedback confirmed that as an accurate, transparent measure of the cost of capital. Current spreads actually confirm that. If you look at where the spreads are today, using that interest rate, we're at 95 to 97 percent of full carry in the nearby spreads.

The trigger level of 85 percent, there has been some discussion of that, and some have used 80 percent as the level to trigger an increase in storage rate. We think 85 percent is the right trigger level. It's a level that makes it a little harder to achieve an expansion in storage rates, and there is an economic incentive in this mechanism for firms who are carrying wheat to try to achieve a higher storage rate by getting those spreads out beyond the trigger level, so we don't want to set the trigger level too low and make that too easy.

We want convergence. We all agree on the objective. We just want to make sure that the mechanism doesn't introduce too much flexibility, I guess, or volatility into what storage rates and carrying charges are.

Likewise, the 50 percent trigger for lowering storage rates was uniformly supported by the marketplace in our survey, and again we think it's an appropriate number at which to lower storage rates, and does make it a kind of difficult target for those who want lower storage rates. If they're trading in spreads to try to achieve that, it's something that won't be all that easy to achieve.

This is just a history, and I know Christa and Dave went over kind of the chronology of the changes in the wheat contract. This is a chronology of the storage rates in the wheat contract.

Jan 2000 through July of '08, they were 15/100ths of a cent per bushel per day or 4.5 cents per month. In July of '08 we made an increase to 16.5/100ths or 5 cents per bushel per month, so roughly a 25 percent increase in storage rates at that time.

We still observed problems with convergence, so we quickly, after the July '08 change, convened an industry group, two industry meetings actually in Chicago to look at what the next changes in the wheat contract should be to address the basis convergence issue. At that time we agreed on the seasonal storage rate which increases from 5 to 8 cents per month during that July through December period, and the additional delivery points on the Ohio River, Mississippi, and northwest Ohio.

So September 2010 going forward, we hope that we have a variable storage rate in place, and as I said, this is what's currently pending CFTC approval.

We wanted to look at why the CME Group believes in implementing this change in September of 2010. All of the previous changes that Christa discussed and the changes that I just discussed have generally been agreed to around this time of year or maybe even a little earlier and then implemented beginning with the next crop year.

And in wheat the new crop begins in July of -- on the calendar it's a winter grain, so July through June is the crop year in terms of the futures market, and that has been our practice in terms of implementing the new delivery locations.

They were effective this July. The seasonal storage rate, same time. In July of 2008, as I said, we implemented the higher storage rate and shipping certificates.

So that has been our practice, is to obviously not affect open interest, and not affect the value of positions that are already held in the market. So I've listed what the open interest here is. This was as of, I believe, the 23rd of October, 185,000 contracts in December, and you can see across the board in the first four months, anyway, out through July, where there's 45,000 contracts in open interest.

So if we were to implement the variable storage rate in December, which the subcommittee proposed and which I objected to in the subcommittee report, that would impact all of this open interest that you see on this slide, this roughly over 250,000 contracts of open interest.

So the Dec-Mar spread is a 3-month spread. That could widen out by 9 cents per bushel at 3 cents in each month, so we would see that spread potentially going from 19 cents to 27 cents. The Mar-May spread could widen out as much as 12 cents per bushel.

Now of course we're just saying

everything else equal, we increase the storage rate by 3 cents per month, this is what the spreads would do. And of course we can't predict what other changes might be going on in the market, but this is the best we can do in terms of trying to quantify this issue today, so if you--

COMMISSIONER DUNN: Wait. We've got a question.

CHAIRMAN GENSLER: I just didn't understand the arithmetic. Why would, if you go back a slide --

MR. LEHMAN: Yes?

CHAIRMAN GENSLER: -- why would March-May go out 12 cents and May-July go out 19 cents? I mean, just pure arithmetic, why?

MR. LEHMAN: Sure. Because these actually build on -- these are assuming full carry and they are cumulative, so if we increase the storage rate in December to 8 cents per bushel per month, and then in March we increase it to 11, and in May we increase it to 14, that's -- these build on each other, Mr. Chairman, so that's how the variable --

CHAIRMAN GENSLER: I see. But if it for instance was just put in place in March, then it would be two more months to the March-May. Is that --

MR. LEHMAN: If it was implemented in March, in March we'll have a 5-cent storage rate because the seasonal would have expired at that point, so we would increase the March-May by 3. The May-July would be 3 on top of that, if we're still at full carry, so March-May would go up to 8. May-July would go up to -- and so this is all what would happen if we implemented in December. I'll get to the March --

CHAIRMAN GENSLER: Yes. Maybe it's a later chart. It would be helpful to know if it's March, because --

MR. LEHMAN: Yes. I'll get to that in a later chart.

COMMISSIONER DUNN: But again, Dave, just clarification here, it's based upon the assumption of full carry.

There's no impact to the rule.

MR. LEHMAN: That's right. It's based on the assumption that these spreads are at full carry, and the VSR is triggered based on the formula that we've proposed to CFTC.

So if each of these spreads still remain at 85 percent of full carry, they trigger another increase as we go through time.

CHAIRMAN GENSLER: And isn't it correct that this past year you actually implemented changes on the July contract and they were open interest, so last September and December there were recommendations and they were implemented on contracts that were open? Is that correct?

MR. LEHMAN: Yes, and the September implementation would be on open interest, too, and the requirement for that is that the Commission must approve that.

CHAIRMAN GENSLER: So it's not a pure, black-and-white thing that you never implement something on open interest?

MR. LEHMAN: No. The black-and-white

for us, Mr. Chairman, is that we go to the next crop year. And because the old crop, new crop dynamics, the fundamentals between crop years are usually quite different and there's a lot of variability from one crop year to the next, therefore going out to a new crop month gives us the most comfort, and the market has been comfortable with that as well.

CHAIRMAN GENSLER: But that's with respect to crop years. Just to make sure we clarify, it's not related to the open interest, then. Because you have, the CME has put in place changes even when there's open interest outstanding.

MR. LEHMAN: Yes, but that's subject to Commission approval.

So doing the math, and this is again a static analysis of what the financial impact would be of implementing the variable storage rate in December of this year, which is what the subcommittee recommended, would have a potential worst case scenario of $384 million impact on the marketplace. Implementing in March --

COMMISSIONER DUNN: Dave, again a point of clarification. That impact is on swap dealers. Is that --

MR. LEHMAN: No. This is an impact on the entire open interest in the marketplace.

COMMISSIONER DUNN: Okay. Did you try to calculate the cost of the inefficiency in the marketplace on producers, grain handlers, processors, and end users?

MR. LEHMAN: We did not make that calculation, but as the charts that Dave and Christa showed, the basis from September of 2008 until September of 2009 in Toledo, anyway, strengthened from about $2.00 under to roughly.60 under. So I would theorize, and some of the commercial traders who are here could confirm it better than I, that that's a pretty good pick-up for the short hedger.

So the short hedger has a basis position there of long cash. They sell futures, and when the basis strengthens, that benefits the short hedger. Now, if the basis weakens -- so it's all timing. It's when you put your futures position on and how the basis moves during the time you hold your futures position. But if you were buying grain at harvest, buying wheat at harvest last September at $2.00 under and you sold it in May or June of this year at $1.00 under, you gain $1.00 on the basis as a short hedger.

So, you know, I would let -- obviously anyone else who might have a comment on inefficiencies by producers, they can certainly --

COMMISSIONER DUNN: I kind of circumvented what I set up as ground rules, saying we would wait until after the presentation, but I would like those that are producers, grain handlers, processors and end users to think about that and during the round of questioning or comment period, get your input on that.

MR. LEHMAN: Very good. So, moving on to the March, if we implemented this in March of 2010, obviously we miss the big hump of open interest that's in December. There's 182,000 contracts, open interest, in December. In March would get us beyond that, but March is still -- the March-May spread was 97 percent of full carry when I calculated it the other day. So that means if we implement this in March, that spread could go out by 3 cents per bushel. The May-July spread could expand as well. And so when you calculate the feedback effects of implementing in March on the open interest in each contract month, you come up with a total of $46 million that would be transferred as a result of the exchange implementing a change on existing open interest that affects pricing of the contract.

CHAIRMAN GENSLER: Dave, just arithmetic. Again, this assumes that it stays all in full carry. These fancy Latin words, "ceteris paribus" means all out --

MR. LEHMAN: Yes, everything else being equal.

CHAIRMAN GENSLER: -- which also means like that's not the real world. Okay.

MR. LEHMAN: It's the best we can do

with the data we have.

CHAIRMAN GENSLER: Well, all right.

COMMISSIONER DUNN: Mr. Chairman, I thought after our last hearing you weren't going to use Latin.

CHAIRMAN GENSLER: It's others that put them in reports. I don't know.

MR. LEHMAN: My economist threw that in, so I'll have to go back and have him stick to English in the future.

If we implement in May 2010, now we're getting -- you know, we have less open interest that potentially is impacted.

The May-July spread, though, is at full carry, so that spread would be impacted, and so we see that spread widening out from 10.25 to 16 cents, and the financial impacts then are shown on this slide, of what we estimate at $8 million.

If we implement in July of this year, the July-Sep is trading inside full carry, so that, potentially implementing variable storage rate in July may not affect that spread at all.

And, as I said, the July futures contract is the first month in the crop year for wheat.

The reason we didn't propose July is that on July 18th, the day that the July -- the day the storage rate would be increased under the variable trigger, we already increase the storage rate by 3 cents, by the same amount, under the seasonal rate that's in place today. So there is significant open interest in July.

It's possible, under the variable storage rate, that as the market dynamics are changing, the variable rate might not be triggered in July. The July-Sep spread might trade under 85 percent of full carry, and we would then not have an increase to 8 cents on July 18th.

However, if we leave the seasonal storage rate in place that's there today, we will increase to 8 cents on July 18th, and then we move to September and the variable storage rate would then replace the seasonal rate in September. It would work on top of the 8 cents that's already in place because of the July seasonal going into effect.

So that's the play on July. I mean, it's a little complicated, and I apologize for that. It seems like July would be a good alternative, but it does have the other side of the equation, of the rate perhaps not being triggered by a variable mechanism in July when it's already going to increase due to the seasonal rate. So there really is no estimated financial impact of a July or September implementation, although the caveat on the July is that it could be impacted the other way.

COMMISSIONER CHILTON: But, Dave, you seemed to indicate that May wouldn't have a material change in the contract.

Is that correct, too?

MR. LEHMAN: Well, our estimate is an $8 million effect, and that's across the open interest that's in May and July that would be impacted. So as you move through the months of the old crop contracts, you have less open interest that would be impacted, and you don't have this building and cumulative effect that we assumed as we went from December through --

COMMISSIONER CHILTON: But again, that's the best guesstimate that you can give right now, and so it's a time certain length enough that your presumptions, the calculations you're making could significantly change.

MR. LEHMAN: Yes.

COMMISSIONER CHILTON: I mean, it's a pretty long way away. So it's $8 million. I'm not saying $8 million is a de minimis amount. It's definitely not if you're a farmer or an elevator or somebody dealing with this. But it could change significantly between now and then, right?

MR. LEHMAN: It sure could. That's right, Commissioner, and as I'm sure many of the producers and merchandisers in the room can attest, we've got a very challenging weather situation in the Midwest right now. Wet weather is delaying planting of the winter wheat crop. I have been reading estimates we may have 1 to 2 million acres less winter wheat planted this year because of the wet weather. A lot of winter wheat is planted double crop with soybeans, and the soybean harvest is just delayed because of the wet weather, so we may have a very different fundamental situation by May or July of next year.

COMMISSIONER O'MALIA: Dave, Professor Irwin has kind of drawn a bright line at the 80 percent level of full carry.

Have you run these numbers against that calculation?

MR. LEHMAN: This chart, Scott, Commissioner O'Malia, that I just put up now, looks at the spreads as a percent of full carry going back to March of 2007. So what we see in this chart is that out of these 14 -- I believe there are 14 -- expirations, an 85 percent trigger would have been hit nine times. We wouldn't have triggered the lower storage rate at all during these 14 expirations, and in five of these expirations there would be no change, meaning we fell between 85 and 50.

Only one of these expirations fell between 85 and 80. So in March of '07, as you can see, there was an 82 percent calculation. And again, this is based on what we saw in history, and it doesn't take into effect if you triggered higher storage, then what would the following spread trade at?

I mean, the following spread is going to be different if you triggered higher storage, but we didn't -- you know, we had no way to observe that from the data.

So we just said from the data that we have, if we look back through time and back-test this a little bit, there's only one case where it fell between 80 and 85. So that's kind of a non-event, it looks like, from the data, but to be conservative -- you know, our primary goal is to really do no damage, do no harm in the market. We thought choosing 85 was a cautious way to proceed on this.

There is an Appendix in the hand-out, and if there's anything that anyone has seen in that that they would like me to comment on, I would be happy to. This just gives really kind of a recap of a lot of data that Christa and Dave already presented, shows the actual basis convergence at expiration for the last year and a half or so, but I don't plan to cover this unless anyone would like me to comment on anything in that appendix.

COMMISSIONER DUNN: Thank you very much. We will now take a 10-minute break. It might stretch into 15. And after that break the panelists are going to be joined by Mr. Bruns and Mr. Burlet, who are going to give their reaction to the presentations we have heard so far. Then I'll open up for any other public comment that they may have on this proposal, and then open it up for questions by the AAC. So if we can get back here in 10 to 15 minutes, we're in good shape.

(Recess)

COMMISSIONER DUNN: Ladies and gentlemen, I think we'll go ahead and continue.

We did a good job earlier this morning of staying on schedule. So if we could have Mr. Bruns and Mr. Burlet join the panel, and also Josh Kirley, who has also asked to make a presentation. And so I will go through with Mr. Burlet and then Mr. Bruns and then Mr. Kirley, and then we'll open it up for any other public comments that we might have. So if we could begin, please.

MR. BRUNS: Commissioner Dunn and other Commissioners, we appreciate this opportunity to appear before you today, and we thank you for calling this meeting of the Agricultural Advisory Committee to focus on the solutions for the Chicago Board of Trade's wheat contract's lack of convergence. And I thank you for the opportunity to present the National Grain and Feed's views on this today.

I am Matt Bruns, Vice President for Exports for Archer Daniels Midland Company in Decatur, Illinois. In that function I manage ADM's risk management on a daily basis. I also serve as Vice Chairman of the NGFA's Risk

Management Committee as well as NGFA's representative to the Agricultural Advisory Committee.

As you know, the NGFA and its member companies have worked for many months for solutions to the lack of convergence on the CBOT wheat contract. Less convergence and less predictability in the futures and cash prices has resulted in a less useful hedging tool for our member companies, who are the first purchasers from producers, and who hedge their price and inventory risk on regulated exchanges.

The NGFA's member firms play a critically important role in helping producers market their crops by offering a variety of cash forward contracts. Unfortunately, some of the availability of these cash forward contracts has been constrained in the last couple years due to spikes in the future prices which have caused large margin requirements on most end users and commercials, as well as CBOT's wheat contract's unpredictability in basis levels.

Over the past two years we have worked closely with the CME Group for solutions that could reestablish convergence.

We support the contract changes made to date by the CME Group, and we agree that additional action is necessary in order to reestablish a reliable relationship between cash and futures values.

With respect to the current proposal by the CME to implement a variable storage rate on the contract, we are in complete agreement that this contract amendment is the next logical step. We believe that, over a period of time, the variable storage rate will reestablish convergence.

That is an important point. The variable storage rate will take some time to work. We believe that it eventually will result in convergence, but it will be a process as the storage rate ratchets up over time. For that reason, we have recommended strongly that it be implemented as soon as possible, ideally on the

December 2009 contract, so it can begin the process of working immediately.

Our industry has struggled with this for more than two years on the wheat contract, with the lack of convergence.

Waiting until September of 2010 to implement this change proposed by the CME could result in another couple years before the change would have its full effect. Our member firms and their farmer customers who rely on a properly functioning futures market to manage their risk cannot afford to wait another couple years.

A second compelling reason to implement the VSR right away is, if we don't, the storage rate will actually move in the wrong direction. Under the current seasonal storage rate implemented earlier this year, the rate is scheduled to move down from 8 cents per bushel per month to 5 cents per bushel per month in December.

Clearly, this would be a move in the wrong direction. Even if the VSR is implemented this December, it will simply have the effect of keeping the storage rate at the current level, but at least better than letting the rate tick down and allowing further delays in implementing the VSR's effects.

Currently, right now in Toledo the cash basis bid is around.95 under, so you can see to get to convergence we have about.95 from today's values. Now. that's the bid, and Mr. Lehman, there's a long ways between the bid and what's actually trading, but that's where we are today. So we just view that as one reason to implement it sooner rather than later.

It's also important to note that the Agricultural Advisory Committee's own Subcommittee on Convergence has recommended the VSR be implemented in December of 2009. We have appreciated being part of this subcommittee's discussions, and we hope that the Commission will place a high priority on implementing its expert recommendations.

In the interest of balance, we do recognize that implementing the VSR in December will have some impacts on market participants. However, we believe that those impacts would be relatively small compared to the consequences for commercial grain hedgers and producers of essentially putting off the solution for another couple years.

And below we've got an examination of the open interest which was probably one or two days away from Dave Lehman's example that he used on OI. Generally we agree with the CME group that significant changes should not be implemented on contract months with high levels of open interest. However, the numbers show that open interest drops dramatically after December 2009, and by May 2010 is not significantly higher than September 2010.

A second factor that supports quick implementation is the fact that spreads are not at full carry on the July through September 2010 contract, a condition that the CME Group has indicated in the past would make them more comfortable on making changes with open interest. We urge the CME and the Commission to take these factors into account when determining the final implementation date.

Another reason for early implementation is old crop versus new crop, which for a fact in July when you start harvest, you have more supply on the market than you do demand because of the harvest bushels that are upon us. Thus, any material changes on a contract will be slower to see starting in July because of the new crop supply, whereas if you implemented in this old crop, old crop months, you would see the changes more quickly in the basis levels and this VSR would work more quickly, in our opinion.

With this exceptional and urgent situation, we submit that the Commission and the CME Group need to weigh the potential impacts on the market participants with open positions, some who may already assume that the VSR is coming, versus the harm that could be inflicted on the wide swath of commercial grain hedgers if convergence is deferred for another couple of years.

We believe strongly that the broader public good of implementing the VSR quickly outweighs the concerns about potential negative impacts. If December 2009 implementation cannot be met, we urge the implementation be no later than the March 2010 contract.

We would view this quick implementation as a one-time, extraordinary action, made necessary by the specific circumstances surrounding the CBOT's wheat contract. If the VSR would be considered in the future for corn and soybeans, we would anticipate a more traditional approach to amending those contracts.

In order to ensure that the VSR more robustly and quickly encourages convergence, the NGFA also recommends that the trigger rate where higher storage rates be implemented is 80 percent, instead of the 85 percent that the CME has proposed. We view this as a small and subtle change in order to more quickly achieve our goal of convergence. In conclusion, the NGFA has worked diligently with the CME and the CFTC on this important issue, and we continue to support efforts to bring balance and viability to this contract. We stand ready to continue with that support, and we will provide technical and practical assistance in bringing conclusion to this matter as soon as possible. Thank you.

COMMISSIONER DUNN: Thank you very much, Mr. Burlet. Mr. Bruns?

MR. BURLET: Mr. Chairman, Commissioners, thank you very much for this opportunity to speak today. My name is Chad Burlet. I am President of Burlet Trading, and over the course of my career I have had the good fortune of being able to view this issue and similar issues from four very different perspectives.

From my time with Cargill, I can appreciate the view of a company that is often a maker of delivery and is owner of a considerable amount of storage space, so I clearly understand why they would encourage or the National would encourage a quicker implementation. Through my time with Goldman Sachs, I can appreciate the role that the over-the-counter market has in this process, as well as a firm that very often participated as a taker of delivery.

Also during that time I served four years on the Board of Directors at the old Chicago Board of Trade, and I can appreciate the exchange's responsibility in this process. And now as a professional trader I sit in somewhat more of a neutral corner and can observe the process hopefully a little bit more objectively.

Clearly the key issue today is the question of timing. I would like to respectfully disagree with the suggestion that this needs to be rushed into because it will take time to work. I can assure you that once the decision is made by you Commissioners, the market will price it within a day, and the market will begin to react.

The irony is that the previous change, which was a massive expansion of delivery territory, actually does take time to work because of the physical aspect of adding space, adding transportation, building business relationships, and positioning one's facility to participate in the process. I think the chart that Mr. Kass put up demonstrating a significant improvement from 2008 to 2009 is an indication that that change is beginning to work.

One of the principles that's being considered today I think is a principle that transcends the futures business and really relates to all businesses in general, and that is the sanctity of a contract. And our legal system has frowned upon changing legal contracts after they have been entered into, and I don't think the current situation reaches the threshold of ignoring the sanctity of the existing contracts.

I would also submit that I think David's estimates of the dollars involved are decidedly understated, as they only consider the impact on the open interest at the exchange. The impact would be far greater and would far exceed those holding futures positions. The over-the-counter market would clearly be impacted, and the cash market is going to be impacted.

So what's being considered with a change within the crop year is a massive wealth transfer, and puts the Commission in the inappropriate position of choosing winners and losers.

And I can't say whether the beneficiary or the harmed party would be the hedged or the unhedged farmer, whether it would be the hedged or the unhedged miller, but clearly a massive wealth transfer would occur, and I think the law of unintended consequences would certainly rear its ugly head.

So, in closing, I would encourage the Commission to follow the recommendation of the CME to wait for new crop for implementation. I think rushing to make the change in the next couple of months would do the contract far more harm than good.

Thank you.

COMMISSIONER DUNN: Thank you very much, Chad, and I apologize for calling you "Mr. Bruns."

MR. BURLET: That's actually a nice

compliment.

COMMISSIONER DUNN: And I apologize to you, as well, Matt.

Josh Kirley had asked if he could make a presentation, and now is the time for any of the public that wants to have any input into this that were not on the original schedule. So with that, Josh, if you would, please.

MR. KIRLEY: Thank you very much, Mr. Chairman, Commissioners. I will do my best to be brief.

As you said, my name is Joshua Kirley. I am the Vice Chairman of the Wheat Futures Pit Committee and a high-volume liquidity provider for all spreads in the CBOT wheat futures contract.

Let me say firstly and clearly, given my direct experience in trading these spread contracts every day, both in the pit and on the screen, I feel very strongly that this current VSR proposal is a well-intentioned but one-sided and misguided solution to a serious problem. Implemented at any date, variable storage rates will decimate liquidity, encourage market manipulation, confuse and destabilize an already skittish marketplace, and discourage people from trading futures past the first month, particularly if they are a long hedger.

But the reason I flew in from Chicago to be here today is a far more pressing issue: That is the possibility of early implementation of variable storage rates. I can say with a fair amount of certainty that early implementation will cause irreparable damage to the integrity and functionality of this wheat contract. It would be similar to yelling "Fire" in a crowded theater and then sealing the exits.

To realize how one-sided and significant a change this would be, you must first understand how important full carry is to a spread trader. In a market with so many variables, it is the closest thing we have to an absolute. Full carry is the cornerstone of the spread trade.

Full carry allows traders like myself to manage risk. Like futures themselves, there is beauty in its simplicity. It is a stabilizing force, providing definitive parameters often acting as brakes to a runaway train. While there are no perfect analogies between commodity spreads and outright equities, the closest thing that exists is comparing full carry in spreads to a stock price of zero. That is, when a person buys a stock, they know their downside risk. They cannot trade below zero. Having that certainty contributes to a liquid market.

Liquidity providers like myself are willing to bull spread inside a full carry because it is a trade with clear-cut, measurable risk parameters. Much like the person who invests in a stock, they do so knowing the risk and only risking what he or she can afford to lose.

The very fact that you have people who are willing to take that calculated risk provides a service to the market.

When everyone feels the need to sell, that wall, be it full carry in a future spread or zero in a stock price, it creates a pool of willing bidders.

In a stock, those bidders provide an orderly exit to people who are long and wrong. In a grain spread, those bidders facilitate the role of a position for the long hedger.

Without that fixed value, long hedgers could lose up to $2 or $3 a year on their long position even if the price of wheat itself does not go down a single penny.

What you are proposing through early or immediate implementation of this VSR would be akin to interceding in a publicly traded stock and telling the shareholders that zero is no longer the end of the line. Imagine the person that bought 1,000 shares for $5 apiece. They did so knowing the maximum risk of that trade was $5,000. Now, what if an outside agency were to step in and decree that now this particular stock can trade as low as negative $5?

Only with immediate implementation of variable storage rates it gets worse than that, because that negative $5 mark is now a variable, and the closer the stock price gets to it, the further away it moves from you. That's why I said earlier by this formula, it rewards bullying. The more you can move a market in one way, the more potential it has to continue moving in that direction.

Once that person is finally able to offset that loss, a loss far greater than what was possible according to the rules at the time they purchased the stock, even if they are still solvent, they're never going to buy that stock again. They will probably never invest in any stocks offered on that exchange.

Even if VSR will lead to convergence, and I side with a number of academics who believe it won't, what good is convergence if there is no liquidity left in the marketplace?

After all, you cannot execute a trade if there is no one to take the other side of it. How can it be a market improvement if it blatantly serves one segment of the trading population to the clear detriment of the other?

Or, in another sports analogy, how can you allow the players of one team to change the rules of a sport during the fourth quarter of a game? And, to quote a Reuters reporter, immediate implementation of the VSR would be like moving the goal posts after the football has already been kicked.

Earlier Dave Lehman here stated that $7 million would be lost if this proposal is fast-tracked into a market that does not have the time to prepare for it or the energy to absorb the policy change. It is the people who are on the right side of that $7 million that are trying to press you into doing just that. The others, even if they are still solvent after it's over, the traders who were just burnt by having the rug pulled out from under them are not going to stick around to get fooled again.

Making this degree of wholesale change to an active contract with more than half of the open interest, especially to a spread that is already trading at full carry, would profane the integrity of the contract, violating the trust that us market participants have placed in this body and our exchange. In the wheat contract, our liquidity pool has already dwindled by more than 50 percent, with the remaining few market makers only willing or able to take less than half of the size they once did. If this VSR is forced through in the short term, that liquidity pool will run dry.

Earlier, in making the case for immediate implementation, Mr. Bruns stated that we must act now because it could be two years before we see the desired results. All I ask is that they extend that same patience and courtesy for changes that have already been made by our exchange.

Markets are not like a sports car, where you turn the wheel and there's an immediate and precise and immediate reaction. It's more like driving a big boat. If you've ever done that for the first time, you turn it and you think nothing happened and you turn it back, and you're not sure which turn is causing the changes.

Well, in the wheat market we've had six minor and one major changes in the last year. We've changed the trading hours, we've changed the algorithms, we've changed the seasonal storage rate, we've changed the settlement procedures. It's just too many changes in too short a time for the market to absorb. It's over-baked. We need to let this market breathe and find out what effect these changes are going to have.

In my opinion, the changes already made by the CME have made and continue to show promise. The CME's seasonal storage rates are already working. Convergence has improved for 12 consecutive months. Just because the existing plan does not provide for limitless profits for grain elevators and short hedgers is no excuse to destroy the remaining integrity and liquidity to the contract.

I know I went on longer than I wanted to, so if I could just say one last thing, I wrote a long letter, as you can guess, to the CFTC web site. I encourage you all to read it. And, finally, I would like to thank you all very much for letting me come here and speak today. At no point in this process have you heard from the liquidity providers, the people that actually make the trades in the pit and on the screen, and I appreciate your giving myself and us the chance to be involved in this process. Than you very much.

COMMISSIONER DUNN: Thank you very much, Josh. We genuinely appreciate your coming here today and expressing your point of view. That is what this Commission and this Advisory Committee is all about, hearing all sides of the issues.

Is there anyone else from the public that would like to make a comment or a statement at this time?

(No response)

COMMISSIONER DUNN: If not, then I will turn this over to the Advisory Committee for their questions that they have, and feel free to call on any of the panelists that you have heard to date. Please identify yourself.

MR. COPPOCK: Thank you, Mr. Chairman. Daren Coppock with the National Association of Wheat Growers. I have a question for the last speaker.

I believe you opened your statement by saying that this variable storage rate concept was a well-intentioned but wrong approach to solve a serious problem. What I'd like to know from you is, in your view, what is the problem, and what would you propose to fix it?

MR. KIRLEY: To be totally honest, I have no idea. There are a lot of great or macro-economic factors in place here that I don't understand. What I do understand is the actual physical trading. I know what happens. For example, in my opinion, variable storage rate has already been introduced and the market rejected it.

On August 24th the NGFA issued a statement that said this committee was leaning towards immediate implementation of variable storage rates. The next day there was no liquidity in the market. There was about a 3-cent pocket where everyone cancelled bids and offers. $15 million changed hands. People -- it basically destroyed liquidity and order. I don't know what the solution is, but this isn't it. This just will not work in a real, practical sense.

MR. COPPOCK: Let me re-ask my first question, then: What's the problem?

MR. KIRLEY: A lack of convergence, and I think a lack of convergence is not so much the problem as a symptom of the real problem, which is a lack of liquidity. That is, there are a lot less participants willing to take a lot less risk.

COMMISSIONER DUNN: Yes?

MR. WILLETT: Does additional volume necessarily mean additional liquidity in the marketplace?

MR. KIRLEY: Additional volume within, say, two or three ticks above whatever the trading price is. When I'm speaking of volume, I'm speaking of not trading volume but actual bid and offer volume. I'm saying on August 23rd if you had 1,000 Dec-May or March-May contracts, you could have gotten out of that position within one or two ticks. The next day, after this was not green-lighted but it looked like it might happen, it would take you 50 or 60 or 70 ticks to get out of 200 contracts. What I mean by "volume," I mean the size of the bids and offers. They were there before and they're not there now.

VOICE: I think you meant September, right, Josh?

MR. KIRLEY: Yes, I'm sorry. Yes, September. Sorry.

COMMISSIONER DUNN: Gary?

MR. NIEMEYER: Gary Niemeyer with the National Corn Growers. I am a farmer, and first of all I'd like to say that I'm really not a person who relishes regulations. I just want the markets to perform in a reasonable and expected fashion, minus the volatility that is normally associated with commodity markets.

And in some of the questions, you know, there is not going to be a good time to implement any of these, ever. I mean, quite honestly, if you really are interested in new crop, you could start with corn and soybeans right now, but obviously wheat is the larger problem.

And you say that it would have a financial problem. If I'm not mistaken, you almost trade three years worth of products currently on the board, so again, there is no good time. But I would hope that we could resolve somehow something that makes it possible for me to be able to sell my grain and to get financed from a banker and expect a reasonable convergence at a certain point in time.

I think delaying this much longer is just not going to resolve the problem. It's probably going to take a year for it, even with the variable rate, to see how it works. And I'm sure that there has already been a lot of leaked-out information for the last several months. I read it every night on my commodity reports, about regulations that are coming down, so I don't think it's unexpected.

COMMISSIONER DUNN: Just to follow up, Gary, I had asked for producers to try to come up with some type of back-of-the-envelope guess of what is the lack of convergence costing you now.

MR. NIEMEYER: Well, I'll answer that question. I think when I was here the last time, we had a meeting, it was in April a year ago or something of the sort, and I was just really getting into it. But at the time, in the middle of the summer I decided to purchase fertilizer because it looked like the price was going up dramatically, and I wanted to sell my crop and I couldn't do it. There were no elevators. I could do it if I had a multimillion-dollar financial backing that I could go borrow money to trade commodities with.

Those input costs continued to climb all the way through September, so I did make a smooth move by prepurchasing, but I couldn't sell my grain. And I tried several times to sell December, this year's crop that we're currently harvesting, for $6.51. I do follow charts. And I couldn't get the job done at multiple elevators. Again, I could have gone and borrowed maybe $250,000 or $300,000 to cover a position as large as the amount of corn.

I don't know how to answer directly, but I also got to thinking about the concerns and the situation where we're in right now. If we would have had this kind of fall last fall, I can't even begin to tell you what the markets would have done.

I can't anticipate that. There is a certain amount of volatility you're never going to get away from in this market, and it's price risk management. But the ability for me not to sell through my elevator, which I've sold through for 40 years I've been farming, the next year's crop or a portion of it just to cover my cost, was not available.

COMMISSIONER DUNN: Thank you.

MR. DOUD: Greg Doud with the National Cattleman's Beef Association. I have a question for Mr. Lehman, and would like the other panelists to react to it as well.

I'm curious as to why you didn't go to a cash settled contract, and instead chose this variable storage rate. And I'm curious to know from the other panelists whether this would resolve some of these issues or not.

MR. LEHMAN: Cash settlement, as you have read the report from the Convergence Subcommittee, was one of the alternatives that that subcommittee discussed and reviewed. It's something that the exchange has looked at for quite some time, much, much longer than the Convergence Subcommittee has been in effect, and we do use it in some of our livestock markets.

We have cash settlement for lean hogs. We have it for the feeder cattle contract as well.

The industry, the grain industry, as we discussed it with them, really felt that they weren't comfortable with the reliability of cash prices that are available, since they are only bids. As I wanted to confirm with Mr. Kass earlier in terms of his basis charts, these are public bids that -- in his case apparently they were from a private source, but typically what's available, what we would have to use if we were to try to construct a cash index, would be public bids that USDA collects from grain elevators, ethanol producers, processors.

And those bids are what -- you know, what that entity wants to be published for that location, and not necessarily what price they would pay for grain if they were buying grain, and certainly they don't represent the price at which they could sell grain because there's a margin. So several issues over reliability of data, over concentration of who the firms are that would be providing that data, have really made this a non-starter for the marketplace that we talk to when we're working on contract design changes. So that's my perspective.

COMMISSIONER DUNN: Mr. Lehman, are you then advocating mandatory price reporting for grains?

MR. LEHMAN: No, I'm not.

COMMISSIONER DUNN: Just wanted to be sure.

MR. BURLET: To elaborate on what Mr. Lehman said, I'll use soybeans for an example. The soybean market, with a processor, when you have a $1.00 or $1.50 crush margin, you know, the bids and payables can vary between.30 and.50 a bushel as far as what they're posting compared to what they're paying, just because of the amount of margin that the processor is making.

So there's a big push in soybeans, for example, compared to the other grains, so soybeans would be a problem as far as a cash settled contract, getting accurate information on what bids are out there.

MR. CRYON: I'm Roger Cryon with the National Milk Producers Federation. Our members don't necessarily buy or sell wheat, but we are interested in effective grain futures markets generally.

Last year there was an academic roundtable to discuss this issue, and I thought the Chief Economist's office did a very nice job describing what I thought at the end of that meeting was a consensus, that the underlying issue was that these wheat futures with the fixed storage rates effectively had an option for storage attached to it, and that when the actual market value of storage diverged from that fixed rate, it created a premium on the contract that caused divergence from the cash market.

I haven't really heard that discussed in quite that sense, that the solution then, the theoretical solution is to find a way to set the storage rates so that they reflect the market value of storage when the time comes to take delivery of one of these contracts. And actually, in fact, when I first read this proposal, that's what I ought I was reading. I guess I didn't read it closely enough.

I thought I was reading a proposal to actually set the storage rate for the current month's contract at a function of the spread from that month to the next month, which seemed to make a lot of sense to me. But what I think I see in this proposal, with the 3 cents that has the potential to kind of continually ratchet up the storage rate 3 cents at a time without necessarily ever bringing it back down, is a kind of implicit forced load-out.

That's one solution. You know, that's a solution that's a little bit of a gross instrument, but it is one solution.

But I think it's worth recognizing that under certain circumstances the result of this proposal is to essentially put into effect a forced load-out. I just think that it ought to be made clear, as this is being discussed, that that's effectively what is being proposed.

MR. LEHMAN: Just as a point of clarification, the variable storage rate mechanism does let the storage rate come back down under the formula that we have defined. If the spread trades below 50 percent of full carry, then it comes down at the same rate that it went up, by 3 cents per month. There is a minimum that we specified at 5 cents per bushel per month.

And just another point: These rates that would ratchet up potentially by 3 cents at each expiration or following each expiration are maximum storage rates, and that has always been the case in our contracts. The storage rate that's specified is the maximum, so that an individual warehouseman could negotiate a different rate with someone if they choose.

And I think the difference in how, Roger, you're perceiving the optionality issue that the academic roundtable reviewed -- and I think that's an appropriate theoretical analysis of how these contracts really work, is they do have a storage option in them, and the fixed storage rate caps the premium on that option. So by having a mechanism to allow the storage rate to expand, we remove that, you know, that barrier, if you will, on the premium of the option.

And I think the only difference we have is on when it would apply. It sounds like you're suggesting that it should apply on the current delivery month, so that you would actually be paying that rate if you take delivery in the current month, and our thinking is that that's probably unfair to the marketplace, to make a change that close.

So it would be changing it -- five days, essentially, before you entered deliveries, you would be changing the economics of whether you took delivery and carried that instrument or not. So we choose to implement it after deliveries in the nearby month, and so it has a little bit of a lag, but I think that's a little fairer way to do it.

MR. CRYON: Can I respond? I think -- I'm obviously not taking a position on this, but the way I read it, what I imagined was a reasonable approach was that you would apply the -- because the objective is essentially to set the storage rate as close to the market value of storage as possible, that you would have that apply to the current contract, and then the next contract would start over again. Instead of having a continual escalator/de-escalator, that it would be refigured every month based on how the carry relates to the spread. And that's a theoretical observation. It's not a position.

MR. COPPOCK: If I can, let me jump back in with a few comments. I apologize. I'm going to have to leave shortly for another commitment. But from the Wheat Growers' perspective, let me just offer a few brief comments on how we look at what's being proposed.

Fundamentally, lack of convergence is an impairment to the functioning of the market, and so it results in higher, more volatile basis. It creates a situation where producers can't hedge their risk, where our commercial customers can't hedge their risk, either, and it impacts the ability of grain merchandisers, to whom we sell our crops, to be able to offer the kinds of services that Gary was talking about earlier, whether it's cash forward contracts or other things. Our marketing options get shrunk when the futures market is not performing adequately.

So there has to be a strong link between futures and cash markets and strong convergence. Otherwise, trying to play in that market is like playing fantasy football. We might as well trade the contract in Las Vegas if it doesn't have any more relation to the cash market than what it has shown in the recent years.

This proposal may work to improve convergence. It may not work. The consensus within our organization is that it's worth a try, and it's worth a try sooner rather than later.

I know the open interest issue is a valid concern. None of us, I think, want to cut across commercial contracts in any circumstance if we can at all avoid it.

But also keep in mind that the longer we allow the market to continue not functioning also relates to harm, as Commissioner Dunn has alluded to, and that there are farmers and commercial players in the market who are impacted by that.

And so the sooner we can get a solution in place, the better. It's not a perfect one.

It's a bit of a blunt instrument.

But there are no perfect solutions. Some have noted that it's going to be a major wealth transfer from one sector to another, and that may be true, but I think it will help convergence and we think it's worth a try.

It's also important to remember this is part of the solution. Lots of other changes have been made: the vomitoxin specs, new delivery points on the contract. All of those things together hopefully will lead us toward more convergence down the road.

One of the signals from the market that we have watched and the somebody asked earlier for other comments, not necessarily related directly to this proposal, but one of the things that really caught my eye was, at one point the Chicago market had something like three times the amount of open interest as the actual production of the underlying commodity, which signals that there is some huge disconnect between the cash and the futures.

Now, I know there's lots of reasons why that can happen. Part of it is that production variability in soft white winter bounces around from one year to the next. People that raise soft white wheat from the Northwest tend to hedge it in Chicago because there's no white wheat contract. Lots of global players will hedge their wheat risk in Chicago. And so there's lots of reasons why they might not exactly line up, but three times the actual commodity production seems a bit high.

The last thing I would say is that we would like to see CFTC and CME proceed, but proceed with caution. And I think a concern that probably all of us share around the table is, let's make sure that the cure isn't worse than the disease.

COMMISSIONER DUNN: Thank you, Daren. Jim?

MR. BAIR: I'm sorry, Josh. I didn't catch your last name.

MR. KIRLEY: Kirley, K-I-R-L-E-Y.

MR. BAIR: Would it be possible for the

Commission to make his statement available to the committee? Electronically, preferably, but I would like to have that if I could. Thank you.

COMMISSIONER DUNN: When we get a transcript of this, we can get it out, but I can't give you an absolute period of time that we're going to get that done.

MR. KIRLEY: I can e-mail it to you right now, if you want.

COMMISSIONER DUNN: Others? Gary?

MR. NIEMEYER: Yes. Mr. Lehman, I want you to understand, we really don't want to destroy the market. We want to make it work. That's our whole purpose. And the gentleman from Beef brought up the last thing I was going to bring up today: Why don't you develop a new, side-by-side index trade of cash settlement or something? That would not upset this gentleman, would not upset this gentleman, would not upset this gentleman. And maybe that is the means, by achieving convergence for me and keeping the market viable. I mean, that was just my general observation.

MR. LEHMAN: I work in research and product development. That's my responsibility at CME Group. And we're always looking at new products. We already have a cash settled wheat calendar swap that was launched in April of this year.

We have a cash settled corn calendar swap as well, and a soybean calendar swap, so we have cash settled instruments that are available. In fact, they're available for you to trade directly with a counter-party rather than trading it on our centralized order book platform.

Now, maybe you would prefer to have it traded in the central order book, and we are looking at potentially an index product that would be based on some prices that we think are maybe more reliable than the cash prices that are available.

There's always a concern, when you launch kind of a look-alike contract, that it would impact the liquidity of the existing contract. If you just transfer some liquidity from one contract to another, then you may end up with two contracts that are less liquid and are less efficient, really, for the marketplace.

So, you know, it's not clear necessarily that adding an additional wheat contract -- and in fact, talking to the marketplace, they don't really want to see an additional wheat contract. There are three already. There's a Chicago contract, a Minneapolis contract, a Kansas City contract, and the market actually seems pretty comfortable with having those three existing contracts.

But we do have a cash-settled wheat swap, calendar swap, that's available, that really looks just like a futures contract, that might be a good idea for us to get out and meet with the corn growers and make sure they're aware of that product.

And we have it in corn and soybeans as well.

MR. BURLET: Mr. Chairman, just to follow up on what Matt and Dave said when the question of a cash index was first raised, as many people in this room probably know, the nature of the cash wheat market is decidedly different than corn or soybeans. In the latter two you have liquid, clearly identifiable markets virtually year-round at multiple locations.

The nature of the wheat market, as was stated, the difference between posted bids and where one could buy a reasonable quantity of quality wheat, that spread is tremendously wide, for reasons I think that are well understood.

So that, for wheat, poses a huge challenge. Then the second comment I wanted to make, just as a follow-up, I know you shared the frustration of not getting a new crop corn bid from your local elevator. I don't think VSR in wheat will change the modus operandi of your local elevator on corn. I think the changes that are in place and that are coming with the physical side of the contract that were changed, are going to be more effective over the long term than is VSR.

MR. WESTERN: Thank you, Commissioner.

Obviously there has been a lot of thought put in on this on both sides. Convergence is always a serious issue, and I just want to kind of follow up on something Mr. Burlet was commenting on. Obviously things have been tried. I'm all for seeing what can make this work.

In sugar in particular, we have domestic contracts, we have world contracts, and for us in particular, just in the case that there's precedents or as people are thinking forward, there's usually a big difference for us crop year to crop year, and you can really see that between August and November.

So I just kind of wanted to state that, so as we're looking forward any future changes, right now luckily everything is working fairly smoothly in our markets. It's generally kind of a small market, compared to a lot of the rest of you around the table, but I did want to make sure I commented on that, on the crop year issue.

COMMISSIONER DUNN: Thank you.

MR. WORTHEY: I am Mark Worthey,

representing the American Bakers Association. The company I work with is a baker, an end user of the raw agricultural product. And from the American Bakers Association, I would say that we are a reluctant supporter of the VSR, and I say reluctant because as it will act to expand the spreads between -- in the deferred, that creates, as an end user, for us a higher cost for acquiring those materials in that deferred time.

Relationships that we have with customers are not, and pricing agreements that we have, are not determined on spot market. They are planned in advance, and as a producer we have to take positions that are significantly further out into the market than just dealing with a spot contract, so that is a negative as far as a commercial baker would be concerned.

From a timing standpoint I will agree with several people that have spoken already, that doing this in a December contract would represent a very disruptive event in the marketplace. I believe the intent of any action that is to take place is to avoid disruption rather than to create disruption. We had comments concerning the contract sanctity which we would certainly agree with, and changing the terms of a contract once the contract is actively being traded does not seem to be an appropriate action for the Commission to take.

And I would be remiss, while I have the microphone, if I failed to mention, as Commissioner Chilton had in his opening comments, that there hasn't been any reference as a solution to the convergence problem dealing with the index funds.

Index funds currently are holding a position size which is 212 percent of the current wheat crop. As a comparison, soybeans are holding 23 percent and corn, 13 percent.

So, again, the reluctance to support the VSR is that it is making a step toward the problem, but again it seems to be not addressing the -- that it is addressing a symptom rather than what appears to be the root cause for the convergence problem that the market is experiencing.

COMMISSIONER DUNN: Thank you, Mark.

MR. WILLETT: Sam Willett, National Corn Growers Association. My question is for Mr. Burlet, and that is, could you elaborate on the impact of this change by timing on the over-the-counter market?

MR. BURLET: Well, the over-the-counter market is very diverse and there are an almost countless number of different products that are out there. Many are indexed to the exchange settled price, so my comment relative to the size of the financial impact that David showed in his presentation is that there are a great number of contracts that are tied to those prices that are not represented in the open interest numbers that he showed. That's why I felt his estimate of the financial impact was low, or at a minimum conservative.

MR. KIRLEY: If I could respond quickly to what I believe Gary Niemeyer said earlier -- do

I have that right -- first in terms of an index contract, I think that would be a very good solution in terms of a less violent, more consistent with the free market approach. I think if you had two side-by-side contracts, whichever one was the stronger, more viable, more useful one would survive, and the other one would fall away.

Secondly, in terms of making a change to a contract with open interest, I know that's unavoidable, but I think we should make it to a contract that represents 3 or 4 percent of the open interest, not that represents 70 or 80. You're talking about a difference between a couple hundred thousand dollar loss versus $70 million.

And to what you just said, I think that these commodity funds and hedge funds have had a negative impact on our markets in terms of their usability, but finding an approach that punishes them, we have to also be careful not to punish the long hedger.

And, finally, in terms of just this committee, I think it's important that in terms of giving advance warning, we not over-politicize the wheat contract. Every time one of these meetings finishes, or there is a rumor that goes around the floor, or there is a press release by the NGFA or the CME or whoever, invariably the next day there's pockets -- I mean, spreads don't trade. They gap, they re-price themselves, and that's not trading. I mean, hundreds of thousands of dollars change hands without a single trade happening.

You know, it used to be markets moved on crop reports or fundamental factors or technical factors. Now they move on, you know, the decisions of this committee and rumors on what they're going to decide. We've got to be careful to let the free market decide the spread prices, and not the government or the decision of people in this room.

COMMISSIONER DUNN: Jim?

MR. BAIR: Jim Bair, North American Millers Association. We're not perhaps as convinced as others that the VSR will have the intended effect, but we have no counter-proposal so we're willing to not oppose it, and we wish us all good luck that it may have the effect that people hope that it will.

We also might like to see an earlier adoption of the reduced vomitoxin limits in the contract. We think that's long overdue, and putting that off for another two years, we think that deserves some consideration to be accelerated there.

But listening to all the comments that have been made so far, I think it might be a reasonable compromise to have the VSR become effective perhaps with on of the spring 2010 contracts. Either the March or May contract might be a reasonable compromise to close this discussion.

But I also wanted to say I think this has been one of the most positive and constructive Ag Advisory Committee meetings that the Commission has held in a number of years, certainly in my memory, and I think this roundtable format has worked particularly well, and I just want to congratulate you for a successful meeting.

COMMISSIONER DUNN: Thank you. Any other comments? Chuck, from the CMC?

MR. LAMBERT: Thank you, Chairman. I'm from Commodity Markets Council, and we understand and share the concerns about the need for convergence, but we also philosophically have the idea that a policy change should not be an additional source of uncertainty in the markets, and that we affect as little of open interest as possible.

In my former life we had policy that said we would not accept contract changes until the next new contract to be offered. So I don't think we have the luxury of waiting that long, but given that conditions are taking us in the right direction and narrowing the basis, we think September is a reasonable compromise. It does get you out into the new crop year, and it affects as little open interest as possible.

COMMISSIONER DUNN: Any other comments? All right. I will now turn to the Commission and let them ask their questions. And then, since this is the advisory group, we have heard from some of you what your advice is on this matter, but for any of the others that would like to give us their advice on it after the Commissioners ask their questions, I'll be open for that advice.

Mr. Chairman, I'll start with you.

CHAIRMAN GENSLER: Thank you, Commissioner Dunn. I have a question I guess for each of the panelists, but I'll express it a little bit as a concern, as to whether the variable storage rate really is going to work. I do know that, I think it was Mr. Lehman who said we are finally there, so I'm wondering whether there is a real "there" there.

But my concern is whether we are really addressing the fundamental issue about this contract, and I noted Mr. Kirley said that he wasn't really for variable storage at all, didn't think it gets us there, so I guess he would say we're probably not finally there. But I might be, you know, a little closer to Mr. Kirley and worried as to whether this is really going to work, whether it's in March or September.

And why not some of the other recommendations? We've talked a little about the cash settle contract, but to me sometimes it feels like this is a contract designed for decades ago. Some of the production has moved elsewhere, and obviously distribution is down in the Gulf rather than in the Great Lakes dominantly.

MR. LEHMAN: I will comment, Mr. Chairman, if I might. You know, the changes in the underlying cash market certainly are that production has moved farther south, but western production that was mentioned earlier, in North Dakota and Minnesota, is not soft red winter wheat. That's spring wheat in that region.

So the CME contract, I think when it comes down to it, it is a fundamental contract design issue. It's really acting as a world benchmark for the wheat market. As I think Mr. Coppock mentioned, it's used to hedge white wheat because there is no white wheat contract, or it's used to hedge even hard wheat produced here in the U.S. at times because of its liquidity, and it's used to hedge wheats from all over the world, but yet it has a very narrow delivery quality and grade that's a small part of the total wheat crop.

The question is, how do you construct a global delivery mechanism, if you will, that would better match up with the price discovery function of this contract? And I've been at CBOT for quite some time, and we've had a number of groups convene to try to figure that out. With the kind of frictions in international trade, with subsidies in some countries, whether it's through a single desk selling function such as the Australian Wheat Board or the Canadian Wheat Board, or problems in Argentina with the government putting restrictions on exports, or wherever, all of those things really have led us to think that it's not a feasible instrument to try to create a physical delivery contract.

Now, cash settlement I think deserves more research, and that's one of the subcommittee's recommendations, is to continue to look at that. Another idea was to move delivery to the Gulf, the primary delivery point there, and we did vet that pretty thoroughly with not only the convergence group, but the CME Group staff talked with the marketplace independently.

And the concern there is that about 60 percent of the U.S. wheat use is used domestically, and if your pricing basis is at the export location, you're really restriction what a taker of delivery can do with wheat that has stopped at the Gulf. They have to go into the export market, and with the predominant use of wheat being domestic, that doesn't seem to work very well for a hedger, you know, that's a miller in the domestic market.

And also it's a pretty concentrated market at the Gulf. It's a high volume throughput market, obviously. There really isn't an intention to store wheat there. It's to move it through that location.

CHAIRMAN GENSLER: But doesn't the oil

product work in Cushing? I mean, WTI is all at one point, and obviously it's only a small percentage of oil that actually goes through Cushing, but there's convergence in that product. There's a form of forced load-out there, too.

MR. LEHMAN: Yes, there is. Right, there's no storage rate in that contract. It's a flow. I mean, that's the kind of fundamental structural difference between the energy markets and the grain markets, is that energy products are continuously produced and they are flowing from production to consumption at a pretty constant rate.

Grain is produced annually. It has to be stored, then, until the next crop is available, and so this carrying charge structure that Josh really I think expressed pretty articulately, that the market has come to depend on to provide signals of should I keep it in storage or should I move it into the cash market, would be gone with --

CHAIRMAN GENSLER: But this just seems,

while it's not unique to wheat, it seems so pronounced in wheat compared to corn and soy.

MR. LEHMAN: Yes. I think the difference in kind of scale of the wheat market versus corn and beans -- corn and bean futures are world benchmarks as well. The cash market grades that are deliverable on those contracts are world benchmarks. U.S. No. 2 soybeans, China will buy those all day long, and they certainly do. And U.S. No. 2 yellow corn is the benchmark livestock field in the world, and we have customers worldwide who use that commodity.

Soft red winter wheat, wheat is a different commodity. It has three major classes -- hard spring wheat, hard winter wheat, and soft winter wheat -- and then a variety of different qualities within those classes, based on protein content, based on vomitoxin --

CHAIRMAN GENSLER: And I understand soft red winter wheat is, what, maybe 20 percent of U.S. production, and maybe single digit, you know, 2 or 3 percent of worldwide production.

MR. LEHMAN: It's a small --

CHAIRMAN GENSLER: I mean, it's a sturdy crop but we've got the entire world trying to trade on top of it. You add the index investors that have over 50, roughly 50 percent of the open interest, and that's a lot to put on this sturdy crop.

MR. LEHMAN: It is, and you know, I guess we're a victim of our success. We've built this liquidity in this market, and Daren expressed a concern --

CHAIRMAN GENSLER: Actually, Mr. Kirley would say there's not the liquidity in the market.

MR. LEHMAN: Well, different perspectives are always -- that's what makes the market. But having three times the soft red winter crop in open interest would tell you, well, there's a lot of liquidity in the market.

CHAIRMAN GENSLER: No, actually, that would just say there's a lot of interest, not necessarily liquidity. Mr. Kirley, is that what you would say?

MR. KIRLEY: To answer your first point, I think my major fault with the variable storage rate is the formula itself.

It is confusing, it is complicated, and it is off-putting. You know, if we were that bright, we would be options traders.

A lot of us don't understand this. I've been studying the thing for two months and I still don't quite get it. You know, if someone came up to me six months ago and said, "Josh, what's full carry for DFDs?" I'd say, "It's 91.5 cents. That's it." If they ask me that question in six months, I'll give them a formula of variables predicted on three variables and I still can't narrow it down within $2.00. I mean, it is confusing.

CHAIRMAN GENSLER: May I just turn to other panelists? And then I'll turn to other Commissioners and hand back the mike. But those who have asked for this to be earlier -- no, you haven't asked for it to be earlier, Chad.

MR. BURLET: I was going to answer your

first question: Is it going to work?

CHAIRMAN GENSLER: Yes. All right, Chad. Is it going to work?

MR. BURLET: I think the most important change in terms of making convergence occur is the change that went in a few months ago, which was the massive expansion of delivery space, delivery territory, tripling of the amount of delivery capacity. As I stated in my comments, I think that's already starting to have an impact.

What the VSR will do is make that more effective. It will make that more attractive, and things will happen more quickly. Space is being built. Companies are making decisions to configure themselves to participate in the delivery process.

And the VSR complements that existing change that went in in July.

CHAIRMAN GENSLER: I hope you're right, but you had said earlier -- I was listening intently -- you said that markets don't need a long time to adjust. They adjust within a short period of time. So why hasn't that all been priced into the market? Why hasn't convergence collapsed in anticipation of all that you've just said is such good and well-intended --

MR. BURLET: Actually, I differentiated. Where this change, the VSR will be priced within a day, the previous change takes time because of the physical aspects that are involved.

Companies are forming relationships to back delivery space, to enable them to --

CHAIRMAN GENSLER: Let me go to my next question, but I would note that Commissioner Dunn has already said it's not "if," it's only "when." So you would think that it would have already been priced into the market, this change, possibly.

MR. BURLET: What we're talking about is the physical side of it in terms of more participation. Christa's chart where she showed unused capacity and reduced participation, I think that's the physical side of the market.

CHAIRMAN GENSLER: Let me just ask, and this is not just for the panelists but anybody on the Advisory Committee, those who are recommending that it's earlier, whether it's December, March, May, earlier, that's not what the CME has proposed. So I'm asking whether you think it's necessary or appropriate, either for the protection of persons producing, handling, processing or consuming the commodity -- I'm reading straight out of our statute, by the way -- but I just want to know whether you think it's necessary or appropriate for the protection of persons producing, handling, processing or consuming any commodity traded in the futures delivery, or do you think it's necessary or appropriate for the protection of traders who are on the markets, those who are dealing on the markets? And there's an important reason I ask this question, for anybody who wants it.

MR. BRUNS: Well, from the National Grain and Feeds perspective, our reasoning is to protect the producer and the persons, the people that are using this commodity on a daily basis, the first definition, which you just explained to us.

CHAIRMAN GENSLER: Anybody else want to address -- I mean, there are some people in the room recommending it earlier, and I'm trying to understand if that's your basis or it's some other basis.

MR. NIEMEYER: I think our basis would be that we would echo what the National Grain and Feed Association wants to do, because we grow corn, and there may be different possibilities to rectify different markets differently.

MS. LUDLUM: Mr. Chairman, from the American Farm Bureau's perspective, we have requested implementation sooner rather than later. I don't know if -- there is a problem in the wheat markets -- I don't know if it is serious enough that it would justify the CFTC using its statutory powers to do something on its own, you know, above and beyond what CME has already submitted in its proposals, which just require the CFTC to sort of meet a lower threshold in terms of determining whether to allow that to go into effect.

We don't have the solution to the convergence problem, and I would just sort of echo some of the things that Mr. Coppock said from their Wheat Growers' perspective, many of whom are our members as well. The market is not performing effectively right now. We would like to see a remedy to that. I don't know whether the VFR is the right solution. It seems like the best solution at this point, but I don't know if it rises to the level of CFTC action compared to a market proposal.

CHAIRMAN GENSLER: Thank you. That was very well -- I think you understood where I was reading from, 8(a)(7).

And I turn back to Commissioner Dunn.

COMMISSIONER DUNN: Thank you, Mr. Chairman. Commissioner Sommers?

COMMISSIONER SOMMERS: I have a couple of questions just following up on some of the things that the Chairman was talking about, for Dave.

When you consider a world wheat contract that potentially is cash settled, can you explain to me what the structure of that contract would look like, that would take all different varieties of wheat that could be delivered -- not delivered, because it would be cash settled, but you would be hedging all different kinds of wheat into that contract.

MR. LEHMAN: One of the ideas that we have discussed, and it came up in the April roundtable last year, I believe, we talked about just creating an index from the Chicago-Kansas City-Minneapolis contracts, and using the futures prices from those contracts to create what would be a proxy for a world wheat contract. It wouldn't really be a world wheat contract because we wouldn't have prices from Argentina or from Australia or from Europe or the Black Sea embedded in that contract, but it would represent the three primary classes of wheat that are produced and consumed in the market.

So that's probably one of the most realistic approaches. Now, we haven't had business discussions with Kansas City or Minneapolis to determine if they're willing to enter into that kind of an agreement, and as I said, the industry doesn't really want that. They see it as adding a fourth contract to a market that is already kind of crowded with three separate contracts and most likely just diminishing the liquidity or open interest, whatever you want to refer to it as, in these existing markets. And I think that is a real concern for the Minneapolis contract and the Kansas City contract, where their open interest is much, much smaller than Chicago.

We've also looked internationally, and there is a consultancy that has developed some world wheat indexes, and we're in discussions with them over obtaining their intellectual property to see if there's something there that might work as a world wheat contract. It would likely be -- I think it's settlement prices for different futures contracts around the world in one version, and of course these contracts are not very liquid. Paris wheat. There is a wheat contract in -- well, there are a number of wheat contracts around the world, but they are all relatively illiquid, so it would most likely have to use cash prices if it's going to be truly a global contract.

So those are some of the ideas we've been working on.

COMMISSIONER SOMMERS: My other question also follows up on where the Chairman was going, I think. Is there anyone around the table besides Mr. Kirley that would say that they think the VSR does not work, that it's not somewhere the Commission should be considering? And if not, are there any other potential solutions that we have not talked about today besides some of these other potential contracts?

Thank you.

COMMISSIONER DUNN: Thank you. I'm going to kind of stall here for a minute until Commissioner O'Malia gets back.

But we haven't really heard from some of the folks on this right-hand side of the panel, and John and Mary, we've heard some things, concerns about CITs and other interest in there.

Do you have anything to contribute in this arena?

MR. GAINE: Yes. In my 32 years involved with that statute, Mr. Chairman, that you were reading, I think the Commission has shown a tremendous restraint and judgment in its reluctance to interfere with an ongoing contract.

I remember one meeting, one member of the Commission moved to add a delivery point to cotton, and that was roundly defeated, 1 to 4, by the vote. In the March '79 wheat which is referenced in the report here, we closed down the market after a lot of anguish and nail-biting, etcetera, to interfere with ongoing markets.

In the silver market back in '79 and '80, either we did directly or we spoke to our friends at COMEX and the Board of Trade on the silver contract. They put in liquidation only, and there were petitions to close out all the contracts, which would have had enormous economic disruption because the distant months were way out of line with the nearby prices.

My comments, I don't have an answer whether -- having grown up, Mr. Chairman, on Brookville Road about three blocks from where you used to live, my knowledge of soybeans and wheat and winter wheat and soft and hard is probably very inside-the-beltwayish, that is to say, very close to zero. But I think the process is important, that the Commission -- and the sanctity of the contract was raised as well -- and I think the Commission is being deliberate here.

Anytime you alter the contract -- and I represent, pardon the expression, speculators. Okay? I think we add a lot of good to these markets. We add liquidity. We help in the price discovery process. But we need predictability. We have no interest in divorcing cash prices from futures prices.

We like fundamental supply and demand to operate. We'll take our research and do what we -- I guess what our members feel, which way everything is going. We have no interest in volatility.

So it really is one of process. I think people have raised -- I mean, cash settlement, did I see something? Did Minneapolis have a proposal a year ago or so, a couple of years ago, on some cash grain, cash wheat --

COMMISSIONER DUNN: Layne, would you like to respond?

MR. GAINE: Wasn't that kicking around?

COMMISSIONER DUNN: Layne, could you get to a microphone?

MR. CARLSON: I was going to say the Minneapolis Grain Exchange does have five cash settled contracts, corn, soybeans, and the three different wheats. Because of what we've seen -- the industry has had problems with convergence and we've seen what's going on. We've had some explosive growth in our soft winter wheat index. Right now we have open interest of over 2,000 contracts and trades every day. Again, looking at it from a cash basis, what the makeup is, is prices from around domestic United States. About 500 elevators or so are reporting each day, and that's what is used to sell the contract.

COMMISSIONER DUNN: Dave, did you have a point on that? Dave Lehman. Did I see your light on earlier?

MR. LEHMAN: No, I was just clarifying that yes, Minneapolis does have cash settled contracts and they are national average cash prices, so there actually is a way that you could trade our contract, our physical delivery contract, as a spread against that national average contract, and have a position in the average basis. And we think that at some point that may develop, but I think the market still has a concern over, are the cash prices that are going into that index really representative of where values are in that market?

COMMISSIONER DUNN: Thank you.

MR. GAINE: Again, as part of the process, cash settlement down the road might be something to think -- you will regret you asked me to speak. Do I have until 1 o'clock?

No, it's processes, really, and everybody has raised it. I don't have a clue, quite frankly, about the storage rates, the quantity, the quality. I do have a concern of interfering with ongoing arrangements that are already in place. So thanks.

COMMISSIONER DUNN: Thank you, John. I'm well aware of your ability to filibuster.

Mary, did you have any comments?

MS. JOHANNES: No. This is my first meeting, and I really appreciate the opportunity. I'll refrain right now.

Thank you.

COMMISSIONER DUNN: Let me turn to our folks that are providing credit to this area, and ask Robbie and John if they have any concerns as far as the providers of credit for producers and many of the elevators out there.

MR. BLANCHFIELD: The American Bankers Association doesn't have a position on this particular question. I would just point out, though, that banks provide credit to both sides of the trade, and that's what they do.

MR. BOONE: I'll agree with John. We are fairly agnostic to the issue, and like Mary, this is my first meeting, so I'm listening and learning for the most part today.

COMMISSIONER DUNN: We will note that the Farm Credit system and the American Bankers have agreed here. That is a first.

Neal, you had a comment?

MR. GILLEN: I don't have a dog in this particular fight. I will have a couple of issues to bring up under new business. I have followed it, was at the economic roundtable that Andrei so effectively ran last December, and have monitored the conference calls. And I think we had Joe Nicosia on the subcommittee, and I think the subcommittee really put their heads together and came up with some sound recommendations.

But I want to turn the tables and ask Chairman Gensler a question on this particular issue. I have a question for the chairman.

Hypothetically, let's say you had the full support of the Commission, and a determination was made that you would use your emergency powers. How would you go about resolving the issue of convergence?

CHAIRMAN GENSLER: I'm benefited that you said it was a hypothetical, and I don't think it's appropriate for the chairman of a regulatory commission to address themselves to hypotheticals, so you gave me an easy out, Neal.

I do think, and I will express just my own concern, that this is going to take a long time to figure out, that we're not at the right place yet. Sixty or 70 cents lack of convergence just doesn't feel right to this Chair. It's not right for farmers or grain elevator operators or anybody along the line that wants to hedge in these marketplaces. That the fixes, so to speak, to date haven't fully worked. Maybe it, as was said by Chad, it needs more time. Maybe, as Mr. Kirley said, we should give it more time. But I think that they haven't worked yet and that's not satisfactory.

There is a proposal on the table. I hope that it's correct, that we're finally there, but there seems to be even a debate on that, so we could find ourselves one year from now back in the same room, looking at another incremental, small change. And I'm wondering, you know, what's the real -- and I'm not an expert here. I'm relying much more on Commissioner Dunn and this committee.

What is the fix that we're going to be faced with a year from now when we're debating what's going to happen in 2011 at that time, when this variable storage rate thing only modestly helps? But I'm hoping that it's more than that.

COMMISSIONER DUNN: Thank you, Mr. Chairman. Commissioner O'Malia?

COMMISSIONER O'MALIA: Well, the Chairman just about took my question. If we are here in a year, and this variable storage rate is implemented and the spreads widen to full carry and reflect in the new storage rates, what happens next?

The other question is, how does this cash-and-carry trade end? Somebody mentioned there was a shortage of wheat being planted. What happens in a year if the crop doesn't come in? I'll open that up to anybody.

MR. LEHMAN: I'll respond to that, but I think probably Matt with the commercial grain companies is probably in a better position to actually make that comment than I am.

But if the crop is short, if we do have the acreage reduction that we're hearing from the market analysts because of the trouble planting the winter crop this fall, that will act to tighten spreads. The variable storage rate mechanism won't be needed, and that's the beauty, in my eyes -- and I admit I'm biased, but I think that's what is beneficial to everyone here about the variable storage rate. It's only going to expand storage rates and expand carrying charges when the market calls for it, so it is market-driven. There is no up-side cap on the amount of increases. They can increase by 3 cents every expiration. We have five expirations per year, and it will continue to build if need be.

So with a short crop -- I mean, this is really kind of Plan B. Plan A was the new delivery locations and the seasonal rate. Plan B was the variable rate, and so I guess now we're trying to come up with a Plan C, and I don't know what that is at this point.

As I mentioned in response to Commissioner Sommers' question, we're looking hard at other product ideas, and I think those might be Plan C: The cleared-only products that we've already listed. We have another set of those pending in draft form at Commission staff. We will continue to work with the industry to look for other new product ideas, such as perhaps the index of the three major contracts, and will continue to work with all of you to make sure we're providing the best risk management and hedging tool that we can.

COMMISSIONER DUNN: Well, at this point the Advisory Committee advised, and I think we've heard from almost all of you. I don't know that we've heard from Kent from NFU. Do you have any recommendations?

MR. PEPPLER: Well, I'd like to say this is my first meeting, and I'm subbing in for South Dakota State President Doug Somke. So I'm not only the JV squad, I'm the redshirt freshman.

The only thing I can really ascertain from this meeting -- and I think it has been a good meeting, I agree with what other people said -- the only thing that I can ascertain is that I'm sure glad I don't have you guys' jobs. I think you have a very difficult job.

I think we agree with the Farm Bureau that the markets are not working, and in our position at Nationals we don't think they've worked for quite a while. And we do have some fundamental changes that we would like to see made, but I don't think today is the day to bring it up and I'm certainly not the person to articulate it.

I would just like to remind the

Commission that historically farmers tend to be the one that pay the ultimate price. Ag producers tend to be the one that pays the ultimate price when we do see changes in the commodity markets. You spoke about the silver mess in the late '70s and the early '80s.

I'm still paying for that one because the Hunt Brothers owned a sugar company that they bankrupted to cover their position there.

So we are the last ones. We are at the bottom of the totem pole, and I would just like to remind the Commission that agriculture producers today are facing declining commodity prices. We are facing ever-increasing input costs. And our banks do a great job but credit is tight.

We're seeing a severe attrition in rural America right now. Mr. Niemeyer said this is around his 40th crop. This year was around my 30th crop. And I hate to say it, but we kind of represent the norm of producers out there. So we're an aging group, and the reason that we're an aging group is because of profitability. So at the end of the day I would just ask that you put agriculture production's profitability at the top of your list. Thank you.

COMMISSIONER DUNN: Thank you. Bob, anything from the Renewable Fuels?

MR. DINNEEN: Thank you, Commissioner. Our companies don't really have a dog in this fight, either, other than we share an interest in making sure all commodity markets are working properly, and this is clearly one that is not.

T seems to me that the solution that has been identified has a fair amount of support, and I would see benefit in making sure that's implemented as quickly as possible, to try to get as much convergence as quickly as possible. But, again, this is not something that our association has taken a specific position on, and we're not directly impacted by the wheat markets.

COMMISSIONER DUNN: Are there any other words of wisdom or advice from any of the members of the Advisory Committee for the Commission?

(No response)

COMMISSIONER DUNN: If not, let's turn to the final piece on the agenda, and that is other new business. Mr. Gillen, I believe you have something you want to discuss.

MR. GILLEN: Yes, Mr. Chairman. I had two issues. One is a rather short statement. It pertains to the cotton investigation. In March 2008, the Commission directed the Division of Enforcement to undertake an investigation of the speculative activity in the February-March 2008 ICE No. 2 futures and options contracts which culminated in the financial ruin and decimation of approximately one-third of the U.S. cotton industry's marketing infrastructure, leaving many U.S. producers with unfulfilled contracts. It also had similar effects on the foreign cotton trade.

The U.S. cotton industry cooperated fully in the investigation, providing all materials and documents requested by DOE, and by making people available for questioning. DOE completed its report some three months ago and submitted it to Chairman Gensler, who I understand has now circulated it to the other Commission members.

The cotton industry and key members of the Congress have requested the immediate release of this important report.

Injured parties and their legal counsel have a right to review this report and to determine whether the DOE investigation has identified specific parties and specific conduct that would give rise to civil causes of action.

The cotton industry urges the Commission to issue the DOE report today. Thank you.

My other statement is on position limits. I wish to remind the Commission and the members of this committee of the importance of imposing position limits in order to restrain the rampant and excessive speculation that has distorted the agricultural markets in recent years. I would note that most agricultural commodities have trading limits.

Cotton is one commodity that has, but

our contract is managed by the Intercontinental Exchange, and they desire to eliminate trading limits.

The commercial interests in the cotton industry have been financially decimated as a result of such speculation, resulting in the elimination, as I said in my previous statement, of one-third of its merchandising infrastructure. The potential for speculation in our markets is such that many producers and small and medium-sized merchants are wary of using the cotton contract as a risk management tool. There is a lack of confidence in the market, not only in the U.S. but elsewhere in the world for similar reasons. But cotton is not alone, as other agricultural contracts have experienced speculative run-ups in prices.

The results are well-known: An increased cost of doing business, given the larger margins caused by the widening basis, a cost that the banking industry is unwilling to finance.

I need not dwell on the horror stories

of the past two years in our markets. We all know what happened, and we know why. What we need is prompt action by the Commission.

As the Chairman just said a few minutes ago, the U.S. Congress authorized contract market designations in the agricultural and non-agricultural commodities for the purpose of trading in futures contracts primarily to hedge against price risk, discover prices through vigorous competition, and to facilitate commercial transactions.

The contract markets were established primarily for the commercial interests -- producers, cooperatives, merchants, processors, and end users -- while the speculative ventures were judged to be a secondary concern of the Congress. Though the Congress recognized that futures contracts offered an investment opportunity, it was made clear that such a role was subordinate to the interests of the commercial users of the contract markets.

Unfortunately, for too long it has been

the policy of the Commission and the exchanges to facilitate expanded trading through expanded limits, while the commercial interests have had little or not influence in how the exchanges set limits.

Over the years, the Commission has acquiesced to the exchanges' requests for increases in limits with little regard for the concerns of the commercial trade.

I applaud Chairman Gensler for his leadership on this issue, for the new direction he is taking the Commission, for his willingness to take the reins and come to grips with setting position limits.

I would add that there is no need for reluctance in taking such action, lacking an authorization by the Congress to also establish such limits on the OTC instruments, or because of inaction by foreign regulators. Such reluctance is aided and abetted by the fear argument that we may have heard for too many years -- fears that have never materialized, and there is little reason to believe that they will now, given the willingness of the governments of competing foreign markets to take appropriate action along with the U.S. Congress, which I expect will soon close the remaining regulatory loopholes.

In recent weeks the Commission has had an ongoing dialogue with the futures industry in response to the perceived fear that Commission-prescribed limits would drive the speculative business to foreign markets. I respectfully suggest that we should not be concerned with such a development. Were the excess speculation to leave our shores -- speculation that has adversely impacted our markets -- we should welcome such a development, since this is speculative money we do not need or desire to have in the contract market.

I urge the Commission to act promptly on position limits, to act promptly to protect those who the Congress directed it to protect, the commercial users who rely on these contracts for price discovery and to hedge price risk. Thank you.

COMMISSIONER DUNN: Thank you, Neal, and you segued nicely into the two issues the Chairman of the Commission has indicated he would like to speak about here, the position limits and OTC. And I am going to turn that over to him on the cotton investigation as well, so if you would like to respond, Mr. Chairman.

CHAIRMAN GENSLER: Well, on the two issues it was really just to hear from you all, I mean, and Neal just commented on the need for reform in over-the-counter derivatives and anything that we as a Commission are doing in support of Congress to bring broad reform to that marketplace.

As you may be familiar, that is to regulate the dealers themselves, explicitly, for what they do, making sure we lower risk through capital and margin, we enhance the integrity of this business and bring to it, even though it's an institutional market, bring some business conduct standards about fraud and manipulation to these markets that have not had them to date; and also bring transparency through recordkeeping and reporting, first to the regulators, which we don't have right now, but then ultimately to the public by requiring those transactions that are standard enough to be brought to a listed exchange or trading platform to be brought to those listed platforms and exchanges.

It was historic, in the last couple of weeks, both Chairman Peterson and Chairman Frank have moved bills through their committees. They're looking to reconcile, try to bring something to the floor of the House. Of course there is the Senate and there's a long process yet still in front of us, but just to hear comments would be terrific, as well as on position limits.

I'm intrigued that Neal knows more maybe than I do. I didn't even know when things come to the ninth floor, but I'll have to check with your calendar as to when things come to the ninth floor of this building and when things go out of my office to other Commissioners in the future on the cotton report. You seem plugged in enough that maybe you know exactly when it will be out of the building, as well.

MR. GILLEN: Well, John has been around, John Gaine said he has been around for 35 years. I've been dealing with the Commission before its birth. But people do talk, Mr. Chairman, and the industry would like to see this report. We would like to have seen it yesterday.

If the Commission is considering criminal action, if there are prospects for prosecution, then we withdraw our request if that is the case. But if that is not the case, we would like to see the report so we can proceed if there is reason to do so.

CHAIRMAN GENSLER: I understand the request, and we also got a letter from 11 Senators, all of whom we work closely with and have deep regard and respect for, but I don't have anything today to announce on the specific report that you referred to. Our Division of Enforcement has, as you said, taken a very close look, as well as other divisions, the Division of Market Oversight and so forth in this building, and have been talking about and sharing with each of the Commissioners' offices their thoughts.

MR. GILLEN: Well, when can we expect some announcement?

CHAIRMAN GENSLER: I think I stand by what I just said.

COMMISSIONER DUNN: Are there any other comments or advice on the other two issues that the Chairman of the Commission had asked about, on position limits and over-the-counter?

MR. CRYON: I'm Roger Cryon with National Milk Producers Federation. I certainly agree in principle with what Neal said about position limits, particularly speculative position limits, in that they can temper the impact that these actors have on the volatility of the market. And as you indicated, interest isn't necessarily liquidity, and that's something I have agreed with in the past.

But I also think it's very important to

make sure that the folks that the Act was written for, the producers and the users and the consumers, do have access to all the hedging opportunities that they need, that hedge exemptions are given as freely as necessary, and I believe they ought to have some margin of error.

I hear cases of folks applying for hedge exemptions, they get a hedge exemption based on their actual potential volume, and then they don't have any margin of error, whereas a speculator can go and they can use their full position limit to speculate, but if a hedger goes just 5 percent above their hedge exemption, then they are in violation. That doesn't seem necessarily fair in all cases, but that's a small issue.

With regard to what the Congress is considering, I think the same principle is important in considering the exemption for swaps from clearing. We have cases, for example, where farmers on one end of the country are swapping price risk with processing plants on the other end of the country. I don't see that those all necessarily need to go through clearing.

And I guess I would add finally, as kind of a side note, that in my reading of the legislation, the version I saw -- I guess I saw the House committee version, and I think they all do this -- they push a lot of things into clearing through exchanges and derivative clearing organizations under the assumption that that's a fail-safe. And I hope it's recognized that these exchanges and derivative clearing organizations will in effect become institutions that are too big to fail and will have to be backed up, if we put all our eggs in that basket in terms of guaranteeing the solidity of these contracts.

CHAIRMAN GENSLER: All very good points. With regard to the over-the-counter derivatives, the approach the Administration, what this Commission has recommended, I know Commissioner O'Malia wasn't here then but the four of us had recommended at the time, in terms of regulating the dealers on both standard and customized products, allowing for all the hedging for the associations and the companies that might be around this table, whether it's interest rate risk or all the way into the commodities markets.

So tailored, as you mentioned, a tailored risk that might be a basis risk between two locations would be allowed, and it might not come into a clearinghouse. But if a clearinghouse is able to accept something for clearing because it has the features that they can manage that risk in a clearinghouse, then the presumption would be that the large financial institutions would have to move those into the clearinghouse.

Why do we feel this is a public policy basis? Right now the risk is in society. It is in the markets. It's with the large financial shops. Let us not forget, AIR failed last year, and AIR was a central counter-party. It wasn't regulated a central counter-party, but it sure in heck was. And it failed, and $180 billion of our money -- that's $600 for each of you around the table, by the way -- went into AIR. But more than the $600 was the ramifications for the entire economy.

So we're trying to move as much of that off of the books of the large financial shops and into regulated clearinghouses. They would have to have discipline, mark to market procedures, and posting of collateral just as the CME has or ICE has in the futures marketplace now. And we think that actually lowers risk, and those clearinghouses wouldn't be in the leasing business. They wouldn't be in the proprietary trading business. This is what they would do.

And in terms of transparency, we think that transparency, again only on those transactions that can actually be listed -- there will be a lot that's not -- but let's say even if half the market is able to be listed, that's a real benefit, because then all of you can price your transactions off of what you see coming through the transparent trading platforms.

If you do a standard transaction, just as you right now could see the pricing of a futures contract, you could see the pricing of some swap contract. Even if you're doing a tailored product, you could see the pricing in relationship to the standard product. So we think the transparency initiative is a huge plus for everyone around this table. We think the clearing initiative lowers the risk of the financial system, and of course Congress is working through how end users such as yourself might interface with that.

MR. CRYON: I would agree that it reduces risk. I don't object to the idea of expanded use of clearinghouses and derivative clearing organizations. I just haven't heard the discussion about it that suggests that there is recognition that it doesn't take care of all the risks, that it really is a way of kind of centralizing things. So it is a way you can centralize things and kind of regulate them more effectively, but few comments I have heard seem to suggest that that's just going to solve everything automatically.

CHAIRMAN GENSLER: No, no. It's not a

panacea, and there were a lot of other reasons the crisis came, but it's a way to separate it out as much as possible from the large financial institutions, make the large financial institutions less interconnected. But then the SEC and the CFTC and so forth have to really regulate and oversee these clearinghouses, as we do with the current clearinghouses.

MR. DOUD: Mr. Chairman, Greg Doud with the Cattlemen. We very much appreciate your comments on this topic. The Cattlemen's position has been for a long time that we don't see position limits as a means to an end or, in the vernacular you were using today, if we are "there" by using position limits.

We, however, would strongly agree with you, and the Cattlemen have been long advocates on this committee, Commissioner Dunn, about transparency, and the fact that we do have some ambiguity in the swaps market, and as it relates to exactly what are these position limits and the areas today where they are actually regulated.

Anything we can do to shine light on that, to provide greater transparency in that area, is hugely important to us in our business.

CHAIRMAN GENSLER: Thank you. Other comments?

COMMISSIONER DUNN: Any final comments from any of the Commissioners?

If not, let me thank all of you, those of you that participated on the task force, and obviously the members of the Ag Advisory Committee. This has for me been a great process, and it has been open and transparent. And I understand that sometimes the market gets jittery when people talk about things, but our goal here is to do it in an open and transparent matter so that everybody is hearing the same thing at the same time.

We on the Commission value the input of all the advisory groups that we have, but the Agricultural Advisory group, since it's the oldest advisory group, has a special place in my heart. And I want to thank you for the excellent job, and giving up your time to come in and assist the Commission as we weigh the proposals that are in front of us. Thank you.

(Whereupon, at 12:08 p.m., the PROCEEDINGS were adjourned.)

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CERTIFICATE OF NOTARY PUBLIC

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

/s/Carleton J. Anderson, III

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