UNITED STATES OF AMERICA

COMMODITY FUTURES TRADING COMMISSION

AGRICULTURAL ADVISORY COMMITTEE MEETING

Washington, D.C.

Thursday, December 6, 2007

PARTICIPANTS:

WALTER LUKKEN
JILL SOMMERS
MICHAEL DUNN
BART CHILTON
WILLIAM FERRETTI
DAVE MILLER
DAN BROPHY
TOM FARLEY
MIKE GORHAM
DON HEITMAN
DAVID KASS
JOHN FENTON
TOM COYLE
TOM ERIKSON
DOUG SOMBKE
RYAN WESTON
DAVID LEHMAN
LEROY WATSON
RANDY STEVENS
NEAL GILLEN

PARTICIPANTS (CONT'D):

LARRY MITCHELL

JIM BAIR

ELDON GOULD

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P R O C E E D I N G S

MR. DUNN: First of all, I want to welcome everybody from the Agricultural Advisory Committee here. This is the 31st meeting of the Agricultural Advisory Committee.

This is an advisory meeting, this is not a hearing, and if it works out right, you're going to hear very little from the commissioners here. It's really what you have to say to us, this is a learning process for us. So it's not a hearing, it's an opportunity for you to hear a panel, to give a reaction to that panel, to answer those questions.

You notice I'm not touching this microphone or leaning forward into it or anything else, and that's one of our requests herin which is to leave the microphones alone. We've got great technicians here, and they're going to adjust it so that you can be heard.

And one of the reasons why we need to have the microphones here is because of the three subject matters that we've got out here, the role of speculation, the agricultural markets, the over-the-counter agricultural markets, and the global carbon markets. On a couple of these we've got some federal register notices out, and so we're actually in a comment period on this. Everything that the Advisory Committee tells us on these subject matters today will be part and parcel of that record that we review from the federal register. So it's very, very important that when you get recognized, that you give us your name and who you're representing so that we have that in the record, I appreciate that.

I'd like to just take a quick opportunity here to ask our commissioners to welcome you, as well, and we'll start with our Acting Chairman, Walt Lukken.

MR. LUKKEN: Good morning. I apologize for being slightly late. I realized when I got down here I didn't have my opening remarks, and now that I've read my opening remarks, I'm going to ignore them and just talk to you.

So I appreciate everybody being here.

And I want to welcome all the panelists that are participating today, especially my former colleague, Tom Erikson, who, I'm not sure if Tom's here yet, but -- who, when I first got to the Commission in 2002, he was a commissioner and helped me sort of get up to speed and taught me a lot in his time here, so I appreciate Tom's participation today, as well as my former colleague and good friend, Mike Gorham, who was our Division of Market Oversight Director for several years. And Mike is one of the most intellectually curious people I know, and that's what makes him a great asset to us both here at the Commission and to the industry itself.

So Mike has put together, Commissioner Dunn, I apologize, who is Chairman of the day, has put together a great presentation, both timely and relevant to what we're looking at here at the agency.

Obviously, these markets have gone global as they've grown. This has provided a great benefit to the agricultural markets and added liquidity. But this added liquidity also presents challenges as we try to figure out whether our regulatory structure is still meeting the mission that it was set out to meet: spec limits, the tiered categories that differentiate between energy and agricultural products and the oversight that comes with those distinctions, whether those are continuing to be met. And obviously carbon markets, something that's on the front of everybody's minds around the globe.

So I'm looking forward to the hearing and stop talking and listening for the rest of the day. But thank you so much for participating. And I commend Chairman Dunn and his staff for putting this together today.

MR. DUNN: Thank you. Commissioner Sommers.

MS. SOMMERS: Good morning. Thank you all for being here. I think that throughout my tenure in this industry, the agricultural industry has been such an important constituency to the futures markets. I really appreciate your participation here today and look forward to the important issues, and again, thank Commissioner Dunn and all of our staff for putting together such a great agenda, and I'm looking forward to listening to your important views; thanks.

MR. DUNN: Thank you, Jill. Commissioner Chilton.

MR. CHILTON: I'm not going to touch this because you told me not to touch it even though it's pointed away. This guy is a friend and mentor and I do exactly what he says, and he told me not to touch it, I'm not going to touch it.

MR. DUNN: Good; my house needs painting.

MR. CHILTON: Yes, sir. Good morning, everybody, and thank you for everyone being here, in particular, Doug and others who have traveled from so far away. It's important work that we're doing and I think we can do good together. When I woke up this morning, I sort of nudged my wife and looked out and we had left the holiday lights on, and the snow was all over them, and I thought, you know, how pretty is that, and it made me think of that song, the Turn, Turn, Turn song, to everything there is a season, and I'm sort of humming that in my head on the way in, not listening to the radio, and the next line, there's a time for every purpose, and I started thinking about this rich history in agriculture and how there was a time for the purpose 155 years ago, and people wanted consistent supply and demand, and farmers and ranchers wanted a consistent price, and we didn't want food to rot, and that's still important today, what we're doing, but there's also a lot of opportunities, and I'm pleased that Mike has put on the agenda the global carbon markets.

That is such an exciting and new opportunity for us to address global warming. When I say "us", I mean the collective world us. And the futures industry has really taken a proactive role on that issue.

Lewis Redshaw, the head of Barclays in

London, said that he expects that carbon will be the number one commodity market, if not the number one market in the world at some point in the not too distant future. In London, carbon is a $30 billion industry. And carbon credits, carbon products are trading on the European Energy Exchange, they're settling at €23 and €25.

But in the United States, as we'll hear later, you know, it's about $2. And I know Doug will speak about that.

But, you know, the reason is, because they've got a cap and trade system, they took the Kyoto Protocol seriously, and we need to do more work here. So, for everything there's a season, and for every time, there's a purpose, and hopefully that purpose is sooner rather than later. Thank you.

MR. DUNN: Okay. Before we get going with our first panel, what I'd like to do is, have all the members on the Ag Advisory Committee to identify who you are and who you're representing. And, Doug, why don't we start with you?

We'll do the inner table and then we'll do the outer ring.

MR. SOMBKE: My name is Doug Sombke, I'm President of the South Dakota Farmers Union representing National Farmers Union.

MR. COYLE: My name is Tom Coyle, and I represent National Grain and Food Association.

MR. FENTON: My name is John Fenton, and I'm the Director of Markets --

MR. HEITMAN: Don Heitman, I'm with the Division of Market Oversight.

MR. KASS: And David Kass, also with the Division of Market Oversight, from the Chicago office.

MR. GORHAM: I'm Mike Gorham, Director of the IAT Center for the -- Markets, working --

MR. LEHMAN: Dave Lehman, CME Group.

MR. FARLEY: Tom Farley, I'm the President and CEO of Vice Futures US, formerly the New York Board of Trade.

MR. BROPHY: Dan Brophy representing Commodity Markets Council.

MR. STEVENSON: Randy Stevenson representing Mark -- USA.

MR. GILLEN: I'm Neil Gillon, American -- Association.

MR. MITCHELL: Larry Mitchell, American --

SPEAKER: Jack (off mike) Managed Funds Association.

SPEAKER: Francis (off mike) National Swaps Association.

MR. YONKERS: Robert Yonkers with the International Dairy Foods Association.

SPEAKER: (off mike) with the National Range.

MR. WILLET: Sam Willet, National -- Association.

SPEAKER: Alan (off mike) Assistant to the Administrator of the Risk Management Agency.

MR. GOULD: Eldon Gould, Administrator of the Risk Management Agency.

SPEAKER: Mark (off mike) Minneapolis Grant Exchange.

SPEAKER: Tom (off mike) National -- Association.

MR. DUNN: The other members of the Ag Advisory Commission?

MR. McGUIRE: John McGuire, National -- Council.

MR. LUSTON: Brian Luston, American --

MR. DUNN: Remember, I said this is to inform the commissioners, so theoretically, we wouldn't ask many questions, although my colleagues are prepared to ask -- but it really is to the Advisory Committee to get off what's on their chest, to bring forward -- and with that, I'd like to start with our first panel here, and it's the role of speculation and agricultural -- I think from the very beginning this has been something that -- whole term of the Ag Advisory Committee -- agriculture trading has become increasingly more global -- in there. There is a need to understand what's happening in the market with price discovery mechanism and how is all this effecting things. I think we have a tremendous first panel here to begin talking about those issues. I'm looking forward to it. After they finish, then we'll open it up for the Advisory Committee to ask them questions or to do comments. Our first presenter on this is somebody who literally flew in from India, Mike Gorham. And as our Acting Chairman has said, Mike is an alumni from here at the CFTC, he's worked the federal reserve, he's been with exchanges, he's an academia, this is a great person to give us a broad oversight. So, Mike, could we start with you and your presentation?

MR. GORHAM: Absolutely; Walt said that I was an intellectually curious guy, and the thing is, if you don't know much, you've got to be intellectually curious, because you'll never learn anything otherwise.

So I was asked to address this issue of price discovery and market -- changes in price discovery and market structure. And I have to confess something, I hate the term, price discovery. I know it's in the act, and so I know we've got to use it and we've got to know what it means. But quite -- the reason I don't like the term is because it's always been a fuzzy term, it's always been a somewhat complex term, and if you talk to different people, they really mean different things by it. So what I'm going to do is kind of structure this just slightly differently.

So I'm going to start with talking about structural changes in the way exchanges operate, and then I'm going to talk about what the implications are for those structural changes on both the pricing of futures, the price of transactions, as well as the fees that are charged by exchanges for those transactions.

We are probably in the midst of the biggest transformation of derivatives and securities exchanges in our history. For those of us that thought we knew what exchanges were ten years ago, we've had to totally rethink what these things are.

And there are a number of different changes, but the three that I want to focus on today and the three that I think are most important is the shift from floors to screens, the shift from private clubs to public companies, the shift from smaller to larger via mergers and acquisitions. Let me take each one of those.

So this move towards electronic trading is not new. In fact, I don't know if people in this room realize it, you'd have to be kind of old like I am to know this, but the first attempt at electronic trading was actually an attempt to buy an exchange called Intex in Bermuda back in 1984.

And what happened in that case is that there was a guy from Merrill Lynch named Eugene Grohmer, who was tired of getting abused by the floor, and he decided that he wanted to create an electronic exchange where you had transparency, you saw what the bids and offers were, and he actually came, I guess not to this building, I don't know where the CFTC was back in 1982/'83, but he came to the commission, and the commission -- and he explained what he wanted to do, the commission loved it, I mean because this actually gives you much better -- I don't know if you remember, but we had this audit trail concept that we didn't really have much of an audit trail, and this actually made that thing precise and crystal clear.

But the commission actually gave him some informal advice, and the informal advice was, don't do it in the U.S., do it offshore, because even though the commission thought it was a great idea, they said the big floor based exchanges will never let you get this done, it'll take you years and years and years to get regulatory approval, not because we don't think it's a good idea, but just because entrenched interest in floor based trading will keep it from happening.

The exchange started, it was done in Bermuda. Because these guys were pioneers, they did everything wrong, there were all kinds of mistakes, I mean it's tough being the pioneer, and they started in -- they opened in October of '84, and it really just lasted a matter of months, it really was not a success.

There were -- in the 1980's, there were actually six other -- or there were six total attempts to create exchanges, electronic exchanges. Virtually every one of those was de novo, it was brand new, in other words, new exchanges were being created, because you really could not get mutually owned, member owned exchanges to vote to put themselves out of business on trading floors and to go behind screens.

So the funny thing is that the first successful one took place about as far offshore as you can get, in a little country that's about half the size of Chicago, and that's New Zealand. So there were seven wool guys in New Zealand that wanted to create a wool futures market, but each of these guys was in a different part of the country, and of course, each one of them wanted the exchange to be in their own town. Well, it turned out that electronic trading was a perfect solution, because you didn't have to have it anywhere, it was really everywhere if it was an electronic exchange.

They got some bankers involved, and they opened that, and that was a very successful exchange. It doesn't -- that name doesn't exist anymore, the New Zealand Futures and Options Exchange, because it was taken over by another exchange, which was taken over by another exchange, and this is all part of the Australian exchanges now.

The only exchange back then that went from -- that was member owned that actually made the transition was the Tokyo Grain Exchange. And as you know, the government in Japan is a little more involved in telling people what to do than the commission here. So it was basically -- it's what happened in that case.

So most of the world is now converted. China has been fully electronic for 17 years; India has been fully electronic for five years. The CME and the Board of Trade are now about 70 something percent electronic. So even though the U.S. was a dinosaur, it's made this move. And the biggest dinosaur in the U.S., and I don't think anybody is here from the exchange, but it wouldn't matter anyway, was Nimex. I mean Nimex, while everybody was trying to move towards electronic trading, they were sitting up floors in Europe. I mean it was just kind of a crazy thing. But they finally realized that they weren't going to survive unless they went to electronic trading.

So this is all history, so what does this really mean from the point of view of pricing the products that you're selling? Well, first of all, it has created unprecedented transparency. In other words, what you guys get now is information that was only available to floor brokers when we had floor based trading.

You can see, depending upon what the exchange is, you can see either all or some substantial proportion of the resting bids and offers, so you see the full book, and you know something about the structure of the market. That just didn't exist before and that's just an unmitigated wonderful thing, that that has happened.

It also has made possible things like a technique that's known as smart order routing. So, for example, let's say that you want to take a position in sugar, and I don't know if this is still the case, but both life and nightbite (?) had active sugar contracts. And so what would -- what I'm told, I've never been involved in this myself, is that there were programs that basically if you wanted to cover yourself in sugar, basically the program would take the position to the exchange at which you could get the best price. A lot of that happened with Nimex and Ice, as well, where there were multiple contracts traded in each of the exchanges.

So despite these wonderful things, there are a couple of concerns. Number one, liquidity vacuums, I don't know if you remember, but back when electronic trading started, the electronic stock indexes at the Board of Trade and at the CME, you would find that sometimes on the day before a holiday, when there was not a lot of liquidity, the market would be going along, and then suddenly it would plunge for a matter of a few seconds or a few minutes, and then come back up again.

And essentially what was happening is that orders would come in, market orders, that were bigger than could be accommodated with the resting buy orders, and they would actually hit some sell stops and cause the thing to plummet. Now, this hasn't -- I think this has basically been taken care of because it hasn't occurred in a while, but that was an initial problem. Number two, high frequency algorhythmic trading. At my university, we've got -- one of the most popular things that students are studying is how to build black boxes, how to build black boxes for trading. And these systems are such that you can really -- you can actually put -- you can put in hundreds of orders per second.

Now, this is wonderful from the point of view -- because most of this is arbitrage. So from the point of view of getting markets in line, from making markets efficient, you know, where if something is a little too low and another one is too high, people that are doing this trading bring things back into line, that's all good.

But having spent two years here and worrying about what John Fenton worries about all the time, and Dave Kass, about manipulation, just -- I just have a gut feeling that this could be used in a way that's not the best, and so I just think that's something that needs to be looked at.

The third thing has to do with deceptive trading. Now, I said that this is a great thing, that we have all of this transparency and you can see all of the orders in the market. The problem is, is that sometimes those orders are not real orders, and here's the scan. Somebody goes in, and let's say that you believe, not that anybody in this room would ever do this, but let's say that you believe that the market is actually going to go down, and what you want to do is, you want to put on a relatively large short position. What you do initially is that you put in a bunch of buy orders, limit buy orders, and people look at those and they say, you know, these buys must know something, the fact that you've got so many buy orders in there, so they start coat tailing or piggybacking, and they start putting -- they start putting buy orders in, as well, and then what happens is, as soon as you see all these other buy orders come in, you cancel all your buy orders and you take the other side of all the guys that you tricked into the market.

So it's a complicated thing. I mean we should think of trading as poker, because that's what it really is, I mean from the point of view of bluffing and all the things that take place. So these are just a couple of the things that we have to be concerned about.

So the other two factors, the other two shifts, private club to public company, now, we all know what that's about, and we -- basically this means that you've gone -- that we're going from member owned exchanges to what we call demutualized exchanges, and then ultimately doing

IPO's and listing stock. This has been an incredible thing for anybody who's a member at the Board of Trade or the CME. I mean they've really been able to unlock the value of the memberships in these things.

But I'm going to make a bold statement, and that is that I think that this move is actually a very positive move from the point of view of customer service. These exchanges have basically been private clubs, and they have acted in the interest of their members, I mean there's no pretention about that, I mean they are associations of members, and the idea is, they want to do things that will enhance the revenues to the members.

What that means is that sometimes customers really don't get the kind of service that they ought to get. And I -- we don't have time for this now, but there is -- one of the best stories in finance has to do with this miraculous transformation of markets in India by the creation of a new stock exchange that was stockholder owned and went -- basically took all the business away from this really old Bombay Stock Exchange, finally, the shift from smaller to larger.

Now, there's so many exchanges world-wide that no longer carry their original names because they were swallowed up by a larger exchange, it's happening everywhere. In the U.S., Ice has taken over Nibot, Eurex has taken over the International Securities Exchange, the NYSC has merged with Archipelago and then again with Euronext. And, of course, in the mother of all mergers, the Board of Trade and the CME, well, the CME has either merged with or taken over the Board of Trade, depending upon how you want to sort of spin that.

This really does raise a pretty interesting issue. I didn't read the Justice Department's analysis of this situation. And I mean I know, I just took a look, I know that during the first three-quarters of this year, 87 percent of all futures and options trading in the U.S. took place at this combined exchange, or it took place at the two exchanges and the combination of the two.

Eighty-seven percent is quite a bit. I believe that what Justice decided is that, yeah, that's a big number, but there really is competition from outside the U.S., and we know that's the case, because back in 2004, Eurex attacked the Board of Trade, and Euronext attacked the CME. Both were failures, but that exists. And the exchanges also argue that there is a lot of competition from OTC, so that might be the case. But the last point that I want to leave here has to do with the structure of these markets, in other words, whether 87 percent is a big number or not, and I just want to make sure we're all on the same page on this, futures -- a market for a particular futures contract is really a liquidity driven, naturally occurring monopoly.

As an example, when the CME and the Board of Trade merged, I want you to guess how many contracts they had in common, how much of an overlap was there between the two exchanges; does anybody know? It was zero.

And what that says is that, if you've started a contract and you've developed liquidity in that contract, nobody is going to take it away from you, nobody is going to really make any end roads into getting market share, and the only exception to that is, for example, when you have an electronic exchange that comes and offers all of the advantages of electronic trading and they compete directly with a floor based exchange.

So that's why Ice was able to get a huge part of the market share of Nimex's contracts. That's why the Board of Trade was able to get a huge market share in silver and gold when they were offering their electronic versions. So I think as we go forward, there are a number of really interesting structural issues in which economics and politics are really intertwined, and I can't wait to watch what you guys do with all this.

MR. DUNN: All right. Thank you very much. You'll observe that you do not have Mike's paper in your packet that we had sent out to you over here. And it's the fact that he literally was flying back from India and put it together last night or in his head earlier, I'm sure. But as soon as we get that, we will get copies to you. So anything that you're missing, when we get hard copies, we'll get them out to you.

The next three panelists, I'm going to introduce all three of them right now and their subject matter so we can just go right on through. I was recently in Chicago, at the industry meeting, and person after person got up and said how great the CFTC is and what a great job we do, and there's a reason for that. I think we have some of the most professional, the most dedicated group of employees of any agency in government. And you'll see that these next three gentlemen, not only are they knowledgeable, they've got a lot of institutional knowledge, as well. I'm not saying their old, but they have. And we're going to start off with Dave Kass, who is going to give us an update on our commitment of trader's report and how that's worked. This was a big topic, a subject from our last meeting, and I think it's worked very well, but Dave will give us an update on that. Dave, I have treated him like a member of my staff. He's been one of the greatest advisors I've had on the Agricultural Advisory Group.

The next person who's going to make a presentation, and not sitting in this order, is John Fenton.

John is the heart and soul of our surveillance program. And this guy we rely on to tell us what's happening in the market place. If there's something that looks odd, he's the first one to notice it, and again, somebody that has had a great deal of knowledge and background, and he's going to talk about the increase and speculative position limits for numerated agricultural commodities.

And last, but not least, Don Heitman, who is going to discuss the commission's proposal to allow certain Risk Management positions, in an exempt from federal position limits. Don's name you might see. He signs many of those federal register pieces, and that allows him to get a lot of strange email. But these three guys are tremendous assets to the commission. And so with that, I'm just going to let all three of them go right into their presentation, one following the other. Dave, if you will, please.

MR. KASS: Thank you, Commissioner. First of all, and I'm sure I'm speaking for the three of us staff opinions, we always have to do the disclaimer, any opinions that might sort of creep in or leak out are those of the staff, not necessarily those of the commission.

And unlike my colleague here that is no longer a commission member, who has obviously expressed many opinions, we, like I say, we speak for ourselves here.

I have sort of a task of bringing us up to date. Well, actually 16 months, when this committee last met, in August of 2006, of course, as Commissioner Dunn said, a big topic was getting input on whether we should, and if so, in what form we should add more transparency to the market through this disclosure of index trading.

And I made a presentation at that panel, and of course, we could only talk about hypotheticals, because we -- although we had the data in-house, it would have been, you know, a felony violation for somebody like myself to disclose sorts of confidential data to the public. So our hands were tied a great deal talking about hypotheticals, and maybe it's this sort of a, you know, big share of the market, without getting into any kind of specifics. Well, now, of course, those sort of fedders (?) are removed to some degree.

There is data out there; we did begin publishing a report this past January of '07, and we published a year's worth of data going back, so that's out there, and it sort of frees my hands a bit in that I can talk more about that and say some things about, you know, who's in the market, again, in general terms, nothing too specific.

So with that, let me get started. Commodity indices, and people talk about them, and we talked about them, again, 16 months ago, is sort of an amorphous thing, it's a commodity index, it's -- the S&P -- commodity index, or it's the Dow Jones IAG, and they treated it just sort of a lump of, you know, you're exposed to commodities, and you're sort of in the whole thing.

And that's certainly true, and there's a lot of institutions, and people in the financial world that treat it that way and could care less about things like corn. Did I lose my -- no, here we are, things like, you know, individual commodities. Oh, there we go.

But we, as commission staff, particular in the markets, do worry about things like what's happening in corn, or what's happening in -- you see cotton here and some of the other ones. Not only -- apart from what's happening in the index as a whole, but what's happening to each of these individual markets. So we do not lose sight of the individual markets and focus a lot on the individual markets.

And, of course, we don't want what's happening in the commodity indices somehow, that trading -- to somehow work us back down into, in effect, these very real products.

They're not real necessarily to a big pension fund or insurance company, but they're certainly real to the people that you all represent in this room, and to the people that produce it, process it, export it, you know, use it, whatever it is. And I can assure you, we don't lose sight of that fact.

We started with the individual markets before they were indices, and that's, you know, we still -- that's what we work with, so --

So now, like I said, last -- I want to talk a little bit about market transparency, and hopefully we've added some transparency through our publication, and that was the purpose of it. But some of the other regulatory implications that, again, we couldn't talk about a lot, only more in general terms, and I can be a little more specific not. In terms of position limits, both the federal and the exchange, and in terms of the potential impacts, our concerns about impacts on not only the prices themselves, but spreads.

First is sort of a background. This I think -- I find a lot of information in this particularly graphic. If we start over here, this is -- there's groups of folks out there, institutional investors, maybe some high net worth individuals, that we're going to get exposure to commodities, and again, this sort of morphous thing, not the corn necessarily, or cattle, or anything else, as an asset class, and then there's various ways they can do that, and they do that through these indices.

And so here's a pension fund, and they want to get this exposure, their reps and folks trying to sell them products that said things like, if you get, you know, put two percent, five percent, whatever it is, of your assets into commodities during certain markets when maybe equities aren't doing so well, or bonds, or foreign currencies, or real estate, or all the other things they invest in, there's certain advantages, portfolio advantages and things like that. I'm not going to go into all that, but they get into it as another asset class. And they might go to somebody like a financial services firms, and you know, I'm sure you're all familiar with, and some of you, you know, may deal with some of these folks, swaps, dealers, banks, you know, whatever these folks deal with, and there are other investments, and there are other asset classes they're going to these folks to get involved in the equities and debts and other things, and they might do a swap with them.

And there is a standard swap, where they're getting the return then on this index, whether it be one of the major ones. I think, you know, anecdotally, I guess the Goldman Sacks and the Dow Jones AIG are the two largest, and there's lots of sub indices of those main ones and then other proprietary indices and what not, and they'll do a swap to get this returned.

And then this group here that we have in this first blue box has then created a short position for themselves. Their client is long commodities in the form of this index, they're short, we consider that a hedge. They now want to cover that market exposure by going over here. This is where you're going to get coverage. You're going to go to a designated contract market, which are generally U.S. Futures exchanges, you might go to some OTC thing, where there's a highly developed over-the-counter market, or in some cases you might go to another exchange, a non-regulated exchange of something. Another way they might go is, there's certain essentially mutual funds and others that have set up a fund, just like the -- just to pick one out of the air, the Vanguard S&P 500, which replicates the S&P, well, there's funds out there that say if you want exposure, this fund will do that, it will mimic the Goldman or the Dow Jones, and if you give us money, you're going to get that return, and it should be a part of your portfolio, blah, blah, blah.

But these guys, since they're getting money that essentially wants to get exposure to the markets, they're not trying to cover a hedge,

their clients may be thinking of this as sort of a hedge against inflation, but nonetheless, they want to get market exposure.

So to the extent they go directly into these markets, that's considered not a hedge, but a non-commercial type of position, and they do not get relief through bona fide hedging through speculative limits.

But if they were to run afoul of speculative limits or approach at least speculative limits and wanted to still -- they've got more money coming in, want to get even larger positions, they can then do a swap up here to these guys, and then the money finds its way back into the markets, well, particularly, in our case, designated contract markets, which is where you'd run afoul of spec limits.

So there's various ways that they can. And that's why they could go up here and convert what wouldn't be eligible for spec limits relief up to these guys, who then would do a swap, and do get -- and want to cover market exposure, then they can transfer it from something that wouldn't get relief to something that would.

Or an institutional investor can say, well, I can bypass these big financial guys who are obviously going to earn a commission and do it myself. Some of these indices are published. They'll tell you what proportions of what markets, when they get role from the nearby future, the next deferred, and all these things.

Well, I can pull out this manual and just do it myself and manage the trading strategies and all that, and do the direct. Again, if a pension fund is doing this as part of a gaining exposure to market, again, maybe in terms of their whole portfolio they consider this as an offset to something else, but nonetheless, from the perspective of our commodity market, they're gaining market exposure, not covering exposure, so again, this is a non-commercial position, and if they stay within speculative limits, they're free to do that themselves, if they run afoul, they could then, again, go back up here, this route, and go through a swap dealer to supplement what they're doing or do it exclusively. So that's sort of the characters in the market and how they operate and how they're treated from our regulatory perspective in terms of spec limits or non-spec limits.

We're going to hear in the next couple panelists some things we're doing in terms of spec limits and a new exemption category that address some of these issues.

Now, what markets, all these markets, and as you see here in this little note, for eggs and the soft, coffee, cocoa, sugar, things like that, they primarily use designated contract markets, because they really don't have good ways to use OTC or other exchanges, they're just not highly developed.

In something like cattle, there's really not a real strong OTC or certainly another exchange, unlike crude oil, or silver, or gold, where they're very highly developed.

So in the energies and the metals, they

tend to use all three, which tied our hands as staff in terms of how we were able to publish data. To the extent that most of commodity index trading finds its way into this category, we have a pretty good handle on it because we see that's our extra reporting system.

To the extent -- in these other markets, where there's lots of other options for them to do things, and OTC and others, we're not seeing much of it in our markets, so we were unable to publish data for those.

All right. Now -- so then, to add transparency again, we listen to what you all had to say 16 months ago and we began publishing. This is the way commitments looked, and still looks, we do still publish the traditional one. Where you have reportable traders, we divide the market into essentially non-commercial speculative and commercial.

And, of course, the concern was that, you know, particularly on the long side, these long funds, here we're seeing commercials. It looks like they're about, if you look at the long and short, they're net long, what, about 16,000 contracts, yeah, almost exactly 16,000 contracts. So if this is all you had, this is all you had up until January of this year, it would look like commercials were net long 16,000. Now, of course, we all knew that the index money was in here, we just didn't know, well, you didn't know how much, we sort of had a better handle on it because we do get the data. Well, this is what -- beginning in January, we started publishing this additional category. And particularly, to zone in on, let's look at that long now, there's nearly 205, nearly 206,000 contracts that we are now seeing long.

And now look at the long with its left over here. Remember, we were about 16,000 net long commercial. By taking some out of the commercial account, in fact, specifically, this 205,000, almost 206,000, it was -- 178,000 of it, or about 86 percent of its number, came out of that commercial category, and the other 14 percent, about 27,000 or so, came out of the non-commercial side.

Now, remember, back -- that flow diagram, you could go different ways. If you went up through the swaps dealer and they were hedging, that would have come out of the commercial category. If you come through doing it yourself or doing it through a fund of some sort that wants to gain exposure, that would be coming out of this category. But this now is dated, we weren't able to disclose before that here we have 206,000, the commercials are now obviously way net short, not net long, the more traditional commercials, to the tune of about 150,000 contracts net short, and here's the proportions coming. This is all now public data, of course, and this is the most recent report that's out there in the public domain.

So that's the transparency now that you all asked for and now you all have, and obviously we'll be interested in any comments. We've gotten comments over the past year, of course.

Now let's see how this breaks out.

We're, of course, publishing data for 12 markets. These are the 12 markets depicted here along the bottom, live cattle, hogs, wheat, feeders, et cetera. These are the markets where the data was best in terms of not clouding it by adding metals and energy where we really weren't seeing much of the picture.

And some of these firms that are -- do index trading were also doing lots of other things, proprietary trading in metals or individual markets swaps and things like that.

The blue bars, which the scale is over on this side, is the thousands of contracts. So in live cattle, and this is as of the 27th, the date that we published the most recent data, you can see it looks like about 120,000 contracts. And you've got little feeder cattle down here, maybe 10,000 contracts or so, and you can see the numbers of contracts. The red represents -- what those contracts represent in terms of percent of open interest, because it tells a lot different story. Here's feeder cattle, which if you just looked at the bars, looks like it's very small, but that's a small market. And that represents, it looks like about 33 percent of the feeder cattle market.

So what you end up with is sort of grouping things. You've got these three markets way over here on the left, and they're grouped by size or percent, cattle hogs and wheat with fairly high percentages, at least relative to the other 12 markets, 40 percent, 45, you know, and slightly above 45 percent.

You've sort of got this middle group, eight more markets in here that range from, oh, 21 to, what, 32 percent, just looking at broad numbers. And then you've got cocoa over here which is markedly less. But again, so these are data we couldn't show a year ago, and this is all public data, let's see if we can get this out of our report, just put the numbers together in the right way. So again, this is all adding transparency to the markets, what proportions. Okay. If you look over time, going back to --

now, we had this data going back, but the data deteriorates as you go back because traders were doing different things. But let's look at where we've published data since January 6th. Here you've got the Board of Trade, wheat, in terms of thousands of contracts, and you can see it's fairly, you know, it's a little bit less over time, it's grown a little bit recently.

We just sort of picked different sort of market sectors. Here's a soft market, sugar. Now, this big jump up here and this sort of decline here during this time frame, these are market readjustments, rebalancings at the end of a year when a market, you know, the dollar value of sugar in '06 dropped very dramatically.

The price of sugar was off, it may have been off as much as 50 percent. So to get the same dollar exposure, you've got to add a lot of futures contracts to get that same dollar exposure that the index market required, and that's why you see this big leap up.

And similarly, wheat, which had

increased in price, had to come down a bit and that sort of thing. So some of that we're aware of why this is happening.

Just to look at it in another way, this is as percent of open interest, same data, and these are all data you can -- although this is maybe daily data, so it's something you wouldn't normally see, but it doesn't change that much day to day. So this is -- percent, and you can see wheat going, in the earlier period, January through May, was well above 50 percent at times, and it's down more, rising a little bit very recently, it's approaching 50 percent.

And then you've got cattle up here, and you can see where sugar is in terms of percentages of markets. So these are all now added transparencies.

Now, what are some of the other regulatory issues about this data? Now, this next graph you cannot get out of our report. This is semi-confidential data. I guess it's obviously not confidential anymore because this is a public thing, but this is not something you would normally see. But I wanted, within the bounds of not being cartered off to jail for disclosing confidential market -- within those sort of bounds, I hope, we can say a little bit more, and so you're going to -- and I have used this at a couple other conferences.

What this represents, the green bar is the positions, and this is futures and options combined, in the December wheat futures contract individually. Now, remember when we publish the data, it's across all futures, so you're not seeing what's in -- you're seeing what's in the whole collections of futures contracts and options combined, not in any one individual future.

And, of course, we all know, if you know anything about these index, they tend to load in the front, not exclusively anymore or as much as it was in the early days, but they tend to front load, and then they roll on a prescribed schedule, and you certainly see that here.

Look at all the contracts in dese (?)

meanwhile, this is the next deferred contract, the march, and you can see it going down at a much lower level. Now, you say, well, Mr. Kass, where's the scale over here; you know, I'm not what -- how many thousands of -- well, that's the part where I don't want to be cartered off to jail and those sorts of things, so that I've left off.

But it's not important for the meaning of what this is to see the open interest in the dese coming down quite sharply, and march, all of a sudden you get to this five day roll period and you're seeing it come down very, very sharply, you're in that five day window, and it's standard, it's published, and it's the fifth through ninth business days of the month prior, so for the dese contract, fifth through ninth business days are the 7th, the 8th, the 9th, 10th, and 13th of, in this case, November. And this red line now, I've left out one of the major lines in this, is the spread, because as you roll, of course, you're going to sell, you're going to sell the nearby the deferred, so what's happening to the spread.

Well, they're pretty much locked in up here, the -- and this red represents the spread. Now, this scale I can certainly disclose, that's public information. That's the deeds mark spread and this is the zero line, so that would be if it happened to touch this line, this red line, that would mean they were equal in price.

To the extent this is below means the dese is below march, it's a carry, and to the extent it rises above this line, it's a premium, it's an inverse. They say contango (?) and stuff in the east coast; mid west guys tend to say carry and inverse.

You can see what happened here, in wheat, you had a lot of news came out about -- if you remember the conditions in October of a year ago, a lot of news was coming out about the devastation to the Australian wheat crop and what not, and wheat prices were going up, and this would tell you they were going up disproportionately into December versus March. The spread, which had been at a carry down here of about, oh, let's say 18 cents, all of a sudden went as far as an inverse of several cents. And what's happening, here you've got these guys, long only, who might have been a source of selling to liquidate at an advantageous time.

These folks know they've got to roll from this nearby future, and they're going to roll up hill. They're going to roll from a low price to a high price. And if you go and move a long position from a low price to a high price, obviously that's not particularly advantageous.

If you had rolled here, that would have been very -- you're rolling down hill essentially, you're selling something at a high price and buying something at a lower price. So it would have made a lot of sense, if they would have been allowed to, for them to take -- particularly if they thought it was a short term phenomena. Of course, nobody knew at the time whether that spread might, you know, continue, and then it might have looked like a terrible decision.

But in any event, that's sort of the

economics. And so one regulatory concern that was expressed to us at the time was these folks, these commodity index traders, or CIT's, were somehow a drag on the market. They were not a natural source of selling that may have reduced some of this pressure of people on -- who wanted to buy the dese because of what was going on in Australia and some other things going on around the world. They weren't there as somebody -- a willing seller of a long position at an advantageous time, because most of them are locked in.

Remember, this is a hedge, they have to guarantee a return, and the best way to do that is simply mechanically passably follow the rules of their index, which dictates that they roll during this five day window.

So that was a concern that was expressed of us at the time, and it's something we're certainly interested in and are looking at. The other thing kind of to note here, here's the spread prior to this, and then during the roll itself, the traded spread was remarkably stable.

Here you have this massive roll, and remember, wheat we saw was up in the area of 45 -- 50 percent of total open interest, and again, without giving you specific numbers, it does tend to concentrate in the nearby, in this case, the December.

So here's a whole bunch, so it would have been even a higher percentage of the dese of a single month. Here's this huge percentage of open interest being liquidated, and a short window, and they're all doing the same thing, selling dese, buying march, and here's the traded spread, you know, not showing much reaction, so that's probably a good thing, although recently, and we may hear from a panelist or two, concerns have been brought to our attention that we're not looking at the right thing necessarily, but if you just look at the traded spread, because these guys don't get their role on the traded spread, they get the settlement price each day, that's what they have to replicate, so they go into the pit, and the pit difference is, if you look at the calculated spreads, can be way different, they can be all over the map here.

So that's something we're looking at, and we're very concerned about that prospect. Of course, as pit trading becomes less and less, and if ultimately the exchange were to -- because settlement prices are based on pit trading, not electronic.

Even though electronic trading is the majority of trading, it still doesn't fix the settlement price, and it's the settlement price that drive the index, et cetera, et cetera, so that's why they use the pit. Ultimately, of course, the settlement price is as they converted in treasuries and other things, will be determined presumably on the electronic market, and that may make the problem go away, but I'm starting to bleed over into that opinion thing, so I better stop while I'm ahead and not get myself into too much trouble. But at this point, I guess John is next.

MR. DUNN: John, before you start, I did

see Bryan Dieriam walk in from Congressman Goodlatte's office; Bryan, if you'd stand up. There he is, okay, I thought he was out here somewhere. Thank you, Bryan, for being here. Are there any other congressional staff members that are here? All right. John, if you will.

MR. FENTON: Good morning, everyone. I'd like to thank our guests for coming and visiting us. I'm looking forward to hearing your views on the various topics and I hope you find today's meeting useful to you.

The last time we revised federal position limits was May of 2005. We raised them to higher levels basically on the size of the market. And at that time, we said we would try to keep them up to date. They've changed fairly infrequently through the years, so we're trying to be a bit more proactive and keep the position limit levels commensurate with the size of the underlying market. So in November of this past -- a couple weeks ago, we published a federal registry notice proposing to, among other things, increase the federal limits in all the markets that have limits, except for OATS, and that's what I'm going to talk about today.

Now, the purpose of position limits are stated in -- Exchange Act, Section 4A(a), and it's to prevent excessive speculation that could cause sudden or unreasonable fluctuations or unwarranted changes in the price of a commodity, so big positions that -- not necessarily an attempt to manipulate the market, but just the size of the position, the size of putting them on or taking them off or rolling them could cause destructions in the market.

And also, the core principal five, which is Section 5D5 of the act, also speaks to position limits, in this case really to exchange said limits. And there it's -- the rationale is to reduce the potential threat of market manipulation or congestion, especially during the delivery month or the spot month. So slightly different rationals, but in both cases, it gets to the size of the position and the potential impact in the market. The federal -- the position limit structure in the futures industry is basically two pronged. There are federal limits in a group of agricultural commodities, a relatively small group, the Chicago Grain and Soybean Complex, the Ice Cotton contract, the Kansas City Wheat and the Minneapolis Wheat.

And the reason there are federal limits really is just a legacy of -- that there were limits imposed prior to the creation of the commission back in 1974, they were for the markets that were regulated at that time by the Commodity Exchange Authority. And then in '74 or '75, when the commission started, many additional markets were brought in, Nettles (?) and the beginnings of financial markets, and later the energy markets.

And initially, there was no requirement for the exchanges to set position limits. But in 1982, probably mostly as a result of the Hunsilver (?) episode, the commission published regulations requiring exchanges to have position limits, and that's evolved through the years, and now positions are -- exchanges are allowed to have position accountability rules in place of position limits.

But most position limits in the futures industry are set by and administered by the exchanges, although the commission does have enforcement authority, so a violation of an exchange position limit would be a violation of the Commodity Exchange Act and could be pursued by our enforcement folks.

For the markets with federal limits, it's basically there are really three parts to how we police them; one, we set the limits, and there are separate limits for the spot month, any single month, and all months combined.

And then we have the aggregation policy, which is the way we will combine positions for the applications of position limits, so any commonly owned positions. So if a corporate entity has several trading units that it owns, those positions would be combined for purposes of position limits. Also, any commonly controlled positions would be aggregated for position limits.

And then we have exemptions to position limits, and the main one there is for bona fide hedging, and there are some other limited exemptions that are permitted.

So the current proposal is to increase the single month and the all month combined limits, as I mentioned, in all commodities except the Chicago Board of Trade OATS contract. As I'll get into in a couple of minutes, the reason we're increasing the limits, the reason we're proposing to increase the limits is because the underlying size of the market has grown since two and a half years ago when they were most recently set. So all months combined limits would be increased based on the same formula that we used two and a half years ago, now applied to a higher open interest.

The single month limits would also be increased, maintaining the ratio between the single month limit and the all month combined limits. And the spot month limits would not be changed, because the spot month limit analysis is different.

In the spot month, we're very concerned about the potential to squeeze or corner a market, so the level there is primarily focused on the deliverable supply, and the size of position that could potentially be used to squeeze the market.

So even when the overall size of the futures market and futures trading grows, it doesn't necessarily mean the amount of deliverable supply has increased, so we're leaving those unchanged.

We're also proposing to aggregate positions that are in contracts that share substantially identical terms that are trading on two different exchanges. Back in 2005, we first -- this concept that similarly -- contracts with similar terms should be combined, but only at the same exchange. Now we're saying that if there are two contracts that have substantial identical terms at different exchanges, those -- and the existing contract has a federal limit, then the federal limit would apply to the other contract, as well.

And one example of this is the New York Merchantile Exchange. Not too long ago, they started a contract that was cash settled to the Ice Cotton contract, and so that's obviously substantially identical terms, and so we're proposing that that contract -- positions in that contract be combined. The Nimex contract would be combined with the Ice contract for compliance with position limits.

So the overall all combined limits are based on a formula that is in Section 150.5C of the commission's regulations. And the way it works is, we apply the formula to the average combined futures and delta-adjusted open interest for each month for the most recent calendar year, so in this case, 2006. At the end of each month, we take what the open interest is, and the options are on futures equivalent, and they're an option that's at the money has a future equivalent of half a futures contract, and the money is more than half out of the money, it's less than a half. So we take that open interest, average it for the year, and then apply the formula. Now, the formula is that the limits shouldn't be greater than ten percent of the average month end open interest up to 25,000 contracts, and then an additional two and a half percent of any open interest above 25,000. So there's kind of a kink in the curve that -- it rises at a ten percent rate until 25,000, and thereafter, it rises at a two and a half percent rate.

So using this formula for corn, the average month end open interest in corn for 2006 was 1.6 billion contracts.

And then the ten percent of the first 25,000 contracts would be equivalent to 2,500 contracts. Two and a half percent of the remaining open interest of just under 1.6 million would be equivalent to 39,808 contracts. And so the addition of those two is the proposal for the limit of 42,308, we've rounded up.

So here you can see what we're proposing to adjust the limits to. Corn would be 42,400 in all months, and the single month would be 26,000. So that would retain the existing relationship between the single month and the all month limit. So it would be the same ratio as the 13,500 in a single month to the 22,000 in the all months combined. So the same analysis has been done for all of these markets. And the one exception is that we have traditionally had parody in the wheat contracts between the Minneapolis Grain Exchange Wheat contract, Kansas City Board, and the Chicago Board Wheat contracts, and we're maintaining that, and the level is based on the size of the Chicago Board of Trade Wheat contract.

So that is a brief overview of what we're proposing to do. And I'll be interested to hear views of the members of the committee. Thank you very much.

MR. DUNN: Thank you very much, John. Don.

MR. HEITMAN: I was going to try to keep this to ten minutes, but I was rehearsing last night with my fiance', and after five minutes she screamed, I can't take it, I can't take it, and tried to throw herself off the balcony, so I didn't get to do my entire rehearsal.

MR. DUNN: What folks don't understand is, Don also does stand-up comedy.

MR. HEITMAN: Actually, I appreciate that David and John made some of the points already that are in this presentation, because this involves spec limits, as well. On November 27th, the Commission proposed a risk management exemption from spec limits, and this involves the statutory basis for spec limits that John already discussed, and the regulatory structure of spec limits. There are three elements: The levels of the limits; the exemptions for hedging, spreading, arbitrage and other positions; and then the policy on aggregating commonly owned or controlled accounts and applying the limits.

And there are the federal spec limits for certain agricultural commodities that are on the slide, and then the exchange limits for the others. And as John explained, that's kind of a historical anomaly.

So looking at the current exemptions, to get an exemption from the hedge limits, currently the most obvious examples are, first, if you have a bona fide hedging transaction. Well, if you're a hedger, you're not a speculator, so you can be granted an exemption from the spec limits. Another example is multi-advisor pools with independent account controllers, and John explained that, as well.

The exemptive rules were last amended in 1991. And this is the situation that was in David's slide, that big complicated slide, where say you're a pension fund, and you want to get commodities exposure because you want to diversify your portfolio. So you would go to a swap dealer and do a swap for the index, so that as the index goes up, the swap dealer is paying you money. The swap dealer now has short exposure; the swap dealer goes to the futures market to offset that exposure by taking a long position in the futures market.

Well, as the swap dealer's long position that tracks the commodities in the index, as that position goes up, at some point -- say the index is at 60 percent energy commodities, 30 percent metal, ten percent agricultural, and the ten percent is five percent corn and five percent wheat, well, if the pension fund wants a big enough index position, as the swap dealer's hedge of this goes up -- at some point that five percent of wheat in the swap dealer's portfolio of long futures positions is going to hit the speculative position limit.

And that actually happened in 1991 with a particular swap dealer that was hedging an OTC transaction with a pension fund, and the swap dealer came to us, and we said, "yeah, that qualifies for a hedge exemption," so we granted a hedge exemption to the swap dealer. And in the years since then, we've done the same for other swap dealers, as well.

We also included conditions in there to

protect the market. The swap dealer's futures positions must offset specific price risk. The dollar value of the futures positions can't exceed the dollar value of the underlying risk. And you can't carry a position into the delivery month when, as John pointed out, we're most concerned about squeezes and market congestion. So since 1991, we've been granting these hedge exemptions.

Well, recently, we started to get inquiries about an additional type of index trading, and again, this was on David's slide. That's where, rather than a pension fund, say you've got an individual that wants to add commodities exposure to his or her portfolio, a commodities component to balance the financial instruments and securities.

So the individual can go to -- well, actually it starts the other way around, an index trader creates a fund, and he offers it to the individuals who want to add this commodities component. And the fund has an agricultural component, and so that as the fund grows, and different individuals buy shares in the fund, then the fund has to increase its futures position to offset its exposure to the individuals. Well, at some point that fund is going to bump up against the spec limits too. The five percent of corn in that index that underlies the fund is going to hit the spec limit. But that's a slightly different situation than the hedge exemptions that we've been doing since 1991, because the index funds are offering exposure by agreeing to track an index, as opposed to the swaps position, which is directly linked to the index.

And these two situations were different enough that we didn't feel comfortable granting a hedge exemption for these types of index-related positions. Nevertheless, they're a perfectly legitimate investment strategy, and we wanted to allow it to go forward, so we wrote a couple of no-action letters in 2006, to allow this type of strategy to go forward.

The purpose of the proposed amendments that are now out for comment is essentially to create a structure so that everybody that wants to do this type of trading will know what the rules are, and I won't have to write 20 no-action letters, which is really the most important point of having a rule.

There are basically six conditions in here to protect the marketplace from speculative ill effects. The first is, we define a risk management position as a position that results from a fiduciary obligation to track an index or a portfolio diversification plan. A fiduciary obligation to track an index would basically involve the individual who buys a share of this index fund. The index fund has agreed with the individual that they're going to track the index -- that the investment will track the index that they gave the guy, and the disclosure statement says it'll be five percent wheat, five percent corn, 30 percent crude oil, et cetera. So they've got a fiduciary obligation to track that index, whether it goes up or down, so that's -- that's set out in the definition.

The other element of a risk management position is a portfolio diversification plan, which is to say the pension fund. That's the pension fund that always could have gone to the swap dealer to do the swap, and then the swap dealer takes his exposure to the futures market and gets a hedge exemption. Well now, under these rules, the pension fund doesn't have to go through the swap dealer.

It can go ahead and put on this commodities position directly to balance the commodities element of its portfolio. So those are the two different types of trading that would qualify as a risk management position.

The second element is, it has to be a "broadly diversified" index. That's defined as not having more than 15 percent of the index in any one agricultural commodity, and not more than the 50 percent of the entire index can be agricultural commodities. And there are a couple other little rules: Wheat is considered one commodity, so you can't have 15 percent of the index in Kansas City wheat, 15 percent in Minneapolis, and 15 percent in Chicago. Wheat counts as one commodity -- 15 percent for wheat, regardless of where it's traded. And the same rule applies to the soybean complex. You can't have 15 percent in soybeans, 15 in meal, and 15 in oil -- you've got 15 percent for the whole soybean complex.

The third condition is that the positions must be passively managed. They have to track the index with limited discretion as to trading -- as to your trading decisions -- so that the portfolio is managed with an eye toward taking advantage of short term market trends.

So, for example, you can rebalance the portfolio, because as the prices of commodities change, if you want wheat to be five percent, you might have to sell some wheat contracts or buy some wheat contracts to keep five percent of your portfolio in wheat. But you cannot say, "oh well, I think wheat is going to go up, so next month I'm going to put ten percent of the index in wheat and only five percent, or only three percent in corn, and after that, maybe the month after that, it'll be 14 percent corn and six percent wheat." You can't do that because then you're trading to take advantage of short term market trends, you're not hedging. That condition is the primary element of this rule that disqualifies so-called "hedge funds." Hedge funds are not going to qualify for this exemption because hedge funds are, in fact, not passively managed, they're actively managed. They're trying to take advantage of short term market trends and get a better return. So hedge funds are not going to be able to use this exemption.

The fourth requirement for the exemption is, positions must be unleveraged; they have to be fully offset by cash or profits on the positions. In other words, people holding these positions are not going to be getting margin calls that are going to force them out of the market because they're fully hedged, they're unleveraged.

Fifth, the positions may not be carried

into the spot month, when squeezes and manipulation and congestion are the most serious concern. And finally, positions must be established and liquidated in an orderly manner.

There's a couple of other conditions. The regs have a listing of the information that you have to give us in applying for an exemption, so everybody can see, here's the information we have to put in our letter to the CFTC.

And finally, entities that are holding positions under a risk management exemption have to report to us if they know or have reason to know that anybody holds more than 25 percent of the position. So if somebody has got 50 percent of the index, that can, in fact, turn out to be a pretty significant position, and we wanted to be alerted if somebody is attempting to use the exemption as a way of avoiding speculative position limits.

So those are the conditions. The last two slides are just the questions that are in the Federal Register notice, and I'm not going to run through all of those, but you've got them in your written materials. And the first three are -- well, maybe I will run through them just real quickly. The first three are the major ones: Are any of the conditions for getting an exemption unnecessary or should we impose even more conditions; is there anything else, in addition to those, that should be imposed as a prerequisite to get an exemption, and if so, what; and is there any type of index trading that should be covered that we left out. So anyway, that's what the proposed rules look like, and we're hoping to get a lot of comments, hopefully not the same number and type of comments that we got on the Commitments of Traders Report a couple years ago.

My favorite of that group was the guy who ended his comment by saying, "if you do decide to stop publishing the Commitments of Traders, FU, die, and go to hell."

SPEAKER: Pardon the interruption; Mr. Dunn has reentered the conference.

MR. HEITMAN: Thank you, Commissioner.

Apparently your mind wandered there for a moment, Commissioner, and they picked up on it electronically. Commissioner Dunn is now back with us in spirit, as well as body, and that concludes my remarks.

MR. DUNN: Thank you very much, Don. The last member of our panel, and certainly not the least, is David Lehman. I have been very, very fortunate to be on a number of panels with him the last couple of years, and also have been at meetings where he has given presentations; he is an excellent representative. He was with the Chicago Board of Trade, and is now with the CME Group. After the 2005 changes in the spec limits, the Chicago Board of Trade actually commissioned a paper to take a look at some of the impacts that's going on there, and also touched on one of the questions on the convergence that a lot of people brought to our attention last year. And so, David, if you will, please.

MR. LEHMAN: Well, thank you, Commissioner Dunn, and thank you to all the commissioners for your attendance today. Thanks for calling this meeting of the Ag Advisory Committee, and thanks to the members of the committee for their attendance, as well as the other guests.

I think there are some important issues that are on the agenda today and that will have an impact on the competitiveness of the markets, the agricultural market specifically.

We've heard a lot about speculative position limits and the increases that are currently being proposed. What this chart shows is the previous increases that were implemented in two stages in 2005; and June of '05 was an initial implementation, and then a second implementation in December of '05. When these were implemented, there were some pretty significant increases. As you can see, the all months combined limit in corn was increased from 9,000 contracts to 22,000, soybeans from 5,500 to 10,000, and wheat from 5,000 to 6,500. That's in the kind of center section there. And the old limit was the limit prior to the beginning of that two-phased increase. Phase one was the initial increase, and then phase two, the final limits in December of '05.

Following these increases, some market participants began to talk to us, and I think Mike's comment about one of the effects of the conversion of exchanges from kind of clubs and membership based organizations to for profit corporations, driving them to be more responsive to their customers, it's something that CBOT had implemented well before our conversion to being for profit.

We do stay in very close touch with our customers to the extent that we can and to the extent that we know who they are. But we did begin to hear of some changes in the pattern of convergence of futures and cash, contract expiration in corn, soybeans, but particularly in wheat futures. So we discussed this with the University of Illinois and a few of their professors, and I believe this full study that was conducted by U of I is in your packet. And we asked them to take a look at specifically did the increases in spec positions limits have an impact in how the market was performing in terms of three specific areas, liquidity in the futures contracts, volatility in those products, and then convergence, expiration convergence between cash and futures.

And so we asked them to look at these characteristics of the market before the increases in limits went into effect and following the increase. And just to caveat, there's a limit amount of data, or there was at that time, to look at following the increases.

As I said, the final increase went in in December of '05, and they began their study in July of '06, so they just had a few months at that point. But what U of I did is, look at volume and how that had changed, looked at the structure of open interest, they did an analysis of volatility, and then looked at convergence both in position at the delivery points and also out of position at some other locations, primarily the New Orleans Gulf, other points in Illinois, and they came back with some recommendations of additional research.

The look at liquidity found that market activity had increased significantly in 2006, and that much of this was likely due to increased activity by non-traditional market participants, by index funds, as David showed. The level of participation by that new profile of trader in the markets was growing very rapidly at that time, and also by other hedge funds and large speculators.

The increased position limits obviously helped accommodate this growth by non-traditional participants, although as -- I thought it was really interesting to see Dave's chart on the change in the commitments of traders categories once the index trader report was implemented, showing that about 85 percent of the index trader positions in wheat came from the commercial category.

So the change in spec limits really didn't drive that at all. These were traders that were -- many of whom were classified as commercialists who had come in and saw hedge exemptions from the commission and from the exchange.

The growth index fund participation may have caused the markets to be less price sensitive, and that's also something I think was illustrated well in one of Dave's charts, that these are passively managed positions, they're established by prospectives for these funds, the public documents that state how the funds will be invested in the markets prescribed, exactly how they will be moved from one expiration to another, and the fact that in early October of '06, it was an advantageous time for rolling forward positions, they couldn't do it. The index funds were required to wait and roll later, in early November.

So we think there obviously are some temporary changes in market structure. And what you'll see is more flexibility incorporated into these index fund perspectives that allow them to roll earlier, and I believe that's recognized in the exemption that was proposed by CFTC last week.

We also noticed, or U of I did, that the increased limits led to increased activity and deferred months, and I think that's something that all of our customers are happy to see and a reason why we've established the ratios between single month limits and all month limits, is to ensure that some of that position be established in deferred months and lead to greater activity in those months, greater liquidity.

In terms of volatility, the results of the study found that in corn, the range of daily returns, and they're just taking the percentage change in settlement prices each day, during the post change period was higher than in the period before the change in spec limits. In soybeans and wheat, they found no significant change in the range of those average daily returns, so really no change; in fact, there was a slight decline in the absolute numbers in wheat and soybeans, a little increase in corn. They looked at volatility in another way, just looking at the scanner deviation of the daily nearby futures by calendar month, so that they were able to take seasonality out of any changes.

Obviously, the agricultural markets do have different levels of volatility in different times of the growing season. So they compared like months, and it was a similar result. There was a small increase in volatility in corn, but slight decreases in wheat and soybeans.

So the overall conclusion of the professors was that there was little evidence that the increase in spec limits had a significant impact on price volatility. Convergence was the final area looked at, and probably one that we're hearing the most about, and perhaps a very important issue for some sectors of the market.

The study found that there were periods of wheat basis in corn in 2006, but again, didn't describe it as a failure of convergence. Soybeans, a similar notation of wheat basis, but not a failure of convergence. And I think one of the things that's really been difficult for the market to deal with has been the higher transportation costs that are effecting the agricultural markets. And, of course, this period of time that we're looking at was one of particular volatility in that component of the markets. The hurricanes in the late summer of 2005 obviously effected transportation on the Illinois River.

And you'll find in the study that's in your packets a chart of those barge freight rates for the Illinois River. It's actually converted into cents per bushel. And you can see normal cost to ship grain from Peoria, Illinois to the New Orleans Gulf, we're in the 20 to sometimes 50 cents per bushel range for corn and soybeans, historically going back -- I think they went back to 2001 with the data.

And we saw in the fall of 2005, right after the hurricanes, that went to $1.20 per bushel. We've had even higher rates since then. We've had -- barge freight is quoted in the market as a percentage of tariff, and earlier this year we were hearing of rates at 800 percent on the Northern Illinois River, and we heard of rates of 1,000 or 1,200 percent in other locations.

So the demand for freight, in addition to the kind of disruptions of the hurricanes, has played a significant factor. And the increased cost of freight via higher energy costs and fuel costs is effecting transportation throughout the system, even domestically, and also was cited in the study as one of the primary reasons for the weak basis that we're seeing. Wheat probably had a little more stark result than corn and beans in terms of convergence that they really identified a lack of convergence from July of '05 through September of '06.

Now, why -- what are the reasons? And as I mentioned, higher barge freight rates, higher futures values, and you know, some are kind of quick to point the finger at index funds or the speculative traders in the market, however, one of the things that U of I really found is, especially with regard to the wheat contract, is that the contract is a world price benchmark, and it's used to cross hedge wheat by producers and consumers around the world, in Europe, in the southern hemisphere, in Australia, in Argentina, and therefore, with the changes in supply demand factors that were going on in other parts of the world, the crop failures in Australia, export restrictions out of the Black Sea, or most recently we've had a closing of exports out of Argentina temporarily.

The CBOT wheat contract, because of its liquidity, is trying to incorporate all of those fundamental factors into its price structure, and at the same time, the delivery component is domestic, it's softer winter wheat, and the area attributary to Toledo, Ohio, and we've had good supplies of softer winter wheat while the world market was undergoing these very significant changes in economics.

The large carry in the futures markets, Dave's slide on the -- particular slide on wheat showing that during the role, the spread stayed pretty constant, around 21 cents, I think that was a dese march of 2006, and that's essentially full carry.

So when the carry in the agricultural futures contracts is really determined by a specified storage rate that's a term of the contract, it's fixed, and the cost of money or what someone is willing to consider as an opportunity cost of money in the market.

So that carry or storage rate in the contract had been 15 100's of a cent per bushel, that's been increased, will go into effect in July of next year, July of '08, to 16 and a half, and that should let those spreads widen a little further, that certainly benefits the domestic grain industry who are carrying grain and paying storage to do that. What it does is that it kind of adds an additional hurdle for the index funds who are long, the nearby rolling to the next deferred, they'll pay a little higher penalty to engage in that roll. But we think that will help with convergence issue. Limited expiration arbitrage is the last factor that U of I noticed in wheat. And we've also done something to address this. And the limited expiration arbitrage is probably do the fact that the market was in fully carry.

The warehousemen can earn the full cost of storage by simply rolling his short position forward, and therefore, there's less incentive for the delivery warehouses to make delivery. Those who take delivery can also earn the full cost of carrying those receipts or certificates to the next month by also hedging in the next month, so they have less incentive to redeliver those certificates -- markets to provide liquidity when commercial is needed for hedging.

Convergence analysis revealed different convergence patterns before and after the changes, but determine again that there were many factors that were at work, and that's always the difficulty in a study like this, is, you know, economists like to say all things equal, this change will produce this effect. Well, in reality, everything else isn't equal, and there are a lot of things changing at the same time. The researchers did recommend changes in the delivery process for wheat be investigated. And I mentioned, we have made a couple of those, changing the storage rate, also changing the delivery instrument from a warehouse receipt to a shipping certificate. That also goes into effect in July of '08. This gives the warehousemen more flexibility in how they manage their delivery capacity. They don't have to have the wheat in store in the elevator to make delivery, so this will effectively increase the delivery capacity.

And also, the researchers recommended that CFTC begin reporting trading activity -- activity of non- traditional funds. They found in their analysis of the data that they were having difficulty in really identifying from the commitment traders report to who is in the market, so that's been implemented, and we commend the CFTC on that. So again, thanks very much, everyone, I look forward to a discussion.

MR. DUNN: Thank you very much, David. After our break, we do have a follow-up panel of industry members that are going to zero in on a lot of these issues. But right now it's an opportunity for our Advisory Committee members to ask questions of this first panel or to make any comments they might have. So, members of the Advisory Committee, it's your time.

MR. GILLEN: Don Heitman --

MR. DUNN: Neal, please identify yourself.

MR. GILLEN: Neil Gillen, American Cotton Shippers Association. Don, in explaining the hedge exemptions, you put a limit on 50 percent for ag commodities; can you explain why, the composition of a fund.

MR. HEITMAN: Yeah, Neal; I should have made clear, the 50 percent does not apply to all agricultural commodities; it's 50 percent of commodities that are subject to the federal spec limits, which are corn, wheat, the soybean complex and cotton.

Well, I would not say that that was the subject of a big, gigantic scientific study to determine that number; it just seemed kind of intuitively about right to us, and we're hoping that we can get some comments from people that agree with it or question it or have a different number in mind.

But the basic purpose was to avoid somebody using an index, structuring an index, that would basically be a substitute for the commodity itself. So -- and the extreme example is -- what if somebody says, "all right, I've got a diversified index and it's 95 percent corn and one percent crude oil, one percent silver, et cetera." Obviously, that would really just be a substitute for the corn contract, and you wouldn't allow that. Maybe 50 percent isn't the right number, but that was what we were aiming at, just something that would keep out an index that's just a sham to replace an individual commodity that you'd otherwise have spec limits in.

MR. BAIR: Jim Bair, Miller's; I want to ask Dave Lehman a question, on the second to the last point there on the Illinois study. Can you give us some more insight as to what the researchers envision in terms of -- world contract delivery points, and also anymore detail on why or what the recommended delivery process for CBOT?

MR. KASS: I'll actually answer the second one first, because that one is easier. They did recommend an increase in the storage rate for the current contract. They recommended that we look at additional delivery locations for the current contract.

We did a pretty exhaustive review of locations that we thought could augment the current location in Toledo and St. Louis, and look along the Ohio River, looked at some other more, you know, domestic oriented locations, and just didn't find anything that we felt would add enough to help the convergence issue or to add delivery capacity while not being, you know, kind of an unacceptable cost in terms of what's the contract

pricing and that side of the equation. So what we did, we went to the shipping certificate delivery instrument, which we do feel will increase the effective capacity of the delivery system.

With regard to the world wheat contract, that's kind of the dilemma that I think U of I found and it's one that we've recognized for some time, that the Chicago Wheat contract is pricing world-wide supply and demand factors, but yet it has a domestic U.S. delivery component.

In fact, a domestic component, it's one of the smaller grades of wheat, the hard red winter wheat cash market is bigger, the hard spring cash market is bigger, both than the softer wheat cash market.

How to design a wheat contract is something that we've been thinking about for a number of years at the Board of Trade. We had a task force in the mid '90's of probably the most, you know, leading international grain trading company representatives, along with some very successful traders at the CBOT look at this, and we couldn't come up with a consensus on how to structure it. It probably would have to be an index, meaning it would need to be cash settled, and the availability of prices in some regions is not acceptable, or the lack of availability. If it was a physically delivered contract, you might think it could be, like the world -- contract, which specifies delivery in any one of -- I think around 30 or so origins around the world, but again, there was not a consensus that that would be a workable construct.

One idea that we think does have some merit is creating an alternative product that's an index of North American wheat markets. So a cash settled index that would use CBOT, Minneapolis, Kansas City wheat futures prices as the settlement mechanism for a cash settled index.

This may be something that some of the non- traditional users would prefer, because they wouldn't have to worry about delivery and rolling hedges, I guess it wouldn't qualify for a higher position limit, but that's something that we do have under review.

MR. BAIR: Because of biofuels and other reasons you probably know that we harvested fewer acres of wheat last year than we did in 1898, and I think that's a trend that's going to continue, so I would encourage you not to give up on this concept, because I think it's going to grow in accordance.

MR. KASS: Thanks.

MR. STEVENSON: Randy Stevenson with -- USA. I don't recall if it was John or Don that was talking about when the index funds are orderly moving their positions forward, and then you had mentioned that a year ago in October, they couldn't move forward, there was an opportunity, market opportunity, and they were locked in by the perspectives. If they alter that to give them more flexibility, do you perceive some problems with that, where they can be watching market fundamentals roll and cause good or bad problems, more challenges I guess would be a proper way for you?

MR. KASS: Well, the way we described it in the proposed rules is, we said the definition contemplates the position holder could exercise some discretion as to when to roll futures forward into the next month without violating the passively managed requirement, providing nothing was carried in its spot month.

The commission believes that limited discretion as to when a position must be rolled forward can mitigate the market impact that might otherwise result from large positions being rolled forward on a pre-determined date, and consequently help to avoid liquidity problems. So, you know, if everybody knows that all the funds have to roll forward on X day, then the market is going to be waiting for them and they're going to pay a penalty, so they can spread it out, but not to the point where you would roll over, you know, six weeks out.

And so there's a balance between being passively managed and trading with a view toward taking advantage of short term market trends, and if you're doing it six weeks ahead of the roll, then I think that would be the latter.

And it's not an easy -- it's not really quantifiable, you can't have a formula, or at least I can't figure one out as to when exactly -- how close to the roll date, how much legal room you should have in that, and we're hoping to get some help from that from the comments.

But the general idea is, as you approach the roll, you can't just have it on a single date, because then everybody that's in the fund is going to wind up getting penalized because everybody is waiting for them when they go to make the trade. So you've got to have some discretion, but not so much that, in fact, you're getting away from the idea of this being a passively managed long only index line.

MR. FENTON: Just looking at the facts of that particular situation that Dave showed, I think it -- we probably would not view trading in that situation as being consistent with passively managed, it was too far forward of the roll, and it was clearly -- it would clearly have been an end reaction to particular pricing activity, and so it would not have been -- trying to smooth out the -- to the market.

MR. MITCHELL: Larry Mitchell with the American Corn Growers. I want to make a few observations, a couple of basic questions, and some suggestions from our growers. Our growers raise a lot more crops than just corn, so they're involved in a lot of commodities. They're operative traders, they're not speculative traders.

We're aware of much more volatility in the market that's causing some pressure, whether it's ethanol or energy or a host of things, but a lot of it is a lot more speculative traders in the market, which frustrates farmers from time to time, you're probably well aware of that.

Some other observations, according to a couple of our board members, recently the basis for Chicago, pardon me, Kansas City Wheat was 50 cents in Kansas City, and the question was basically, you know, where are the delivery points in Kansas City, and does it cost 50 cents to deliver wheat into the point where it's already delivered. These are the sorts of things that are driving them crazy, because in an operative world, a hedge contract on that wheat, by the time you add the volatility of that basis, renders that hedge worthless for them to use.

We've got producers; in fact, one of the things we're working on right now is to make it easier to borrow at USDA for the on farm storage facility loans, so that farms can store more grain on the farm. And one of the biggest driving factors of that is this basis issue.

Now, that's going to help them market their grain, but it's a long ways home to have to build grain storage on your farm just to deal with that volatility. And the other side is the big traders on the -- within the community. I suspect they won't appreciate that lack of transparency in the market, when farmers start putting more and more grain out there on the farm just to deal with this.

The suggestions is to allow easier and more delivery from a physical delivery from actual producers, and to -- and you've mentioned this before, and we would ask you to review this some more, to find more delivery points for some of these actual commodities so that farmers that are not the speculative traders, but the operative traders, can actually use this as a part of their marketing strategy. Any comments from any of you would be welcome.

MR. KASS: Thanks for the comments and the recommendations. And we really do appreciate the feedback of all of our market participants and the members of this Ag Advisory Committee, whether they're market participants or not. I can't really speak for the Kansas City contract, that's not a CME Group product, that's a Kansas City Board of Trade wheat contract, in terms of the cost or the economics of delivery there.

I do know -- I believe anyway that Kansas City has made some changes to their contract, somewhat similar to the changes we've made in terms of increasing storage rates a little bit, I believe that should help address the wheat basis issue.

In terms of additional delivery points, we actually held an industry meeting yesterday, yesterday, day before, Tuesday in Chicago, to discuss the performance of the corn and soybean contract specifically, and this meeting was really based on recommendations made by the National Grain and Feed Association. One of their recommendations was to consider additional delivery points to serve the domestic market. We think that deserves additional study. We know that the current delivery mechanism is primarily export oriented on the Northern Illinois River. Chicago is a delivery point, and Chicago does serve the domestic market, as well as the export market. In terms of whether additional delivery points would -- it always seems to -- and I can understand, I grew up in Iowa, and I watched, you know, our prices, local cash prices relative to the Chicago futures price and saw that there was a pretty big difference in it, it seemed like, well, I can move my grain to that delivery point for less than that price difference, but when you really look at -- we've had some farm groups in Illinois look at doing this, and we do have a producer organization that's a delivery facility on the Illinois River, when they look at the volume of grain that is required in the contract to be moved and the time period that it has to be moved, it really isn't as economic as it might look on the surface.

In terms of adding points, east, west rail points, something like that, what we would have to weigh is, are there greater benefits to that than the cost of more complexity of what the contract is pricing, is it pricing the Illinois River, or is it pricing Nebraska, Lincoln, Nebraska.

And also, the theory of delivery is that delivery will occur at the cheapest deliver location, so -- where a taker of delivery might want to get delivery, usually he won't, he'll get it at a location -- at the location that he doesn't want it, because that's the least deer commodity for the seller to give up. So when you have a multiple delivery point system, it usually is -- it's more complex, and you have the cheapest delivery issue that also makes it less effective as a hedge for some users. But your suggestion is well taken, and it is one that the Grain and Feed Committee may to look at additional points and --

MR. MITCHELL: You've raised one more I would like you to consider, and that is for operative traders, for these actual producers of the physical commodity, if there were a way to deliver smaller contract quantities, so that they could actually deliver against their own. Just something to throw in the hat.

MR. KASS: We do have --

MR. MITCHELL: Right.

MR. KASS: -- meaning wheat contracts that are 1,000 bushels, and those are physical delivery contracts, as well. So you can deliver against a 1,000 bushel contract in all of those markets.

MR. DUNN: I gave this information earlier. You do have to push the button when you speak. That's the only time you can touch the microphones. Neal, I believe you have the floor.

MR. GILLEN: I just want to make an observation, with Larry Mitchell's comments noted. Commissioner Dunn, you'll recall back in the early '90's, we were discussing the xenophobia of the -- not only of the producer organizations, but the trade with a Chicago proposal to increase speculative limits.

I know for American Cotton Sugars Association commission to study by Roger Gray at the Blue Ridge Research Institute to determine the effect on volatility of the increases in spec limits.

And as a result of all our concerns, you will recall that battle we had in Commissioner Blair's office with the late great Blake O'Nell (?) and -- who was defending an increase in spec limits, and I had Joe Nikosea (?) with me, who was probably the best mind I think in the industry, and he and Blake going back and forth.

But the end result was, the increases were phased in as a compromise, it had no effect on volatility, and here we are, I think it's an example of how far we've matured in this industry and how far we've come, that we have very little concerns now about increases in speculative limits, and -- because it's a whole new ballgame, and that it used to be supply and demand dictated the fundamentals of markets, but now the funds, as Tom mentioned outside in our conversation, now the funds are part of the fundamentals. And so we have extremely liquid markets, and they're now world markets, and I think, you know, taking slight exception to Mr. Gordon's remarks before, yes, they have been exclusive clubs, and they have been monopolies, but they have served a purpose for farmers and for the trades and for processes in that they have provided, and I know he may disagree with this, but they have provided a price discovery mechanism. So I know I've come a long way in my beliefs, and I think you have, too, Mike.

MR. DUNN: Neal reminds me it was much easier when we served together on the Advisory Committee, everything seemed to be black and white then, it's gotten much grayer from this side. Are there other questions that we have; Doug?

MR. SOMBKE: Going back to what Larry and Neal were both talking about, David, I visited with a lot of elevator managers in the South Dakota/North Dakota Plains area who are concerned with the -- if the hedges are actually working for them, but they feel that they can't make a price if they don't know what they can already sell it for, everything is so close. Can you expand on that, why they would be so concerned?

MR. KASS: Well, I think one of the concerns is, from the short hedgers perspective, and that would be the grain elevator that you're referring to, is that this basis pattern has changed. They look at historical data, that's how most traders trade, they look at what's happened in the past and try to predict what will happen in the future.

And historically, basis would appreciate from a weak point at harvest, and you're well aware of this, I'm sure, to a stronger level as we go through the marketing year. So that -- there's been a change in that basis pattern that has impacted the effectiveness of the contracts for the short hedger.

I wish I had the slides that I used in our industry meeting yesterday, or Tuesday in Chicago, because it dispelled this a little bit. We have seen, with the exception of a few expirations in 2007 anyway, good convergence, good basis appreciation from going out six months prior to expiration to an expiration. Another thing that I'm a little puzzled about, too, with the short hedgers perspective is, obviously grain prices have risen significantly, they're almost twice the level of historical averages. And again, you know, comparing to history maybe doesn't serve us too well in this new environment. But with price of levels where they are, we're still seeing near full carry markets.

And Dave's slide on the roll between the dese march wheat contracts showing that that spread went out to 21 cents, that's about full carry. So that's really what the short hedger is earning from the market as he rolls his futures positions forward, they're earning the carry.

So that's been beneficial to the short hedger, while the basis appreciation, when they actually sell the cash grain, or the lack of basis appreciation, has worked against them. So I think that's -- those are two factors that are, you know, that are being observed in the market today that are a little different.

I mean we've always had carries at some percentage of full carry, but probably not quite as wide as we've seen recently. And it's a little contradictory based on the falling stocks of grain world-wide, and some of the supply shortages or disruptions we've had in the wheat market especially. You would think that that would lead to narrower carrying charges and even inverted markets at times. And I think, you know, seasonally, when you look at different points in the marketing, you do see some of these other patterns in the carrying charge, but in general, they've been pretty good.

MR. DUNN: What I intend to do is start the next panel at 11:30, so that'll push things back about 15 minutes or so. So those that are on the next panel that need to get a bio break, it's your opportunity to get out there quickly.

But let me ask just one fundamental question, and this is to Mike and Dave Lehman. What's the ramification of not increasing the spec limit? In the global market arena that we're in today, are we in jeopardy of losing those markets to other exchanges?

MR. KASS: Well, I'm going to go back to one of Mike's comments also that he made about the merger between CBOT and CME, in that this -- there was really very little overlap in the products.

There was one exception to that, by the way, you said zero, CME has an ethanol contract, it really doesn't trade.

But another point that Mike mentioned is that, you know, in the Justice Department review, it wasn't -- it was found that there are other competitive forces in the market other than CME competing with CBOT. And one of those that's very significant is the over-the-counter market. Our estimates are that one of every six trades occurs on a designated contract market. So the over-the-counter markets are six times larger than the exchange traded markets. And that, I think, Commissioner, is one of the effects of not increasing spec position limits, is that you would force more of this business to go into the over-the-counter market, where it's less transparent, and actually, that will lead nicely into our afternoon session, from my perspective.

MR. GORHAM: Actually, let me -- is that for everything or is that agricultural products, the one in six?

MR. KASS: That's for everything.

MR. GORHAM: What about AG only, do you know?

MR. KASS: You know, AG OTC markets are hard to quantify, really what the level of those is. International Settlements has some data on that, but it's commodities generally in a broad class, and I think it even includes crude oil.

We do know there is increasing activity in those OTC markets in agricultural, especially in the grains. As you will see from the slides this afternoon, though, that's expanding into dairy and beef in a number of markets, so I just don't know the sizes.

MR. GORHAM: Well, the only thing I guess I would say is that I -- I mean I think in general that limits ought to be increased whenever the markets grow, as long as you're not in any way increasing the risk of manipulation. And in terms of actually losing business, I mean the agricultural markets aren't that viable, I don't think, offshore, I mean if we just look at exchange traded stuff. So I don't -- I mean nobody else -- has anybody else had the size of a --

MR. KASS: Yeah, Tokyo Grain Exchange has a significant corn contract. Really, wheat, there's a contract in Paris, you know, there are contracts around the world, but none of them are very significant. A new trend into the market, though, is China, is -- exchange has a large soybean futures market and a large corn futures market.

MR. GORHAM: And Jimjo has wheat.

MR. KASS: Jimjo has wheat; those markets aren't easy to access by those who aren't domiciled in China, but that likely will change.

MR. GORHAM: Right; so my gut feeling is that, I don't think we're going to lose -- we would lose anything like immediately to China, because you really can't even -- I mean outsiders can't take positions in Chinese futures markets right now, at least not legally.

MR. KASS: Right; you have to have a

joint venture in China --

MR. GORHAM: Right.

MR. KASS: -- to trade on those markets.

MR. GORHAM: And the wheat market in India was just banned by the government because they -- it was a wonderful political movement since wheat prices and commodity prices generally were rising, and it was very convenient to be able to blame these commodity exchanges as the cause of that, and so that ban is still on, unfortunately.

MR. DUNN: Do the commissioners have any questions?

MR. CHILTON: Yeah, a quick one. Mr. Gorham, one, I think, and I'm sorry I wasn't able to work with you when you were here, we certainly would have gained a lot from your knowledge. My question is, you talked about these three big changes, the technology, the demutualization, and then the larger exchanges. Do you think that there's any relationship between the Commodity Futures Modernization Act and those three changes taking place?

MR. GORHAM: Only -- not the Florida screen, not the demutualization, but the -- I mean the fact that regulators generally are more open to foreign participation, and I think, you know, to foreign -- to cross border stuff. I mean I -- one of the things that I loved during my stay here was the fact that when Eurex came in and was driving the Board of Trade and the Merc nuts, the commission was just totally country blind, as they should have been under the act.

And they, in fact, Eurex had submitted a really good application; the Chicago guys, actually, every single letter in the application was questioned. But I was really proud of the commission, in the way that they sort of did that. And I think that this general trend towards sort of an opening up, which includes the U.S., is making it more possible for these mergers -- for cross border mergers to take place.

MR. CHILTON: You see those sorts of big changes; would you extrapolate that to the rest of the world also, or is it specific to the U.S.?

MR. GORHAM: No, I think it's -- I mean I'm really not an expert on regulation and all the other countries. But my sense is that, with FSA and with some of the other countries, as well, there has been a liberalization and an openness to --

MR. CHILTON: But do you see those same three changes; do you see the technology --

MR. GORHAM: Oh, those three changes are happening everywhere, absolutely, those three changes, and there are some other changes, as well, but those three, you know, in fact, the Florida screen is almost done, I mean it's -- I don't know how much longer -- the only things that's holding that back is options, because people still seem to feel that they can negotiate options trades in a more useful fashion on floors rather than on screens, that well may change.

And the -- and for many years, people said the AG's will never move to screens, and the Board of Trade is what percent now?

MR. KASS: In the 70's for futures.

MR. GORHAM: Right.

MR. KASS: Actually, some futures are approaching percent.

MR. GORHAM: And for some reason, the Merc is behind that, I think, isn't it?

MR. KASS: Yeah; the livestock contracts are --

MR. GORHAM: Right.

MR. KASS: -- haven't moved as quickly.

MR. GORHAM: And I always puzzle over why that was the case. I understand the options lagging, and I think the issue there is really the AG markets have older guys in them, I mean on the floors and, yeah, so -- as well as the participants, so they --

MR. KASS: Right, Dan?

MR. DUNN: Getting kind of close here. Actually, Dave Kass has some excellent slides on this, I don't know if he's updated them recently on the move of electronic trading that's taken place, and we'll try to get him to get those up on our website when he gets a chance to update them so you can take a look at that. With that, let's give a big round of applause for this first panel. And we'll meet back here in about five or ten minutes with the industry group.

(Recess)

MR. DUNN: Members of the panel please join us up here so we can get started. Our industry panel today is Tom Erikson. Okay, Tom's got his card there. We have Tom Coyle from the National Grain and Feed Association, and Dan Brophy from the Commodity Markets Council, and if we could get them to come up and be ready for their presentation. Who are we missing? We're missing Dan, okay. Our Acting Chairman has been called to do some testimony next week, and so he's doing a little work on that right now, so he will be joining us later. So with that then, I'd like to begin by recognizing a farmer member of the nation, the honorable Tom Erikson.

Tom is somebody that I go back quite a ways with, back when we both worked on the Hill. And, Tom, thank you very much for being here today, and we'd like to hear your comments.

MR. ERIKSON: Thank you, Commissioner Dunn, and thank you for putting today's session together, it's certainly timely. I'd also like to thank the rest of the commissioner, Acting Chairman Lukken, and Bart Chilton, and Ms. Sommers for also attending today's meetings, I think it's a great show of support for this part of the community and the trading sector of agriculture.

I wanted to just take a few minutes and talk about three items that Commissioner Dunn had asked that we try and tee up and talk a little bit about this morning. The first is index fund participation in AG commodity markets, and also do a preliminary look probably at the current proposal that's on the table with respect to exempting index funds. The second is spec position limits and international competitiveness, and whether ethanol should be treated as AG or an energy commodity. I'll tee that up now. I know that'll be discussed a little later.

Since the commission has published rules on two of these matters, where appropriate, I'll try and incorporate what I would characterize as preliminary and very early thoughts and observations with respect to those.

Turning to index funds and their impact on the AG markets, the phenomenal growth that we've seen in the open interest in AG commodities in recent years really does reflect a lot of investor interest in commodity markets.

The advent and maturation of commodity index funds has given retail exposure. It's easier to get retail exposure really to those price movements, and also it's become simpler and really -- because arguably less volatile because the funds are comprised to a basket of physical commodities that go beyond agriculture, and I guess I'm talking about these broad based indexes as opposed to some of the narrowly based indexes that we're seeing emerge today.

Index fund investment has created price risk exposure to AG commodities for a class of market participants that is not so much driven by cash market fundamentals as they are by the rules of the index itself. As index funds have grown, they've become a much larger force in our futures markets. For example, as Dave mentioned earlier, for time last year, open interest in the Chicago Board of Trades futures contract soared from its historical average of two times wheat production to ten times the U.S. production of wheat.

The consequences of this growth, both positive and negative, are really just now being made more visible, I think, in the market and within the regulatory community. Most noteworthy concern from a negative consequences perspective is the deal among many traditional market participants, that the index fund positions do not really add liquidity to the market, because they generally are not price responsive. And this is something that was mentioned a little bit in our earlier discussion.

And there is some view that these index fund positions really create a losery liquidity, and that traditional market participants on the commercial market side and even some of the smaller speculators really trade around that block of just -- in the market throughout the contract -- the trade agreement contract without being responsive to underlying cash market conditions. Last year, the CFTC responded to these changing market developments by creating a category of index funds as a supplement to the commitment of traders report. This additional transparency into the agricultural markets has proved to be useful.

Last week's proposal by the commission to exempt index funds and others from spec limits appears to be a further response to what the commission I think is observing in this market. I'd make just a few observations I guess and preliminary thoughts. Thank you.

First, the proposed exemption appears at first blush to be an appropriate next step as it is applied to index funds. It would encourage index funds to offset financial risk exposures in a regulated market environment and provide some information about the size of that investment community.

The proposed exemption seems to provide a way for the CFTC to better identify index fund participants in the market. However, it doesn't appear that it was -- it will necessarily simplify the commission's job in really identifying and reporting for purposes of the commitment of traders report that segment of the market, as you would still only be capturing those index funds that self-report and make themselves available for the exemption, so the smaller class of index fund participants would still not be maybe readily apparent and require the commission staff to continue to do its due diligence to ferret those out. And to that end, the question comes, has the commission given any thought perhaps to expanding on this to provide just a class of registration and its forms, where those kinds of funds could be self- identified and it wouldn't be as much a ferreting work for the commission staff or really dividing the purpose of participation?

The proposal is also limited to broad based commodity funds that have no more than 50 percent of their assets devoted to agricultural contracts. The conversation earlier I thought was interesting on that point.

I think our initial thought is that we would find that the commission's rationale has some -- is sound and has some merit in that it would limit the opportunities of narrowly based fund that would be based as the commission's rule points out on maybe just the soy complex or a bread -- maybe a bread index or whatever it might be, a food index, as being a surrogate to get a way around the spec limits.

Another point would be the proposal would for the first time obligate those trading pursuant to the exemption to the same obligation that commercial market participants currently have, and that is to establish and liquidate positions in an orderly manner. That, I think, is probably, while it's deep in the weeds of the proposal, I think it's probably one of the more significant things that the commission can do, and that I think will have some real value from a regulatory perspective.

Finally, well, maybe not finally, but close, the proposal would also go beyond extending the exemption to index funds and apply -- allow the exemption to go to pension plans and other institutional funds directly.

This is one where I think, at least for us, we would have some real serious reservations about. While it's true that the dollars, as Don talked about earlier, the dollars at the pension plan, if put into an index fund or if entered -- if the exposure to corn, for example, was an over-the-counter exposure with a swap dealer, while those dollars would get that treatment of this exemption, we don't think that the logic really ought to extend to those dollars being directly invested, and the reason really is because those fund dollars, those really are speculative position interests, and to allow that size of a position to go into the market as a commercial, without any risk exposure to corn, whether it's cash or a derivative exposure to price, would really eliminate or do serious damage to kind of the traditional distinctions between hedgers and speculators. We wonder really if there might be some analysis that might be available that would support who would be left really in that speculative community. It may just be those few individuals that choose to speculate. And I'm not sure what that would even do with the commitment of trader report and as far as where the concentration of participants would be.

Finally, I'll just raise a couple of points that the group might want to discuss more broadly later. I think we can all presume that further easing of fund participation through this exemption, you know, would attract increased investments in our agricultural commodity markets, which is not a bad thing.

You know, even today, it's not unusual to see index funds as a category comprising, you know, upwards of close to 60 percent of the open interest in any contract month. Presuming we continue to see growth in passive investments and agricultural contracts, a couple of questions might be worth considering; one is, can we expect to see the further erosion of the relationship between futures values and cash market values; and two, what impacts are likely from even more significant rolls during fund liquidations in advance of the spot month. I'll turn now just briefly to a few comments with respect to the speculative positions limits. We're continuing to consider carefully the proposal that's out there and so these are very preliminary comments and just I think observations.

I think it's fair to say that as an industry, as a company, we're all supportive of maintaining -- you know, allowing a greater participation within the speculative community.

So I don't think that, you know, there's any -- reaction on our part that would, you know, strongly oppose at this point consideration of higher limits in agricultural markets. I suspect, however, some of the questions that may be raised will be mostly directly at wheat.

And again, I think Dave, you know, hinted at some of the issues that we face in the wheat complex. A proposed single month limit of 11,100 contracts is the equivalent of holding 55.5 million bushels of wheat. That single speculative position would be equal to holding nearly 16 percent of the U.S. soft red wheat production of about 360 million bushels, and 12 percent of the U.S. hard red spring wheat production of 450 million bushels, and nearly six percent of the U.S. hard red winter wheat production of one billion bushels. Those are significant numbers, no matter how you look at it. But I know that we all are working closely to try and find ways to accommodate the speculative needs of speculative community, and so I think we will be able to work through these. But I think the numbers on wheat in particular are fairly striking.

Ethanol, agricultural, energy, you know, what appears I think for a lot of folks to be a decision of small consequences really I think fundamental to the commission and what you're charged with doing.

I suspect personally the most logical way of considering the question is to look at the underlying purpose of the product traded. And under that analysis, it would appear that the most logical place for ethanol to trade would be as an energy commodity.

You're not alone in looking at this. And, in fact, the World Trade Organization, WTO, has come out on both sides of the issue so far. You may be aware that, for purposes of trade rules, ethanol is traded as an agricultural product, but biodiesel is traded as an industrial product. And so I'm not sure if that gives you any comfort at all, but you're not alone. And that would conclude my remarks. Thank you.

MR. DUNN: Thank you, Tom. We'll try to find a third side of that issue. Our next panelist is Tom Coyle with the National Grain and Feed Association. Tom, since my tenure on the commission has just been an excellent source of information, and has been a regular contributor to our Agricultural Advisory Committee.

And back in the fall of 2005, Tom, along with our staff in Chicago, put together a trip for Chairman Lukken and me to go down the Illinois River and look at some of the situations that they had in storage and delivery points. That was very, very memorable, Tom, and I want to thank you for that.

MR. COYLE: Well, thank you for the wonderful introduction, and thanks for putting together a great agenda.

The National Grain and Feed really very much appreciates the opportunity to participate in today's Advisory Committee.

I'll make a few comments this morning to provide the -- insight into the specific topics on the agenda. But first I want to thank the commission for the efforts regarding the -- treasury report. At the time of the last Advisory Committee meeting, we discussed the issue of basis changes, the wheat basis, and wheat particularly, and the impact that this new investment funds were having on convergence. We expressed our view at the time that the primary cause was this growth and these new market participants that had different goals and different -- to make a decision. So the change to the -- treasury report is something that we very much welcome, so it's something we wanted for a while, so thank you.

The new category adds clarity and transparency to fund activity in agricultural -- market and allows the traditional hedgers, most of our members, the opportunity to assess who is participating in the market.

There is still some concern I would say about the definition of index, the category, and which transactions go into it, OTC transactions by funds that are managed through sways, do they show up as commercial or do they show up -- in which case they wouldn't show up in the -- as an index fund.

So that would seem to run contrary to

the spirit of the index category.

The historical data that's presented by the CME Group and by Dave Kass, who's got all the data, would suggest that there's been a small growth in index participation total contracts and share of open interest. That would seem counter intuitive, because there seems to be more money entering that sector. So it may very well be that it's actually entering the market through swaps, so it shows up as commercial. So we think that the report is really critical, our trade is using it, and therefore, I want to make sure that the definition is accurate.

Regarding the proposed spec limit increases, the National Grain and Feed has -- we've not had a chance to meet as a risk management committee to discuss the meeting, we'll be meeting on January 10th. And, in fact, we have asked for an extension in the comment period so we can have a face-to- face meeting to discuss this issue.

What I can tell you is that the

Association has traditionally supported the Board of Trade, has supported the increase in spec limits. Generally we've taken the view that the exchanges, with appropriate CFTC oversight, are best positioned to manage their businesses, to enhance market efficiency, and to promote market transparency.

However, in the situation in the market place today, things have changed a bit. The lack of convergence and certain contracts over the past two to three years has led to some concerns by NGFA members about the continued utility of exchange traded contracts for traditional hedgers.

And there's a view at least by a percentage of our members that increased spec limits have contributed to the growth and open interest by non-traditional participants, more volatility, wider than expected basis levels, and lack of convergence.

Some of our members will likely view that further speculative increases will exacerbate those problems. So we'll have our meeting in

January and we'll provide that feedback. But again, generally we've supported it.

If I recall, at the time of analysis of the most recent increase in spec limits, we provided feedback that said we support the increase in the spec limits, but we really requested two changes, one, that there was more transparency, to change the -- treasury report achieve that, and second of all, that there was diligence to assure that the convergence or the expiration process was honored, in fact, that if we had people with -- carrying over 600 contracts into the delivery month, that that really would change the foundation of our cash contracts, we would see that as a major problem.

The Board of Trade has been diligent on that matter, so it does not appear to have been a problem. But it is still -- I expect that will still be -- a response we'll come back with later. As far as the hedge exemption proposal, the logic behind the proposal to issue risk management exemptions to index and pension funds seems sound.

We believe the commission is asking the right questions. This issue has not, again, been discussed by our committee, we'll do that in time for comment, by January 28th.

We see the logic behind the concept, the conceptual notion that allowing index or dealers or pension funds that are managing a basket of risk to assess the AG markets directly, rather than going OTC. We view that that would bring increased transparency to the market place.

It could lead to more accurate reporting of index and pension fund activity, would allow spec funds more flexibility to take the other side of these funds long only positions, and bring more balance to the market.

However, much like the expansion of speculative limits, we expect that there will be some reluctance by our members for the same reasons that I gave regarding the limit.

This will bring more participation by non-traditional hedgers into the market.

On a side note of caution, one of the

conditions that a fund would be required to meet to receive a risk management exemption would be that the fund is passably managed, and that's good. However, I would draw the distinction between passively managed and not traded. Direct fund participation would be positive in one light, it would be observable and predictable. For example, all participants would know when funds roll their positions forward.

However, what happens if trading on a particular contract becomes liquid? Say 40 percent of the contract's volume is not for sale for a two year period. We talk about the open interest of wheat. Tom made the comment, Dave Kass showed the information earlier. But it shows that roughly 19 percent of the open interest in wheat is in an index fund.

If you look at the long only side using those same numbers, it's actually 47 percent of the open interest. If we go back to the situation that occurred last October, on the one hand, we don't want -- we wouldn't want to see the speculation in these huge volumes, but we had a significant portion of the market that couldn't be economic during last October.

So while they were passive, the market went to significant inverses for no economic reason other than there was a demand for futures contracts. So we would prefer funds participate -- participation not be speculative, but that it would be economic -- I think that's a real challenge. But it seems to me that if Goldman Sachs, that had all these contracts that couldn't be rolled until November, if they were able to roll those in October, we would have had a really better balance of the market. We're not expecting a pension fund or an index fund to be uneconomic just because their perspective says that they can roll.

So the comments earlier that were made that there will be some discretion and that they've got some latitude, that's hard when it's gray. But it seems that -- we want that -- once we know they're in the market, we'd like to know that they're acting in an economic manner.

Finally, I'll make comments later about the agriculture ethanol in the afternoon session. But I would like to share the highlights of a task force that the National Grain and Feed established to consider overall market performance.

As we heard earlier from a gentleman from the corn growers, the Executive Committee of the National Grain and Feed, at the request of the Risk Management Committee and the Country -- Committee established a task force to respond to these wide basis levels and the apparent disconnect between the cash market and the futures market. This commission noticed this issue in wheat 18 months ago. But we were beginning to see similar versions of that in soybeans.

The task force was established to consider market performance and develop recommendations for the CME Group that could enhance convergence and also to identify educational materials we should develop for our members to respond to these changing market dynamics.

We set up a task force that was really a broad task force. We had the option of setting one up of country -- it was really our country elevators that are serving farmers that were really concerned about their basis exposure. Wide basis levels, hard time now getting money, so you have higher futures markets, so it's hard to get your margin money covered by your bank, and now you've got a basis exposure that was unexpected. It's unexpected because the landscape is changing.

It was a significant enough issue that the Executive Committee set up this task force. We could have set up a task force when eight people from the country elevator committee, we would have come up with one conclusion, right. But instead, we set up a broad based task force. It had representatives from the professional trading community, it had a fund participant, wheat miller, soybean processor, corn miller, exporter, delivery -- farm manager.

We really had a broad base group, senior executives or senior traders on this task force, all hoping that over a couple months of study, we'd come up with some silver bullet that would really identify ways to enhance convergence.

I'd say that in that regard, we were disappointed. We found no silver bullet. Eighteen months or 16 months ago when we sat down there, I made the comment that the reason for the basis in wheat was because we had this dramatic increase in open interest in the wheat contract, which drove prices higher, and it was really not driven by demand. We had big supplies, we had high prices, and the basis had to offset that.

We can't really say that's the situation today. Certainly, these long only funds have increased price levels.

But we're also seeing, as Dave Lehman mentioned earlier, that transportation costs have really sky rocketed. Not only have they gone up dramatically, but they've also gone -- the volatility has gone up rather dramatically, as well. And then you have the change in energy, where you've got this dramatic growth in ethanol production in this country. Alone, each of those three factors, the investments in agriculture, investment capital chasing agriculture, ethanol or transportation alone be considered changes in our industry. They're all happening at the same time.

So the fact is, we have more exposure, there is more volatility. Over time, the markets will get in balance.

We'd like to find something that would make it happen right now, but that's not possible with those kind of changes.

I heard mention earlier about storage; storage will be built. It may be expensive, but the fact is, with more ethanol consumption, more -- we need the storage, right.

People act economically, so we build storage, basis exposure will go down, because farmers will hold grain off the market, elevator operators are building storage, as well.

When barge freight is at, for years, at 150 or 200 percent -- were struggling to break even. Now it's at 800.

Of course, building a barge is $550,000, not $330,000. But over time, people start building barges, because if you can get 300 percent or 400 percent south on barges, and then let's say that that's $30 a ton, and you also get $30 a ton going northbound, you start doing what's economic, you make enough money with the equipment, you build transportation, as you do that, you start to slim out the volatility and the cost of transportation.

Investment funds, they participate, as well. They start to find creative ways, what they call their alpha, so that they can better manage their exposure, as well. We weren't able to find something right now that would change the contracts to make convergence happen overnight.

A certain number of our members would certainly be disappointed in that. But I would say, looking at the quality of the people on the task force, I had no problem with the fact that, if the people in this room couldn't come up with some silver bullet, it wasn't there.

That said, we did make a couple of key recommendations to the Board of Trade, and then we identified a few points that we thought that they should consider further. The two recommendations that we made, one was that they increase the storage rates from roughly four and a half cents a month to five cents a month. That would make it consistent, corn and beans consistent with wheat. No reason why the two would be different. It allows more of the basis -- maybe to be in a futures market, where it's more transparent.

The second recommendation was to increase the load out charges from four cents a bushel to six cents. They were six cents a bushel in 1999. The wheat contract has always been six cents a bushel; make corn, beans, and wheat the same.

What these two changes do is increase the utility of the existing delivery system. We think that was logical.

It's not going to solve the convergence

problem, but it's certainly in the right direction.

We made -- we gave the Board of Trade three other ideas; one was to consider adding some sites that would be rail -- would have rail access to better serve the domestic market. As Dave said earlier, there are pros and cons of that.

Ideally in the future market, in the delivery market you would like to have one site, one site where it's easy to identify. You've got domestic, you've got export, all modes of transportation would be ideal. We don't have that today. But if you -- every time you expand the delivery locations, you also -- you increase the complexity, and you get in a situation where what you really want, you don't get.

It's like illusory access to grain. But we did suggest that that's something that can be considered.

Another novel concept that was thrown out fairly aggressively by one of our members was to change the contract. Today the owner of the certificates -- loadout, to add the feature that allows the delivery owner to compel loadout.

We had a tremendous amount of discussion, and in the end, we couldn't agree to that. It appeared that any benefit from such a thing would have a significantly more negative impact the other way.

If you compelled the long to loadout when transportation costs just happened to raise from 400 percent to 500 percent, or 800 percent, why would a long be long future? So you've really destroyed -- you've given a delivery owner way too much -- you didn't balance the market because they would have way too much an advantage.

So it wasn't something -- committee, but the fund participant had suggested that the sugar contract had a feature similar to that. He also identified that there was significantly more volatility in that kind of -- that we would see in our grain contract, but since none of us on the committee really understood sugar, we made the recommendation to the Board of Trade that, you know, they could look at that, maybe there's a feature we're not aware of.

And the other recommendation we made for further study was some kind of an index feature, a new contract in addition to the current physical delivery contract, but some index contract or an index feature that would compliment the existing contract and maybe reduce some of the basis exposure or be another conduit for funds.

We didn't -- there's been lots of talk about that, but no one really could give an idea, what would they really want to do, so we just passed the ball back to the Board of Trade and said you study it.

But in any case, our compliments to the Chicago -- the CME Group. They had a meeting this week that David mentioned, they discussed these issues, seemed to be fairly good support from the group of participants on the key recommendations, some reservations on some of the ideas for further study, but our comments to the Board of Trade, or the CME Group, excuse me, for actually quickly responding to that, to get insight. So that's it, I'll make other comments later.

MR. DUNN: Tom, this is probably going through everybody's mind here, but is that proprietary information that you've got or is it something that you might be able to share your report with the rest of the AG Advisory Committee?

MR. COYLE: We'll be happy to share our -- the study. We did it, we surveyed the group, some of the information we got back, some of the thoughts, and I'll be making a presentation at the country elevator council meeting next week in Chicago, as well.

MR. DUNN: If you could make that available to us, then we'll get it out to all the AG Advisory members, because I think that you guys are right on target, as usual.

And speaking of being on target, our next panel member, Dan Brophy, is somebody that's been in this business a lot longer than it looks when you look at him. He has got a tremendous background. Brophy Commodities is one that I'm sure that everybody is very, very familiar with, a member of risk committees on exchanges, and has been on various exchanges. He brings great credentials to this. And Dan presented to us a great overpiece that we got in time to send out with our package. Even though it may be a preliminary piece on the actual comments that the Commodity Market Council will have, it certainly is a lot of food for thought right off the bat.

So, Dan, if you will, please go forward with that presentation.

MR. BROPHY: Thank you very much. Thank you for arranging this. I know everyone else has thanked you before, but this is a very good exercise for the industry. We all have different constituencies we represent, and sometimes the constituencies butt heads a bit, and this is really a great forum for everybody to express frank views about difficult issues.

And I'd also say that, as I said to you privately, that the staff of the CFTC is just terrific to work with. I try to avoid any exposure to dealing with CFTC and forms other than this, and thus far I've been able to, but they're really, as you said in your opening remarks, you have a very good staff, they know the industry, and they know the participants.

My comments today are pretty specific, they're seven pages long. For any of you who haven't read them, I'd recommend them if you're tired of taking sleeping pills. I'm not a lawyer. So what I'm going to do is just summarize them quickly. They're very specific, and they represent the views of the CMC's futures committee. With respect to index funds and commodities markets, we now know that index hedging, in effect, transforms a futures contract into an investment security. I think that's something that we all figured out sometime in '06.

Given that, the CFTC's release of the supplemental report beginning last January was very valuable. In that short period of time since its release, it's become one of the industry's most essential tools for analyzing markets.

The CMC recommends that the CFTC incorporate the COT supplemental report into a newly formatted COT report, discontinuing the supplemental and making the supplemental data part of the standard COT report data series as soon as possible.

With regard to the new release on risk management positions, the CMC recommends an explicit recognition that these risk management positions are, in fact, a new variant of bona fide hedge, and in accord with that view, we recommend that the commission include within the definition of bona fide hedging a new and separate category of financial hedgers, which would encompass the group of participants pretty generally described in the proposed regulations. For purposes of reporting these positions to the market place, we think that a financial hedger's category should replace the index fund category and COT reports.

We also understand that index fund positions also reside in the commercial category, as Dave pointed out, and as Tom mentioned, as well. This, to us, is a limitation in the current reporting mechanism, and we recommend that, in addition to modifying the hedge definition to include financial hedging, the CFTC should include index fund hedges that now reside within a commercial category in a new financial hedger category.

We also recommend that the CFTC initiate a study of the recent trend toward alpha or enhanced return trading by index funds. This is mentioned in different terminology in your release.

We recognize that this activity is completely legitimate, but it is price responsive, it is not passively managed, and it is, in our opinion, speculative in nature, and it should be reported in that way.

Further on COT reporting, we suggest to the commission that you revise your threshold measurement for reporting index trader activity. To us, the relevant reporting objective is to identify the magnitude of hedger open -- financial hedger open positions relative to total open interest. Therefore, the relevant reporting threshold should be based on the percentage of open interest held by financial hedgers regardless of the number of firms.

The number of firms can be useful, but the more important thing for a hedger in particular in these markets is short hedger assessing his risk is to realize the magnitude of the long side of the open interest that is not for sale and has, in effect, been securitized.

So this is not a solution, Tom Coyle mentioned, there's no silver bullet. We could discuss that, but it's certainly not a solution to the convergence problem, but what it is, again, along the lines of the -- our initial request that a commitment of traders report include data on index hedging, this is something that gives the short hedger with this problem some sense of what he's dealing with, the risk he's got.

With respect to confidentiality and reporting thresholds for AG index fund participants, we argued in August of 2006 that there was no risk that reporting requirements on financial hedgers would or could infringe on proprietary information or their competitive position. Since that meeting, market developments have reinforced our position; anonymous electronic trading, as has been noted here today, has taken over the preponderance of daily volume in every major AG futures contract in just over a year, and it continues to gain share each month. So I think within a couple of years, the futures side of the AG contracts at CBOT/CME will -- it'll almost -- I wouldn't be surprised to see 95 percent a year from now in all the contracts.

We have one more recommendation. Considering that there's constant innovation in the index investing area, particularly the invention of new index products, we recommend that the CFTC begin reporting financial hedger open positions in the CBOT soybean meal contract in Minneapolis Grain Exchange spring wheat contracts using some sort of a reasonable open interest percentage threshold, again, not a threshold based on the number of firms involved.

With respect to the speculative limits and what we regard as a related issue, international competitiveness of U.S. futures markets, there seems to be supports in increase in non-spot individual and all month combined spec position limits as proposed by the commission. Every step, including this proposal, which encourages broader participation in our markets, attracts more volume, more liquidity. Volume begets liquidity, liquidity begets further volume. Each of these factors builds beneficially on itself, tending to reduce bid spreads and build depth of order book in every market, and that's exactly what all of us as users should want.

So the CMC supports any effort, including this proposal which attracts more participants and more order flow to our futures markets. Consistent with long standing CMC policy, we're asking the commission again to grant each exchange authority to set its own speculative limits subject to commission guidelines and oversight.

Elimination of this regulatory redundancy would fully implement the core principals of the CFMA for all AG commodities, and most importantly, the CFTC would still retain all of its oversight powers.

We think that giving the exchanges this flexibility poses no risk of irresponsible decisions on their part that would harm the trading public. And we think in no way does it diminish or negate the COTC's authority, yet granting this freedom to exchanges gives them one additional perhaps small, perhaps large step, but one additional step that they can take as they deem appropriate to attract new order flower enhancer to defend their competitive position domestically, or most importantly, internationally. We're fully aware that we're tilting at windmills, that in the past these commission policy has been the opposite of our recommendation.

But we have great confidence in the very well tested system that intertwines CFTC oversight powers, a strong staff, as I mentioned, exchange self-regulation, and the incentives, as has been brought up in this forum, for exchanges to act quickly and responsively on behalf of their customers and market integrity.

The consequences to a public company, just using CME as an example, with probably a $35 billion market cap, the consequences to a public company are just absolutely devastating if they have a head butting situation in public with the CFTC. They're very strong incentives for the exchanges to do things responsibly.

The CMC understands that some agricultural producer organizations in particular, and there may be other organizations, as well, still believe that activities of large speculators in futures markets pose a threat to their members. From our perspective, this is simply not the case.

The speculative activity in futures markets can drive -- can influence day to day prices, but it -- I'm not an economist, but I think any of us involved in the markets every day, as I am, most of us in this room are, we would recognize that this speculative activity, which by the way, is price responsive, is powerless in the face of larger fundamental forces related to the factors we have mentioned.

Our markets today reflect global economics and trends, not speculative buying power. The prices begin to retreat tomorrow on the AG side, speculative activity will follow that retreat, not cause it. And I'd be glad to fill in with some additional comments that I have based, in part, on what Mike said earlier on that subject.

With respect to international competitiveness and price discovery, our general experience on CMC is that users on a world-wide basis trade a contract for a myriad number of reasons ranging from hedging or other commercial utility, its relevance as a proxy for financial or commodity instrument, its liquidity in the depth of its order book, reducing cost of entry and cost of exit, its volatility, its speculative appeal, the level of exchange fees, the level of governed taxes and so forth.

The domicile of the contract may or may not be a factor, whereas liquidity is a major factor, and there's a good example of that in the lack of used of the Matif and Life wheat contracts, where those are a far superior hedge for European internal wheat trading, but that order flow tends to come, as far as I know, and I think you gentlemen on the staff of the COTC could probably find out, most of that order flow does come to the U.S.

In summary, we believe that the best way for an exchange to draw a maximum order flow from all sources, domestic and international, is to have systems and policies in place that encourage low cost, high efficiency futures markets.

In all cases, the most efficient and lowest cost markets are those with the maximum order flow and liquidity which minimizes bid spreads, lowers users costs incurred entering or exiting the market.

We support exchange policies and COTC policies that provide the most attractive trading and execution environment, and as a general policy matter, exchange controlled flexible position limits would be one small, perhaps, as I said, perhaps large step in continuing -- a continuing process to provide the most attractive business climate for U.S. futures exchanges. With regard to ethanol, is it an agricultural and energy commodity, and the related issue of egg (?) swaps. The CMC believes that ethanol is an energy commodity. We recommend that the commission take this view in its consideration of the issue. On a broader basis, we recommend that, where it's possible within the existing regulatory structure, the CFTC harmonize regulations for egg swaps with those for swaps on non-egg commodities.

There are very complex legal and regulatory issues. We leave those to be argued by the staff of the COTC and the capable staffs of the exchanges, who have true expertise. We do not have that expertise on our committee.

However, what we decided to do was go to the broader issue, and the broader issue here is that there's an obvious commercial reality in play. Participants in the cash ethanol trade want their transactions cleared and guaranteed by the central counter party, in this case, CME Clearinghouse, it could be Ice or anybody else in another case.

CMC believes that regulations should promote, not obstruct, legitimate commercial activity. I would say 13,000 contract open interest in the ethanol swaps, what does that represent, Dave, 400 million gallons, or is my math --

MR. KASS: (off mike)

MR. BROPHY: So 400 million gallons, that's legitimate commercial activity. The participants in an OTC trade in any AG commodity or other commodity want clearing services from any U.S. exchange or an independent clearing entity.

The commission should have the regulatory latitude to accommodate that demand.

Legally important, but outmoded in economically artificial distinction should not impede development or delivery of services and products that the market wants. There's an old fear of bucket shops and I wanted to address that with respect to these OTC instruments.

A clearinghouse cannot settle an instrument without evaluation price that is determined in a transparent environment and available to the clearing entity in both counter parties. So the nature of the clearing and settlement process effectively excludes what I would call the bucket shop risk. And at the same time, it provides a credit guarantee, which is clearly of increasing value to OTC participants.

While we respect the responsibility and the burden that the COTC carries in interpreting and enforcing the law, the debate in this case illustrates a central risk factor in the international competitiveness of U.S. exchanges.

Product innovation and the needs of today's market users outpace the law and regulation. And I think, as an aside, the CFTC really has been very good in the past in keeping up with all of this.

I think the last place that COTC wants to find itself is in the situation the SCC is in, where it's under great pressure because regulation that is too onerous has caused some degree of migration of capital formations overseas, causing loss of that business here in the U.S. We don't want to see that with the U.S. futures industry.

As a single organization, CMC, we realize that our voice has a very limited influence, but we do have a responsibility to say what we think to the commission, especially in this kind of a forum where we're invited to be candid.

We would like to persuade the commission to unite the commodities industries and the futures exchange community to ask for reforms that meet market needs and keep U.S. Exchanges healthy and competitive.

With respect to changes in law, there's any notion that the risks in certain of these enumerated commodities can be seen as controllable or that any participant or group of participants in these markets can somehow be protected or shielded from existing risks by the commission or any other governmental entity is just outmoded. The risks are embedded in the climate of today's commodities markets, they reflect economics, not manipulation or speculative access.

No participant in any sector, including the agricultural sector, can avoid or ignore the inherent risks.

The fact is that the AG community needs access to these products to manage those risks, and law and regulation, which impede that access, do not do a public service.

The commodities industry, the U.S. futures exchange, and the CFTC need to work together, not to navigate the maze of existing law, which as I pointed out is unsuited in some cases to today's business environment, but rather to find ways to accommodate the demand for better risk instruments.

These include customized OTC products like swaps, clearing services, and central counter party guarantees to participants in OTC transactions. Part of this effort might involve more commercially oriented regulation, which I see is part of your packet, and part may literally ask -- involve asking for improvements in existing law. With these realities in mind, the CMC has the following recommendations; as the first step, the commission should approve the CME Group and Ice U.S. petitions involving grain and soft commodity swaps. Secondly, wherever possible, the commission should support in its future regulatory interpretations the harmonious treatment of AG and non-AG swaps.

Third, wherever possible, the commission should support in its future regulatory interpretations those industry and exchange product initiatives which bring into a cleared environment OTC AG products that are now unclear.

Fourth, the commission should research by its surveys its direct contacts and other steps the needs of the OTC market place for new products and clearing services. Number five, based on that research, which we suggested here, the further consultation in the commodities trading community, the commission should request changes in law to accommodate the product innovation that is demanded by industry and expanding in pasens (?) and scope daily.

The CMC would be glad to lend its resources to any effort in this area. And I'm pleased to answer any questions or fill in some more. Thank you.

MR. DUNN: Thank you very much, Dan. It was a very thoughtful piece that the CMC put together, and again, I commend you on your speed of doing that. Let's open it up now for the Advisory Committee; are there any questions or comments based upon the panel?

MR. GOULD: Mr. Chairman, I'm Administrator of -- Agency and I'd just like to mention that during the break, we passed out a handout about livestock products available through the risk management agency. It's just a matter of information. Those products are available.

The -- Agricultural Risk Production Act provided some substantive changes in the way the Risk Management Agency does business, and through the direction of the Federal -- Corporation Board, and part of that now is livestock products that have come forward for -- for swine, cattle, and sheep, so I just wanted the committee to be aware of those products that are on board and available through the insurance companies that the corporation does business with.

MR. DUNN: Thank you, Eldon, we appreciate it very much, and we'll make sure that those members of the Advisory Committee that aren't here get a copy of this, as well.

MR. GOULD: Thank you.

MR. DUNN: Dan, a couple of times you talked about, in your paper, that the CFTC should do some research or some survey, and it's something that our Acting Chairman would like to do, I'm sure, but we often find ourselves without the fiscal resources to be able to do some of that, and that is one thing that the Advisory Committee, I think everyone should keep in mind especially as we look at these various things.

Every time we're asked to do something new or something different, there is a cost to it, and we do have very limited, human and fiscal resources.

You also talk about some changes in the law, and I'm wondering, have you suggested to Congress, since they're in the process now of thinking about -- or going through our reauthorization, of making some of these changes in the current legislation?

MR. BROPHY: We've not discussed that as an organization. We're -- as you know, we're seeking a new president, so our resources have been somewhat limited lately, but this will be a subject of our activity. I think I can say that on behalf of the organization safely, and that subject actually did come up specifically, very briefly, in the last committee meeting that led to this presentation.

MR. DUNN: Any of my fellow commissioners have any questions?

MR. LUKKEN: This is a very basic question, but because the commitment of traders report came out of a regulatory need and eventually evolved into a market transparency issue that a lot of us use, it used to be categorized by speculators versus non-speculators. Then it turned to commercial versus non-commercials. We're now talking passive and active, long term, short term. Does the group have a consensus on how we should divide this up?

Both for our regulatory and market needs. What's the best way to categorize some of these things? So that we can, as a regulator, use it to prevent manipulation and fraud and other things that we look for. But then for a market, then we could turn around and provide that to you in some meaningful way.

Because some of the things being suggested as far as index traders (off mike) -- It's a very basic question, but I don't know if anybody has views on that.

MR. FENTON: I guess I'll make a comment. We traditionally had this speculator and the non-speculator or the non-speculator in commercial/non-commercial, but it would seem that we would want to add categories that show speculative interests in the market and then hedging interest in the market. What we're looking for is to make sure that there's a distinction between commercial, meaning grain hedging, and now, as Dan suggested, financial hedging, which is fine. They're both hedging. But it's -- there's different timeframes of decision, so that would be a useful distinction.

MR. LEHMAN: Just maybe make another observation. I think prior to the evolution of this index fund community and the swap community where you have this new financial risk exposure, it was very clean. You've got speculative interest and commercial interest, and all of that interest that's in that index fund category today would fall on the side of speculative. Because of a demand for higher limits and being able to trade above the speculative limitations, you've got a new creation or a new -- a new participant that's emerged that needs, I guess, further refinement in the report from the market perspective, because those are participants that trade much -- much differently. So, I think, you know, part of it -- it's not easy; it's a struggle -- I'm glad it's you guys -- because the markets are going to continue to evolve, and, as you see these new demands, it will be a trick in finding that balance, I think, as to what information is useful from a regulatory perspective and then what information also is going to prove of value to those folks who are in the market trading these underlying cash market risks.

MR. COYLE: Dan, I know you're a Chicago person. I'm a Chicago person. I'm certainly -- to better understand some of the things in your seven pages, I think maybe either with you or with your futurist committee I'd be happy to -- because some of it sounds like you might -- may not have a good understanding of what we're doing now, and others I know are a new approach, to kind of sort out all that and how we do what we do and things like that. I'd be happy to sit down with either you or your committee or however you want to do that, or anybody else up to a point. I mean, there's only so many of me. So -- but we -- we'll certainly want to explore that maybe offline rather than do that here.

MR. FENTON: I'd just like to make a comment and then ask a question. When we were thinking through how we would revise the commitments and we ended up producing a supplementary report, we thought that -- you know, what people were telling us was this new type of trader who was not reacting to the fundamentals in the market, not a merchant or not otherwise trading, you know, in a way that reflects activity in the underlying cash market, okay? Fine. They were also not price responsive in the way a traditional speculator would be whether it's based on fundamental analysis or technical analysis. They're not that type of trader. So, they're a third a type that is a financial hedge or risk diversifier, and so what we think we've done is created three pretty clean categories that have those three trading focuses. So, I guess my question then is why is that not doing the trick?

MR. BROPHY: I actually have a question for you. In what sense is the replication of commodities price through an index that we all recognize as non-price responsive -- in what sense is that speculative? So, that's -- I think that's the best way of saying we're suggesting you just create a new category, because if there's alpha-enhanced return trading around that, that is a difficult question and I'm glad that I'm not in your shoes to figure out how to deal with that and account for that, but as I've worked on these issues and we kicked things around, we keep coming back to it. In what sense is this activity speculative? To us, it's not. It's hedging. It's a different kind of hedging.

MR. FENTON: So -- well, first I'll mention one of the reasons we continued to produce the reports we've produced in the past and then supplemented it was because we've heard in the past that people have been using this data over many years in their analyses -- used the long data stream and so they wanted to continue, so -- but what we think the supplemental report does is it does break out the index trading separately from speculators, so it -- to the extent that in the traditional report they're being classified as non-commercials. They're -- in the supplemental report they're being moved into the index trader category, and to the extent that they're swap dealers doing index trading they're being taken out of the commercial category and being put into the index category. So, I think you could view the index category -- and there's a little bit of kind of slippage because especially swap traders may be doing some other things besides index trading that we are not able to break out, but we think it's a pretty good breakout of the financial hedgers that you're looking for.

MR. COYLE: But again we can -- I can maybe sit down with you or your committee and we can talk about exactly how we put this together without -- obviously without giving away anything but more the process of how we do these things.

MR. BROPHY: We don't want you going to jail. The only -- I'm not sure I have anything to add to this other than to say once again that these flows, these investment flows that have created such -- to an extent they have created volatility in our markets, you can say that these investment flows have created it all, but you can also look at whether an economic development -- around the world and probably do some sort of correlation studies with those influences as even bigger contributors to it voluntarily. But the fact is the volatility or the investment flows are here to stay.

My brother's estate settled last March,

and I was sitting in with a banker from Northern Trust, the most conservative bank I know, and their recommendation for my sister-in-law's long-term portfolio was 2 percent representation in commodities, and I said to the guy if you had recommended this three years ago would you have your job? And he said no, that he's recommended it on behalf of the most conservative bank in the world probably. So, these things are not going away.

Last week I think it was, the Chinese government announced that they'd be selling 2 million tons of corn from their domestic stocks to calm their domestic markets. Well, what does that tell you? China won't be exporting corn. What does that tell you? Their economy is growing every day at a pace three times ours, and they have a population four times ours. It says that China will be importing corn soon. So, these -- those are fundamental factors but those kinds of things also excite the investment community that wants participation. So, I think what we really are coming down to is a conflict that hits the traditional hedging community with its reliance on a physical delivery contract to bring about a convergent string of delivery period with investment flows that are many multiples the size of the crops that have to be hedged by the short hedger -- the farmer all the way to the elevator -- and until we find a new contract design, which Dave Gleeman (?) alluded to, you're going to be wrestling with these problems and we're going to be wrestling with these problems, too. So, I think part of the issue is the old physical contract design. I'm saying that as a private citizen, not as a CMC member.

MR. LEHMAN: Question for clarification. When you're looking at extending the exemption to pension plan money and other institutional investment fund money, clearly those dollars going into the market are speculative dollars. There is no cash or financial price risk exposure to the underlying ag commodity. For purposes of reporting commitment of trader information, where will those pension fund dollars be put? Would they be commercial? Would they be index fund? Would they be speculative?

MR. FENTON: Well, we are already facing that situation. There are those kinds of traders in the market. They're not -- they're subject to position limits as it is. They're -- in the traditional report they're being classified as non-commercial. In the supplemental report they're being moved into the commodity index trader category.

MR. LEHMAN: So, today, if Calpers has a position directly in corn --

MR. FENTON: If it's part of a broad-based index trading program, they're classified as commodity index traders?

MR. LEHMAN: Okay.

MR. LUKKEN: Can I add something? This is something we've heard a lot from pension funds. I remember a Dutch pension fund coming in to talk to us about this. If they were hitting -- as a non-commercial, hitting their caps and wanted, as a big fund, to get broad exposure to commodities, what they were doing was going through a big Wall Street firm. The firm was getting its hedge exemption and putting it into the market. So, we weren't seeing necessarily the right pricing structures going into the marketplace. And I wonder if we don't get them into this category, if we don't allow more front door entrance, that we're not just going to see a back door that's more opaque. And that's the sort of tension we have to sort of play here. And I don't know what the right answer is, but certainly it's worthy of discussion.

MR. DUNN: All right, I'm not hearing any more folks, I'm anxious to hear Leroy.

MR. WATSON: Yeah, I'm Leroy Watson with the National Grange. I'd like to ask Dan a little bit to maybe clarify a little more of his discussion about the classification of ethanol as an energy product rather than an agricultural product and then make a couple of comments to help you form your response.

First of all, I think it's obvious that clearly the price signals coming from an ethanol market are going to have far more of an impact on sort of the on-the-ground production decisions that are made related to people who are actually participating in agricultural operations as opposed to whether or not somebody in the, you know, the energy industry, somebody who drills for oil or natural gas or digs coal is going to poke a hole in the ground and look for additional fossil hydrocarbons related to price signals that have been developed from, you know, the ethanol markets. I mean, I just don't see anybody looking at an ethanol market and saying now's the time to drill for more oil. So, clearly I think the impact that we can predict, at least for the foreseeable future, is going to be overwhelmingly upon the production decisions related to agriculture and not related to energy.

The second aspect I'd like you to comment on related to your (off mike) that in your presentation you talk about the fact that a lot of producers still carry forward a certain degree of apprehension about the speculative aspects of people acting in the futures markets while -- and I think it's also clear that, you know, certain subgroups of traders within, you know, futures and commodity markets have different cultures, and clearly the energy culture has been far more laissez faire, and if we look at, you know, instances like Enron or the Ameraf (?) hedge fund, those are exactly the types of people that producers that I represent don't want participating in an agricultural product, so -- and I don't, you know, have a broader discussion of why energy tends to attract a small amount of those malfeasant participants. I'm sure they're there in all aspects of commodity trading at some point or another. But if you're trying to assure us that these aspects are under control or at least not a major factor, then why do we want to move to energy markets where we have so many recent examples of where they haven't been under control?

MR. BROPHY: You may have to steer me back to make sure I'm answering your question directly.

With respect to ethanol being ag or energy, I personally had to go through my own thought process to justify my support for the CMC's view of things, and one of the thoughts I came up with -- I think someone else mentioned that had a better example earlier today -- but if there were a market for corn-based plastic, would that be considered an ag commodity or a plastic commodity? And I think in the case of ethanol, there was a -- wasn't there a bankruptcy this week or last week of a plant in Nebraska? And I'm sure that had to do with margins, and the margin issue didn't have anything to do with corn; it had to do with ethanol. So, I'm not sure that's answering your question, but at the moment that's the best I can think of.

With respect to markets being under control -- I think that was the phrase you used -- I tried to emphasize in my comments that there is no controlling these markets. They are so much bigger than U.S. production capacity. They're so much bigger than U.S. export loading capacity, which has triggered some of the transportation issues that Tom Coyle mentioned and Dave Lehman has mentioned. They would be this big regardless because of development around the world and the fact that the U.S. produces so much of these key commodities and has such an efficient pricing mechanism through the futures markets, liquid cash markets for domestic users and exporters and importers. So, it's not a matter of anything being under control that you or I can exert through legislative means or through policy means or through articles or ads in newspapers. It's -- the markets are just too big. And in his presentation, Mike mentioned a possible manipulation where somebody puts a bunch of buying orders in and people tailgate those and get themselves long anticipating the big buying orders moving up in price and then whoever it is that did that all of a sudden cancels the orders and puts in big sells. Well, my experience in -- that had something quite similar to that happen in soy beans, and I don't know exactly why, about three months ago perhaps, but my experience is that these markets are so big if you think you can manipulate them, you're going to lose your shirt.

The order flow coming into our markets, our little bitty ag markets, is so immense you can't imagine it, and it is worldwide and it's going to keep growing, and that's order flow from speculative players who are price responsive and order flow from index players who are not. My sister- in-law is not going to sell her commodity portfolio anytime soon. So, I mention -- I hope I somewhat answered your question.

MR. DUNN: (off mike), you get the last question or comment.

SPEAKER: Mr. Chairman, this may not be a question or a comment, but in the context of ethanol as an agricultural commodity or a food commodity versus a field commodity, I'd like to share this thought as a member of the advisory committee -- is the fact that as a function of government decisions, the ban on MTB -- the mandate that we currently have in place, the pending legislation to mandate 15 billion gallons of corn-based ethanol, the tariff on imports, the 51 cent blenders credit -- I might make the point that it is neither; it is more of thinking in terms of a government contract. It is a commodity that may not be responsive to marketplace supply and demand derivatives either in energy or relative to agriculture. It may -- it -- and that's one of the problems we have with it is the fact that it isn't really market driven today, and if we go to this 15 billion gallon mandate, I don't think it will be market driven at all, and that is a particular concern in the value of price per gallon of ethanol and also as it relates to corn.

MR. DUNN: Okay, and with that, that will close out this morning session.

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

(1:53 p.m.)

MR. DUNN: This afternoon I think we have just a group that is going to be very much equal to the morning session. We're going to start off with the role of agriculture in over-the-counter markets, and this is something that many of the folks this morning alluded to. I'd like to get started here with a summary of the legal landscape, and we're going to bring back Don Heitman to give us that overview.

So, Don, if you will.

MR. HEITMAN: The issue I'd really like to talk about is -- what the heck is an agricultural commodity for purposes of the Commodity Exchange Act and why is status as an agricultural commodity so important? And it ties into the Commodity Futures Modernization Act, because the CFMA established a tiered system whereby the degree of regulation depends on the commodities traded, the participants, and the method of trading. So, intermediated training versus principal to principal -- if you're a retail customer trading through an FCM, you're more likely to need protection than Goldman Sachs trading for its own account principal-to-principal, because they've got lawyers to look out for them. If you're on a trading facility versus doing bilateral trading; if you're a retail customer versus a financial institution --

And in this tiered regulatory system, commodities that are more susceptible to manipulation -- for example, physical commodities, such as the agricultural commodities -- are subject to greater regulatory oversight than financial commodities, because financial commodities are recognized as being less susceptible to manipulation. And so whether or not a given commodity constitutes an agricultural commodity can determine where and how it may be traded.

There are three types of commodities recognized in the Commodity Exchange Act, and somebody was asking me at lunch about defining things and how to categorize things. Well, there is absolutely no question in the Commodity Exchange Act. Everything falls into one of these three categories. Unfortunately, Congress only really told us what one of the categories is, because the first category is an "excluded commodity," which is basically an interest rate, an exchange rate, a security, or a macroeconomic index, and there is in Section 1(a)(13) of the Act a huge, long definition of what an excluded commodity is. That's the only definition. The other two categories are an "exempt commodity" -- and all the Act says is well, anything that's not excluded or agricultural falls into exempt. Then there's the third definition -- well, the third term is "agricultural commodity," but it's not defined. Congress in its infinite wisdom did not deign to tell us what an agricultural commodity is, and so all we know is -- well, we know some things about it. We know that obviously the enumerated commodities listed in the Commodity Exchange Act, which include all the basic agricultural commodities that are subject to speculative position limits, and in addition livestock, livestock products, and some other things -- those obviously have to be recognized as agricultural commodities.

But the concept is clearly broader than just the enumerated commodities, because the House Report on HR 4541, which is a predecessor bill to the CFMA and is pretty much the closest thing we have to a legislative history -- that report says the committee intends agricultural commodity to include all agricultural commodities whether or not specifically enumerated in the Act -- but they still don't say what that means.

The question then becomes why is how we apply the term "agricultural commodity" important? And it's significant in the context of several of the Act provisions. For example, Section 2(g), which is known as the swaps exclusion, excludes certain swap transactions from all provisions -- and it isn't really all provisions, it's "all other" provisions -- of the Act. But that exclusion applies only to a transaction in a commodity other than an agricultural commodity. So, if it's an ag commodity, it's not eligible for the 2(g) swaps exclusion.

And I would like to also point out that before the meeting this morning, Greg Mocek, our Director of Enforcement, pointed out to me that, in fact, 2(g) doesn't completely get you off the hook -- for example, from the manipulation provision. Oh, and he just walked in. I'd like Greg to listen as I read a sentence from the preamble to the Part 35 rules. The Act provisions "concerning manipulation or attempted manipulation of the market price of any commodity in interstate commerce would continue to apply to persons engaging in the swap agreements but not to the agreements themselves." So, swap agreements are excluded under 2(g), but if you're using the swap agreement in an attempt to manipulate the market, Greg Mocek can still come and jump up and grab you. So, in any event, one significant provision in applying the ag commodity definition is Section

2(g), because ags are not eligible for the 2(g) exclusion.

The other two main provisions are Section 2(h)(1), which exempts certain bilateral transactions in exempt commodities for most provisions of the Act. The easiest way to describe a 2(h)(1) market in a shorthand way is that's a one-to-many market. Enron online was a 2(h)(1) market.

A 2(h)(3) market exempts certain transactions in exempt commodities on an electronic trading facility or "exempt commercial market," a many-to-many market, from most Act provisions. And ICE, the Intercontinental Exchange, is the best example of a 2(h(3) market.

And in both of these 2(h) examples, agricultural commodities may not be traded on an exempt market, because an exempt commodity is by definition, not an agricultural commodity. So, whether or not you can trade agricultural commodities under these particular provisions -- whether or not something is an agricultural commodity -- is important, because it determines how the commodity is treated under those provisions.

There is one other important regulatory provision when it comes to ag commodities, and that's the swaps exemption, which is in Part 35. Part 35 was a predecessor of the CEMA. Before the CFMA, it was the Commission's attempt to deal with some of these issues of how do we regulate swaps.

By its terms, Part 35 applies to all swaps. But with respect to everything else, when they passed the CFMA, Section 2(g), the swaps exclusion, superseded Part 35 with respect to everything but agricultural commodities. However, Part 35 is still on the books, so as a practical matter Part 35 applies only to agricultural swaps. The conditions are very similar for agricultural swaps under Part 35. Part 35 is very similar to Section 2(g), with one exception.

If you look at the terms and conditions applicable to agricultural swaps under Part 35, number one, they may be entered into solely between eligible swap participants, which basically is institutional and other sophisticated investors. And that's equivalent, in Section 2(g), the eligible contract participants.

Number two, the swap is not part of a fungible class of agreements that are standardized as to their material economic terms, and that's roughly equivalent to individual negotiation. That's Section 2(g)(2).

Number three, the swap is not entered into and traded on or through a multilateral transaction execution facility, which is roughly equivalent to 2(g)(3), not executed on a trading facility. So, up to this point, whether under Part 35 or Section 2(g), the conditions are pretty much the same. But the fourth condition of Part 35 is that the creditworthiness of any party to the swap would be a material consideration in entering into the swap. In other words, the swap is not cleared, because if it was being cleared, you wouldn't care about the creditworthiness of the opposite party because the clearing house is interposed between the two of you.

So, the one significant difference between 2(g) and Part 35 is that under Part 35 the swaps cannot be cleared. Therefore, if ethanol is an industrial commodity, a non-agricultural commodity, an ethanol swap could be traded under Section 2(g) and it could be cleared on an exchange. You could bring an OTC transaction it to an exchange and get it cleared through an exchange clearing house. But if ethanol is an agricultural commodity, then an ethanol swap could not be cleared absent an exemption or some special relief from the CFTC. And that's the primary difference.

Now let's look at issues affected by the question, "what is an agricultural commodity?" And I actually jumped the gun on my next slide. If ethanol is agricultural, it can only be traded under Part 35 and can't be cleared. If it's not, you could do ethanol swaps and get them cleared. And if ethanol is not an agricultural commodity it could also be traded on an exempt commercial market pursuant to Section 2(h)(3).

What are some additional questions -- and then this is in the context of issues that have been raised with DMO. Are coffee, sugar, and cocoa agricultural commodities? And intuitively one would think "yes," but there has not been a formal determination by the Commission to that effect.

Are pulp and paper agricultural commodities? Well, in fact, the Commission has sort of said that pulp and paper are not agricultural commodities. But we only said it indirectly, because a couple of years ago we got an application from someone to start an exempt commercial market in pulp and paper. So, then the question became can they do this -- can they start a 2(h)(3) market in pulp and paper? Because if pulp and paper is agricultural, it can't be traded on an exempt commercial market. And there was a big internal debate on how you should treat pulp and paper, whether it's agricultural or not, and there was a certain amount of -- I wouldn't say squabbling, but a certain amount of heated discussions within the staff about how pulp and paper should be treated, and Chairman Newsome finally just said, "issue the letter." And so we did. But the letter just says you're recognized as an exempt commercial market. The fact that we issued the letter means that we think that pulp and paper are not agricultural commodities, but there is nowhere any rationale stated.

And another question -- are corn basis swaps agricultural commodities? And are OTC contracts for things such as beef cuts or non-fat dry milk -- OTC contracts that would then be submitted to an exchange for clearing -- are these contracts for agricultural commodities? Aside from the pulp and paper question, we haven't really made a determination about any of those things. In each case, the status of a commodity as an agricultural commodity or not determines whether and how these things can be traded. As with ethanol, if any of these things on the last slide -- if any of those are agricultural commodities -- then swaps involving them could only be traded under the restrictions of Part 35. Among other things, that means they couldn't be cleared. If they're not agricultural commodities, they could be cleared, they could be traded under the 2(g) swaps exclusion, and they could be traded on exempt commercial market.

So, clearly then, it's important to be able to draw a line between agricultural and non-agricultural commodities, and one way you could do it is by source. Is it grown or cultivated? Is it or was it alive? You could do it by use or function. Is it used for human food or animal food? You could do it by correlation with other commodities. Does the market for the commodity behave like an agricultural market or a non-agricultural market? If you apply that to ethanol, does ethanol trade more like corn, or does it trade more like an energy commodity? Or you could do it by degree of processing. How much can a commodity be changed and still retain its status as an agricultural commodity? And the best example -- somebody this morning was talking about plastic products that are made from corn, and this slide use the same analogy for soybeans. Soybeans, soybean oil, and soybean meal are all enumerated agricultural commodities, but where do you stop? Soybeans clearly are an agricultural commodity, but provide the building blocks for everything from candles to crayons, fabrics to flooring, shampoos to solvents. Should any of these products be considered agricultural commodities?

When we were debating this internally in the pulp and paper context, my question to some of the people that wanted to adopt a broader definition was, "wait a minute, the Washington Post is made out of paper pulp and it's printed with soybean ink. Is the Washington Post an agricultural commodity?" So, that's the kind of issues that we're trying to deal with.

What are some of the options for addressing the issue? Well, the Commission could propose a comprehensive definition of "agricultural commodity." In fact, I've got a draft of one up in my office. However, it's a very hard thing to get a handle on, because there are so many different gradations along the line. Where do you draw the line between one thing and another? In any event, the first option would be to try to propose a definition. I hope that, if it happens, it will be after I retire and somebody else can write it.

Secondly, we could grant exemptions to allow clearing of agricultural swaps on a case-by-case basis in response to industry petitions involving individual products. We could do the same thing -- grant exemptions to allow clearing -- on a class-by-class basis. So, for example, we could grant a blanket exemption allowing the clearing of livestock product swaps so that swaps involving various types of beef cuts are all entitled to an exemption as agricultural commodities and you wouldn't need a separate petition for each product. Or, finally, you could grant a blanket exemption and just make ag swaps subject to the same restrictions as non-agricultural swaps. Just say, "all right, the 2(g) exclusion applies to all swaps, agricultural and non-agricultural," and then you have mooted the question of what's an agricultural commodity at least in the swaps context.

And that's the last slide, so that's kind of the issue that we're wrestling with, and I guess, I'll leave it to the chairman.

MR. DUNN: Thank you, Don, and we appreciate your outlining it, and I think you very succinctly put up what's facing the Commission here. We have two entities that are looking at agricultural swaps and are very interested in them, and let's get their perspective on them. Let's start again with Dave Lehman. Thank you for coming back, Dave, and give the perspective from the CME group.

MR. LEHMAN: Thanks, Don, and some of my slides -- and my first one actually sort of covers some of the ground that Don just covered. Sorry about that.

Our understanding is that to clear OTC agricultural swaps, we need approval from the Commission from two of the provisions of the Part 35 swaps rules, and that's subsection (b) and section (c), and those are listed here that the swap is not a fungible agreement with standardized terms, and I'm not -- I guess I'm a little unclear if that's really necessary after hearing Don's comment that as long as they're privately negotiated it would be considered to not be fungible --

MR. HEITMAN: Well, I was trying to just simplify things a little bit for the purpose of the presentation, but it would have to actually be both.

MR. LEHMAN: -- because what we do today, we do clear swaps today in ethanol, and that will -- I'll get to that in a minute, but they are standardized in their terms. They are privately negotiated in terms of the buyer and seller enter into the agreement's off (?) exchange, and then they're entered into our front-end clearing system by a futures commission merchant representing one of the counterparties, and that goes to the credit worthiness consideration requirement, so there -- we need an exemption from both of those. The ag swaps that we propose to offer for clearing would meet the other two provisions of 35.2(a) in that the counterparties would be eligible swap participants and (d) that the swap is not entered into or traded on multilateral execution facility. As I said, we do not intend to offer these for trading on our -- either our electronic or open-option platforms.

The benefits that we believe exchange clearing, centralized clearing can provide to the over-the-counter markers -- it's -- there -- we really see this as a bridge between regulated, exchange-traded markets and unregulated over-the-counter markets, that by bringing these into the clearing house we're able to increase transparency into this market by publicly reporting activity. We do report for our ethanol swaps volume cleared every day and open interest in those products, as well as a settlement price, which is not the transaction price for the swap but a price that we've valued. Our clearing house values that transaction at -- for purposes of margining and for doing the pay/collect.

So -- and that leaves the second benefit. We provide a valuation of service to the industry and a daily pay/collect cash flow between counterparties through the clearinghouse. It also enhances the ability to do market surveillance and -- like bringing these over-the-counter transactions into the exchange clearinghouse you're better able to see what's going on in the over-the-counter market in relation to a futures market, and obviously those two markets work together and the transactions in those markets certainly are influenced by one another. Our ethanol calendar swap product is settled every day to the settlement price for the ethanol futures contract for the corresponding futures contract.

Additional benefits -- these

transactions now have become transactions backed by the capital and guarantee of the clearinghouse of the exchange. CME Group's clearinghouse has a $4 billion financial safeguard package in place, and there's enhanced financial integrity through the elimination of counterparty risk.

So, what we've -- we're doing again is talking to our customers. As I said, we launched an ethanol swap complex -- in December of last year we launched two calendar swap products -- a forward month and a previous month swap. The market has migrated to the forward month swap. Since December we've cleared over 45,000 contracts in ethanol forward month swaps. We have open interest at 12,000 contracts, which is about 400 million gallons of ethanol, so that's about 5 percent of the current ethanol production capacity, and that was as of November 30th.

In addition, in October of this year -- October 15th -- we launched an option on the ethanol calendar swap. Again, it's traded off exchange, traded directly between counterparties and then entered into our clearing house for clearing, and we've already reached 4,000 in open interest in that option just in about six weeks of trading. In addition, we launched basis swaps for New York Harbor, Gulf Coast, Los Angeles in October as well.

This chart shows the activity in the forward month swap. This is how it comes in, and it -- the bars-- the little bars are daily transaction volume. We actually -- it's cut off at the top of the chart -- we did 3600 contracts as the record in terms of daily volume of contracts cleared. I'll note that this contract is half the size of the underlying ethanol futures contract, so this is a 14,500-gallon contract as opposed to a 29,000-gallon futures contract. The blue line -- the light blue line is open interest, and these are the number of contracts that have been entered into clearing and have not yet expired. Most of the contracts that the swap contractors cash settled, it's settled to an average -- a monthly average -- of futures prices for the corresponding future, so these contracts tend to be held to expiration and then cash settled.

The additional products that we've received requests from customers for, an unsolicited in most cases. Don referred to them -- dairy swaps -- requests for swaps on different classes of milk, whey, dried whey, calendar swaps and options, butter, lactose -- a whole range of products. Beef products, as well, beef cutouts, primal beef cuts, subprimal cuts, etc. In addition, feed ratios. So, there's a pretty broad level of interest out there in a number of different products.

So, we talked about the regulatory benefits. The benefits to the market that we think make these attractive instruments and are creating a demand is that it does enhance price risk management. A basis swap can be used to manage the risk between a specific location, the cash price at that location, and the futures price, and, as we've talked this morning, the basis risk is increasing. We think this is a tool that can augment our existing futures contracts and provide a more complete risk management solution. The increased transportation cost and higher flat price levels are factors in why the basis is more volatile. Improved capital efficiency, again through daily market-to- market margin process. The counterparties no longer have risk with one another.

MR. LEHMAN: We mentioned the eligible slot participant or eligible contract participant can participate in these markets. I think if you meet the $10 million net worth requirement, then you're free to operate in the over-the-counter slot markets without regulation. So, what we think bringing these into the clearinghouse does is it does help the smaller sized entity compete because they don't have the balance sheet to compete in the end in the market.

And, again, it may also provide services, clearinghouse services for products that are too small to support a futures contract.

I've listed the contract specs. I think these are in your packets for one of our corn-basis swaps. Again, this looks a lot like the corn contract. It's 5,000 bushels, same months, same price basis. They will expire prior to the delivery month for the corresponding futures contract, so there's no effect on the convergence process or the delivery process.

The final settlement price would be a five-day average of the difference between the cash price at the location in the region that we selected and the corresponding futures contract. So we think that five- day averaging period in terms of the settlement process ensures that that will be a valid representative settlement price.

So, that's it in terms of our swap presentation. What we would prefer as CME Group is Don's final suggestion, that the Commission uses exemptive authority to remove the differentiation between agricultural swaps and swaps on non-agricultural commodities, and that would be the best solution in our view.

We, obviously, have a petition in draft form that we submitted for receiving the authority to clear corn basis swaps, and that's a pretty laborious effort on our part as well as on the Commission staff's part if we have to do that for every product that we want to clear.

So, I look forward to the discussion.

MR. DUNN: Thank you very much. I appreciate your presentation here.

Our next panelist is from ICE. ICE Futures also has a petition in to the Commission to look at certain agricultural swaps. We're fortunate to have Tom Farley who is the President/CEO of ICE Futures U.S. with us.

Tom remarked to me before the session. He said, it's remarkable how candid you folks are here. So he says he's going to change his presentation a little bit because of that.

So, Tom, if you will, please.

MR. FARLEY: Commissioner Dunn recommended that I not give too much of my business plan away because Dave Lehman will be taking notes over there on behalf of the CME.

Thank you very much, Commissioner Dunn, for inviting Audrey Hirschfield, SVP and General Counsel, and me to be here with you today.

Thank you also, Chairman Lukken and Commissioner Sommers and Chilton.

In D.C., somewhere along the line, I picked up the perception of being summoned to the regulator or Congress to sit at one of these tables with one of these microphones is a bad thing. So, I came in today a little bit nervous. I don't know if it was the Oliver North hearings from 20 years ago, but this has been a great day and I won't need Brendan Sullivan (?).

The presentations have been fantastic. I want to, in particular, to acknowledge Don who, just in the most succinct fashion I've ever heard, explained all of the swaps regulatory environment.

By way of introduction, ICE Futures U.S., formerly NYBOT, we changed the name about halfway through this year. We have five main food and fiber products: Coffee, cocoa, sugar, cotton and orange juice.

Our customers have asked us to begin clearing OTC swaps in our world sugar, coffee and cocoa products. Then we, in turn, have asked the Commission for the necessary exemptive orders to facilitate this new business, this new line of business for us.

World sugar, cocoa and coffee, these are all commodities that are largely produced outside of the United States and are listed for trading on foreign markets such as the Light (?) in the U.K. as well as foreign markets in South America such as the BM&F and the Far East.

We're starting on day one with just basic cash-settled swaps instruments, not basis swaps as Dave just described. However, over time, we would expect to add, to have new requests to the Commission or, if you did an exemption, we would expect to bring new products to market that might include basis locations, swaps contracts such as Dave described for corn or contracts based on different qualities of the underlying cash-settled but cash-settled based on different qualities of the underlying physical.

We have not, as of yet, asked the Commission for exemptive orders with respect to the so-called enumerated ags that trade on our exchange, cotton and OJ, the more domestic ags with price supports, et cetera, although we've not ruled that out either.

So, that's just a bit of background on our exchange and the reason that Commissioner Dunn invited us here today.

The OTC markets in sugar, coffee and cocoa are alive and well. If there's one message I'd like everyone to take away, it's that, that they are already active markets. We're not inventing new product here. In fact, we estimate that the annual markets for sugar, coffee and cocoa are between $8 billion $16 billion in terms of notional value on an annual basis.

Every day throughout the world, market participants engage in these swaps transactions, typically cash-settled swaps transactions that, by and large, settle based on the settlement prices of our physically delivered contracts on the old NYBOT and now ICE Futures US.

The reasons why market participants use swaps and a lot of this may just be 101 for this audience, but I'll move through it quickly. The reason that people would trade swaps and not futures are several. One is that swaps are more customizable. Futures are kind of the ultimate in standardized financial products. Swaps are much more customizable.

Two, trading cash-settled instruments eliminates what I call the oops factor, and that's somebody who simply wants to hedge price risk. They're not set up to take delivery or make delivery of physical.

They go on vacation; they forget to exit or roll their position; and now they have to go charter a tanker to go pick up a thousand tons of sugar in a port in Brazil.

A third reason why swaps are beneficial or, at a minimum, a perceived reason is that you can negotiate counterparty to counterparty and, if you have a particularly large order, you can fill it with one counterparty. People view that as an advantage of swaps. It reduces their administrative costs.

The bottom line here is that swaps have real, tangible benefits. The market is active, and the market is here to stay. Our goal as an exchange is to improve the use of swaps and do what we can to bring what we do best to the swaps industry, and I'd like to talk about that just for a minute or two.

You may have noted that my $8 billion to $16 billion of the size of the OTC markets is quite a large range. It's borderline absurd that as a president of a futures exchange, I'm quoting the market in terms of 100 percent.

I noted with interest earlier that David and Mike were having a discussion about the OTC markets, and Mike and David can agree, two experts, I'd note, on agricultural markets. They can agree it's a large market. David can say it's six to one off-exchange to on-exchange for all futures and can't really give an estimate of what it is for ags, nor can I, nor can Mike.

I also can't tell you, moving to something else I can't tell you. I can't tell you what the open interest is in, say, sugar swaps, and I can't give you an estimate of the inherent credit risk that's embedded in these OTC swaps markets. I can't tell you a lot, and this is a classic case of a lack of transparency in these markets.

I can tell you, however, that having better and more transparent answers to those questions is good for all of us, and it's good for all of our constituents in this room. This is why our customers are asking us to start clearing swaps, and that's why we've come to the Commission and asked the Commission to give us and our customers the legal certainty that we need to be in this business.

Stated broadly, there are two areas where we think we can augment the swaps markets.

The first is lack of transparency that I just spoke about. A lack of transparency gives rise to, well, it gives rise to, at a minimum, information asymmetry where a very small number, typically larger participants, have the majority of the information in the marketplace.

The second issue that we think we can improve or augment is we can just add the central counterparty model. I'll explain that in two sentences because it's been covered several times already today. By providing a central counterparty model much like our friends and competitors at the CME, we would allow smaller but credit-worthy market participants to participate in the market, and we would reduce some of the systemic risk that exists in the market because of this daisy chain of credit risk that results from this interconnected spiderweb of bilateral contracts between direct counterparties.

Our model for clearing OTC swaps, I have to say is identical to what David described. I think one of us is breaking into the other's email. If you just slapped our logo on his presentation and substituted the products, it's nearly the same thing.

Our model will squarely address the problems of transparency and credit intermediation or credit amelioration in the OTC markets. With regard to transparency, much like the CME, we'll report open interest on a daily basis, volume on a daily basis, the settlement prices that are used to value these contracts. Again, these contracts are already traded today, so this is just additive. An exchange such as ICE Futures US will be able to publish this information.

On the credit piece, our central counterparty model will enable more market participants to benefit from OTC swaps, as I mentioned a moment ago, and it will reduce systemic risk through the mutualization of risk. I just want to point out that in this regard, this is directly in line with what was contemplated and expressly endorsed by the President's Working Group on Financial Markets as well as by the

Commodity Futures Modernization Act of 2000.

Mechanics for clearing an OTC swap are straightforward, and it's going to sound familiar because it's very much like what David just described in the CME. Market participants will negotiate the terms of a sugar swap or a cocoa swap or a coffee swap away from the exchange, and they will agree to enter into that transaction and then send that transaction to our exchange for clearing.

They'll submit this transaction to the exchange and substitute it for what we call a cash-settled cleared only future. I think a more common sense way of saying that is they're going to substitute to us and we are going to give them a look-alike swap or, simply put, they're just going to pass their swap to us and we're going to clear it.

We're then going to report open interest and buying information, as I mentioned. The swap, much like a standard futures contract, will result in initial margin for both parties and then variation margin for one of the parties depending on which direction the value of the swap goes.

Finally, the swap will be fungible only with other identical swaps. It won't be fungible with, obviously, delivered futures. That's it for the mechanics.

Finally, the merits, I don't think anyone argues the merits of providing a central counterparty model into the OTC swaps market. They're obvious to us. They're obvious to our customers. As I mentioned, these markets are here to stay, and we think it's time in the agricultural world that exchanges bring what they do best, which is shining a bright light of transparency, reducing systemic credit risk to these markets.

Much like Dave, we've requested that the Commission use its exemptive powers to enable us to transact in these original three contracts which we've requested. We, too, think that if you do the work and you get comfortable, if we do the work and we get comfortable, that it would make sense to have more of a blanket approach, although we'd leave that up to you to decide.

Thank you.

MR. DUNN: Thank you very much, Tom. Now is the point where we open the discussion up for the rest of the Advisory Committee to ask questions or make comments.

MR. WESTON: I'm Ryan Weston with the American Sugar Alliance. Thank you very much. I really appreciate your all going through this meeting. I work with almost all of you that are commissioners, and I know you're a very thoughtful bunch and take these issues very seriously.

I'd like to say I know that the legislation left you in a little bit of a conundrum. The enumerated commodities was the best definition at the time for ag products. I believe onions is in there if you look closely. It was something we knew it was always going to be an issue that the Commission would have to deal with down the line. It's kind of the history. You've done that, and you've come up with very good rules and regulations.

The sugar industry, we basically polled everyone and asked what was needed, with ethanol in particular. When we were looking at the designated contract markets, swap markets, we had to look through many things. One of those being how subject to manipulation is it, how big are these markets.

The energy markets, energy swaps were very developed back in 2000 when the legislation was passed. As we look at the ethanol market today, it's pretty large. It is treated as an energy market, I think, by everyone out in the business world. Because of that, we basically decided, as the sugar growers and the sugar industry, we would also consider that it should be traded as an energy product and treated as an energy product.

It's very tricky. We've watched the correlation between corn prices and ethanol, and corn prices are very high. Ethanol has gone down. At one point in time, they were both very high.

People have tried to see if oil and ethanol are directly linked. There is a correlation. They are very tricky.

I know it's an early industry. It's new, but it is, as we look at it, the future of it, it probably is only going to get bigger. If this Energy Bill ever gets passed the House and the Senate, every mandate is bigger. I suppose if the Energy Bill passes, the ethanol industry will grow accordingly and, even if it doesn't pass, it's still going to be quite large. Five billion gallons is not small.

So, I know it will be difficult. I know that we leave lots of tough questions up to the Commission and your staff to work through and decide. We do want to, I guess, be cautious that we do anything that would strangle the industry early on.

It's something where it's obviously very important to corn right now. We think if cellulosic takes off, it may be more important to us. If the prices stay as high as they are with other commodities, it may get to the point in time, where we are a sugar first or sugar consumption currently, but we want to make sure the options are open in the future for all markets, depending on how the industry grows.

So I appreciate it. I know it's tough, but we do think it's a very large market.

I will say that the reason the ags were enumerated and laid out was we spent a lot of time back when I was on the Hill, when many of you were in other jobs and some others here were working very hard on the other side of the Hill for me, we had all of the ag groups come in.

Most people felt safest at that time. We knew how things were working. Everyone was very confident in how the agency was dealing with everything. So we left those enumerated in the most highly regulated markets.

I think most of us in ongoing ag products, we're still happy with that. We think you've done a good job, but we know that things do change. It's hard to believe it's been eight years since that was passed. We were just joking around that Chicago has changed a great deal. The e-market has changed, and the underlying ag markets themselves have changed a great deal since.

So, we appreciate it. Thank you.

GREG: Thank you, Commissioner Dunn. I'd like to make several broad and rambling comments, if I could.

I'm Greg Dudan (?) with the International Swaps and Derivatives Association.

First of all, with respect to the continued discussions about transparency that have come up throughout this dialogue, transparency is a good thing. It comes up in the context of the commitments of traders' reports. It was referred by Tom with respect to the benefits of clearing.

I think it's important to recall what is known as Goodhart's Law. Charles Goodhart was the Finance Minister for Prime Minister Thatcher, and he noted that there is often times an inverse relationship between the ability of government to obtain information and the value of that information as an indicator of price. That's because there's always a certain pool of market participants that will trade transparency for liquidity. They will not enter the market if their activities are overly transparent, and therefore you will, by exposing the line on that market segment, it immediately loses its informational value. So I think that's relevant to the commitments of traders.

Chairman Lukken had said, how do we break down these categories and how do we obtain some level of granularity to provide a more complete picture? On one level, of course, that is exactly the right question to be asked, but on another level you need to be very cautious because, to the extent you're exposing people's trading strategies, then these folks will be reluctant to engage in these markets.

With respect to the ICE and CME proposals, we think that it's a good idea to allow these contracts to be cleared. Certainly a lot of our members have collateral arrangements which work just fine, and they are excellent credit risk mitigation strategies. Nevertheless, there's clearly demand, and so it wouldn't make sense, from our perspective, to exclude the opportunity to market participants to clear these types of contracts. So, clearing is probably good to revisit in Part 35 with respect to risk mitigation.

Lastly, with respect to the definition agricultural commodities, I would simply recall the words of Justice Potter Stewart with respect to whether or not a particular movie the Supreme Court was reviewing was pornographic and obscene. He said, well, you know there is no real definition, but I know it when I see it.

So I would leave that with you as a guide for a definition.

MR. DUNN: Any other comments or questions? Any of the commissioners?

Well, if not, let me thank -- oh, I'm sorry, Neil.

MR. GILLEN: Larry and I were over here fooling around and making charts, looking at a product from its form at harvest. It's interesting, listening to Don. You can take cotton which goes through a gin. From the gin, it goes to the seed. From the seed, it goes to the oil. From the oil, it goes to biodiesel which is not agriculture, but it's a byproduct of a byproduct of a byproduct, and corn is sort of different.

The simple thing in my mind is one of the options, your last options, was just do a blank exemption for swaps. I mean you're just never going to figure out for an ag, for ag swaps, what it is based upon byproduct. You can just go on and on and on.

Larry made another comment, Don, to solve your riddle with the Washington Post. Is it a paper product and seed? What is it? Larry said, it's manure.

(Laughter)

MR. DUNN: I think some other people had

that thought as well. Any other questions or comments? Well, if not, let me thank the participants here, especially Dave and Tom for coming in and providing transparency to this Commission and to this particular issue because often times we get requests for things and other folks aren't aware of it. The opportunity to bring this out and have the entire Ag Committee listen to it and be able to comment on it is certainly helpful for the Commission. So, thank you all.

Now, if we can get ready and quickly move into our final panel here today, this is something that I think every commissioner I've talked to has said they're anxious to hear about. It's the global carbon market and what is taking place there.

We're delighted to have Will Ferretti today, who is with the Chicago Climate Exchange. Dr. Ferretti has a long involvement in the climate change arena. He has firsthand experience, especially working in this new climate exchange that we have here.

So, welcome, Will. We've also got two experts here, whom I consider experts because they're the people on the ground that are really looking at this as a new market for farmers and ranchers: Dave Miller who is from my home state of Iowa, representing the Iowa Farm Bureau, and Doug Sombke from South Dakota.

Thank you both for being here today to talk about how farmers and ranchers look at this issue.

So, I'd like to start, Will, with you giving us an overview.

MR. FERRETTI: Thanks, Commissioner Dunn, Chairman Lukken and Commissioner Sommers. Thank you all for allowing us the opportunity to speak to you.

I also bring greetings from our Chairman, Dr. Richard Sandor who asked me to express his regret that he couldn't be here to join you today. He was called out of the country unexpectedly at the beginning of the week and is going to be gone for another two weeks. So I'll do my best to fill in for him.

What I'd like to do is start, as you suggested, by giving you kind of a broad overview of carbon emissions trading and what we're doing at the Chicago Climate Exchange but spend the bulk of my remarks on what we see as the opportunity for agriculture as a benefit of addressing this global threat of climate change and global warming.

Very quickly, about the Chicago Climate Exchange, we are an exempt commercial market. We operate an emissions reduction and trading program for a suite of greenhouse gases. There's a family of greenhouse gases recognized internationally, six gases. We trade them and run a program to address the reduction of those emissions.

We are a self-regulated rules-based exchange. Regulatory services are provided to the exchange by the financial industry regulatory authority or formally NASD.

Our membership now, we started with 14

entities when we launched the exchange and the program in 2003. We're now over 375 members. It includes corporate and so-called naturals that you might expect to be participating in this kind of initiative. Twenty percent of the major utilities in the United States, companies like American Electric Power and NRG and Alleghany Energy, are involved.

Seventeen percent of the Dow Jones Industrials are participating members of the exchange: DuPont, Intel, IBM and United Technologies. Companies from the Fortune 100s like Ford and Bank of America, Safeway grocery chain, Motorola, International Paper are all participating as are entities that you wouldn't necessarily think might be involved here. Cities like the City of Chicago, state governments like Illinois and New Mexico have joined as have universities are all participating in this.

When these entities join the exchange, what they're doing is committing to reduce their greenhouse gas emissions by 6 percent by the year

2010, and that's measured against a baseline of the year 2000. So, each year, we put them on what is essentially an emissions diet. They have a target, emissions target to meet each year. If they beat that target, they've earned allowances that they can then trade on the exchange. If they fall short of that target, they're obliged by the rules of the exchange then to purchase allowances to meet their compliance requirements. So, that's one pool of allowances, carbon reduction allowances that come into the exchange.

Anther pool that comes in comes from projects that specifically try to either mitigate or sequester carbon in specific projects, and we refer to these as offset projects. The largest part of that pool of offsets that's traded on CCX right now is coming from U.S. Farms and forests. So that brings me to what we see as the opportunity for agriculture in this kind of program.

The Intergovernmental Panel on Climate Change and other have identified a whole range of actions that can be taken right now by farmers and foresters that can generate significant wins against the effects of climate change and, in so doing, provide new income streams for U.S. agriculture.

CCX offsets projects are providing farmers with the capability to meet this particular opportunity. On our exchange today, farmers are earning income from such practices as continuous no-till, sustainable rangeland management, forestation projects, forestry projects and methane capture.

Looking at our no-till program alone, nearly 10 million acres of no-till and grassland projects have already been enrolled in CCX. Thousands of farmers have or are in the process of receiving payment for their carbon sequestration services that they're providing. This is an exchange kind of a business model on farms where you have this supplemental source of income now coming from the provision of an environmental service in addition to the ag service that they are already providing. Total payments to date, just again on our no-till program, fall somewhere on the order of fifteen to twenty million dollars.

If we look at the potential, in our view, we see carbon as being the largest commodity market in the world. Just to give you a point of reference, the annual value of the current Kyoto-mandated carbon crop -- it's a term that we often refer to -- in Europe right now equals the value of the U.S. corn plus U.S. wheat plus U.S. soybean crop, equal value. The carbon traded in Europe right now under the mandated Kyoto program is equal in value to the corn, soybean and wheat crops here in the United States.

It's been estimated that U.S. cropland has the potential to sequester somewhere on the order of 120 to 270 million metric tons of carbon per year. As an exchange, we can't comment or project where carbon prices are going. Right now, they're trading less. Since we launched in 2003, they've fluctuated between $1.50 roughly and just short of $5. In Europe, under that mandated program, carbon is trading at 25 euros or thereabouts, roughly $30 U.S. So there's quite a spread there between a voluntary program in the United States and where a mandatory program is going.

Some folks have estimated where future prices in the United States might be. When you take that capacity of American farmland to sequester soil and attach those estimated values of where carbon prices might go, it's been calculated that farms' incomes could be enhanced on the order of four to six billion dollars per year as a consequence of providing that carbon sequestration service.

To give you another perspective on what that volume or that capacity of sequestration means, agriculture could provide up to 25 percent of the carbon reduction now being called for in legislation that's being contemplated on the Hill. There was a bill reported out of committee last night in the Senate, the so-called Lieberman-Warner bill, that would establish a mandated carbon reduction regime in the United States. Agriculture has a significant role to play in that respect.

In closing, from our perspective, the future looks bright with regards to agriculture and its ability to address the challenge of climate change. We're currently in the process of expanding the territory for our no-till and grasslands program.

Our offsets committee just recently approved a sustainably managed rangeland program, and we've go the first set of offset credits being registered under that particular protocol.

We're undertaking R&D for reduced nitrogen, emission payments and payments are now moving forward under that program as is our R&D for water quality and quantity payments are underway.

So, with that, I again thank you for the opportunity to present today. I'll be happy to answer any questions following my colleagues on the panel.

MR. DUNN: Thank you, Will. Let's turn to Iowa. In Iowa, the Iowa Farm Bureau Federation has really stepped out in a lead role, working with farmers there. Dave, could you tell us how it's operating in the state?

MR. MILLER: Thank you, Commissioner. My name is Dave Miller, Chief Science Officer with Aggregate Climate Credits. I'm also Director of Research for the Iowa Farm Bureau Federation. So I kinda wear two hats.

In fact, let me pass up to the commissioners a copy of the comments and some literature with regards to the carbon activities that we have.

Aggregate Climate Credits was created to deliver carbon credit aggregation services to American farmers, ranchers and private forest owners. Aggregate expanded the Iowa Farm Bureau Federation carbon credit aggregation program which began in 2003. We were, in fact, the first agricultural aggregator that was registered with the Chicago Climate Exchange.

With more than 1.3 million acres aggregated from American farmers, ranchers and forest owners in 25 states, we believe we are one of the leading supplies of carbon credit aggregation services to agriculture. Again, the company is a wholly owned subsidiary of the Iowa Farm Bureau Federation.

In a nutshell, aggregate is the country elevator of carbon credits. That's kinda how we position ourselves. Aggregate combines carbon credits from agricultural offset projects initiated by American farmers, ranchers and the private forestry owners, creating pools of credits verified by a third party and offered for sale through the Bureau or the Chicago Climate Exchange.

As Will indicated, a number of companies but particularly electric power generators, manufacturing companies, state and local governments, are among the purchasers of those credits. For more information, you can visit the Chicago Climate Exchange web site for more detail with regard to that.

The contract that we use as an aggregator with our producers has two primary elements. The first part of the contract authorizes Aggregate to include the potential offset project in one of our pools and to register the carbon credits under the protocols and rules of the Climate Exchange.

The second part of our contract addresses the transfer of carbon credits to Aggregate and sets forth the terms and conditions for sales of such credits. It can best be described as a delayed price contract with specific terms for physical delivery or title transfer, however you choose to look at that.

In compliance with the rules of the Exchange, 20 percent of each year's credits are held in a reserve account until the end of the contract period. Once that contract period is completed, the reserve credits are released and eligible for sale. Those reserve credits act as kind of a self-insurance against weather events that can impact the compliance rate of credits.

The typical soil, forestry or rangeland contract requires compliance with the terms of the contract for a multiyear period which is usually a minimum of five years. Participants who fail to maintain compliance can be subject to recovery of credits that were previously issued, although credit recovery of forest and rangeland projects is limited to the amount in the reserve if that non-compliance is to do weather or other natural disasters beyond the control of the project owner.

Activities under the direct control of the owner are fully recoverable, i.e., if you cut the forest down, if you plow the land, if you do something to reduce the carbon-holding capacity of a rangeland by a direct management activity, those activities would be fully recoverable under the terms of the contracts.

The carbon market continues to expand from the original 20 or so founding members. The Climate Exchange has grown to more than 380 members. Agriculture's role has also grown since the initiation of the Exchange. There now are a number of aggregators providing services to farmers, ranchers and foresters across the country.

The total number of offsets registered on the Exchange is now greater 18 million. Agriculture has provided nearly half of those offsets, and there's a graph that illustrates the breakdown. Ag soils make up about 42 percent of that; forestry, about 2 percent; ag methane, another 2 percent; fuel-switching, about 4 percent. We're a bit involved with registering projects from ag soils, rangeland, forestry, fuel-switching and ag methane destruction. So, we're getting a broad bank of experience on how this market develops.

Simply having a greenhouse gas emission reduction does not necessarily mean that someone will be granted a carbon credit. An individual with an emission reduction must go through the following steps to turn a qualified emission reduction into a carbon financial instrument: The project must undergo an eligibility assessment. It has to be in compliance with the protocol. It needs to undergo monitoring, verification reporting and registration on an appropriate exchange or in an appropriate registry.

After completing all these steps, the project may be registered on the CCX and be issued carbon financial instruments. These instruments then become the vehicle for trading on the exchange. As a CCX-registered aggregator, we take projects and amenities that are too small to deal directly with the Exchange through this process.

The market for carbon credits trades daily. The carbon financial instruments are registered by the year in which the emission reduction takes place. This is called the vintage of the credit. Earlier vintage credits can be delivered against sales for later vintage credits. Bids and offers are placed on the electronic exchange platform, and again there's a graph that shows the prices for those credits over the past four years for the 2006 vintage.

The very first trade on the Exchange occurred at $1.00 per ton. The market has been as low as and I think the ultimate low was 85 cents per ton for carbon early in the history of the Exchange. The high was just near $5 for at least one vintage. In the last 18 months, the price has trended downward. Today's market traded between $2.10 and $2.25. So it's a market that trades 8:30 to 2:00 on a daily basis.

The carbon market responds to supply and demand pressures similar to other commodity markets. In this case, the demand is the need that members of the Exchange have for excess allowances of other members or for offsets. The supply side is determined by the amount of excess emission reductions by Exchange members and offsets provided by qualified projects and Exchange-registered aggregators. In recent months, daily trading volume on the Exchange has been increasing.

In conclusion, it's my opinion that this voluntary carbon market is actually functioning quite well. I believe that a voluntary market will continue to grow as federal and state legislators debate the merits of various emission reduction programs and develop the mechanisms by which those emission reductions will be traded.

I've included -- I think it's also in materials that Will brought -- some of the maps of the credit rates that are determined by zone. The top map is our soil offset map with the red area being six- tenths per credit or six-tenths of a ton per acre per year. Across the U.S., we range from that six-tenths of a ton down to two-tenths of a ton. The drier areas of the country that produce less biomass per acre would be at the lower end of the rates.

The middle map is the rate for grassland offsets, ranging from one ton per acre down to four-tenths of a ton, and then the third map is the breakdown for the rangeland credits.

Again, I appreciate the opportunity to be here and would again be happy to answer any questions that would come in.

MR. DUNN: Thank you, Dave, and we would like to reproduce this and make sure that all of the members on the Ag Advisory Committee get a copy.

MR. MILLER: Yes, I can get you more copies of that.

MR. DUNN: Thank you. Dave has told me that he has to catch a plane this afternoon.

So if he jumps off or runs out, it's not because we're giving him a hard question or anything. He just has to get going.

MR. MILLER: Our annual meeting starts tomorrow morning, and I really do need to be back. I've got a 4:50 flight.

MR. DUNN: Doug has also been very, very active in this with the South Dakota Farmers Union.

Doug, could you tell us what are your experiences?

MR. SOMBKE: I need a little technical assistance here. As Larry pointed out earlier, farmers have a thing about having, feeling, touching and seeing. So I'm going to show you the presentation that we show our urban friends about the carbon project.

Thank you. This is going to touch on a lot of what Dave has talked about and what Will just talked about. It's going to be something you're actually gong to be able to see and touch.

He's working on it. There we go.

MR. DUNN: We have great staff.

MR. SOMBKE: The carbon credit program is something that the Farmers Union has been involved in through North Dakota Farmers Union. They're the aggregator for South Dakota and the National Farmers Union Organization.

This slide indicates if you go back to your school days in science class, it shows how carbon is cycled throughout the environment.

As you can see by the blue bars, it pretty much exchanges itself, nature does, but the red bars indicate man's intervention, the land changing use. Of course, that offsets. But if you look over at the fossil fuel side, the 6.3

billion tons of it that we are already into the atmosphere in that recovery.

Carbon sequestration, a few gentlemen already talked about the prevention and reduction of it. This is just another slide that we use to present to our potential participants. Also, the removal of the carbon from the atmosphere is another form of carbon sequestration.

Our soil organic matter is going to be one of two things, either storage of CO_2 in the atmosphere such as plowing and/or sinking the carbon. Don Recowski, the Soil Scientist at North Central Soil Conservation Research Laboratory in Morris, Minnesota, we consider a guru of carbon, and he sees this as throwing money away.

What are the values of soil organic matter? These are just a list of a few things. Of course, it improves the soil structure, decreases erosion, decreases moisture loss, increases infiltration, increases soil water- holding capacity and increases ability to take up nutrients while decreasing the energy requirement for agricultural operations.

What is a carbon credit? Certain kinds of manufacturing store extra carbon in the soil. This stored extra carbon has a value called a carbon credit. These credits can be sold through the Chicago Climate Exchange, a stock market type trading house that brings buyers and sellers. This has all been covered, so I'm going through it quite rapidly. They are also responsible for rules, compliance and regulations of the buying and selling of credits.

Who buys these credits? As Will demonstrated earlier, it started out with 14 companies, and now it's up to 375. Companies such as Travelocity, for instance, buy them. When you buy your airline ticket, you can actually purchase the credits to offset the credits that the plane will be using.

Again, North Dakota Farmers Union is approved by the CCX as an aggregator. This allows them to contract with producers for a five-year contract. They group these contracts in blocks of carbon credits. They sell the credits on the CCX, and then they pay the producers for carbon storage on their acres.

This carbon credit program is the no-till, cropland to grasses and the rangeland. The no-till total acres across the United States that the National Farmers Union has signed up is 2.5 million acres. We've paid out over $2.7 million so far. Depending upon the prices, as Dave stated, it fluctuates, but the price should hold. In an average range, we should be looking at over $5 million paid out to producers.

This is just an example of the way we used to till. A number of our urban see this. What they don't understand is they've never seen what farming is actually like and how it's changed.

This is no-till today, no-till planted corn to corn stubble. Here is a little closer look. As you can see, the stubble is quite thick.

This is corn planted to wheat stubble. This is beans to corn stubble. Now, I guess I should have pointed out also, if you look real closely, you can also see in this no-till picture there's actually some corn stubble there too from the previous year of the wheat stubble.

No-till guidelines, as Will pointed out a little bit more scientifically than I will, the general rule of thumb is direct seed with no more than 30 percent surface area disturbance. Strip till is a lot more than 30 percent soil disturbance.

In no-till crop practices, crops must be grown annually. Soybeans must be seeded no more than 50 percent of the available acres.

The fallow is permitted either chemically or mechanically, but you can use chemicals on your crops.

If you move a certain amount, there is a rule. Well, I'm not exactly clear on what the rule is: There is a how much straw can you move or how much stocks you can move. Some guys bail and chop, those acres are not qualified.

No-till planters and drills, these are

the ones that are accepted and hydrous applicators, manure knife applicators and represent of course the Phoenix harrow.

Implements not acceptable, the no bore plow, tandem disk, chisel plow, field cultivator, row cultivator and any smoothing or leveling implement, harrowing or generally have too much disturbance. Again, it's that 30 percent rule.

Of the hay land, cropland, planted to grass or alfalfa is eligible. You must use no-till practices when seeding and hay - and seeding it to a crop.

The no-till program. You agree to continuing no-till and row crop through five years. The Conservation Reserve Program is another program which is continued crop plant is grass. You must not seed it before 1999. Agree to keep it grass or forest through the contract. Here's that map that Dave was talking about with the different zones of soil types.

As you can see South Dakota, where I'm from that eastern part of the country, of our state, there's 23 counties on that side. We signed up over 220,000 acres on that side just in the first year. The orange, yellow, I'm sorry. I am color blind, so it's a little bit hard for me to distinguish this. That's more of a range land side, as you get across the Missouri River. We're seeing a lot of interest in the grazing portion of the CCX.

We had a group of ranchers down by the Gregory Area which is in the middle, central part of the state and we signed up over 100,000 acres just in the couple of counties and look for it to grow.

The enhanced range land of vegetation program is the one that they signed up for. As you can see it's only available in Central and Western USA. It requires a grazing plan. It involved graze land practices that include light and moderate stock rates and rotational grazing and seasonal use. The income potential for producers is ideal.

Dave pointed out it ranges upon the

price and which programs you enrolled in, of course, makes a difference and where in the country you farm.

Price of a carbon credits when sold is another example. This is just an example of where the range has been as we marketed our carbon credits. Cropland using no-till practices, and cropland seeding grass, and then the range land again is just a recap of the programs that are available.

And the forestry offset pool, such as shelterbelts. It's something that's just being opened up and I guess when I came here, I wasn't, I really didn't know what this program was going to amount to so maybe you can answer questions to that.

The methane gas anaerobic digester, that's a good project. What we're finding out as we talk to people with the digesters is that they are being approached by the companies putting them in to sign over those credits as cost reduction to the project. So those are pretty well captured already.

And you have, of course, restoration or creation of wetlands is a pending project. And this is the website that we want people to go to. The North Dakota Farmers Union Organization has a direct link to the project.

I will say that we are finding more and more interest on West River. Again, it comes down to the trust factor. Many farmers, as Larry pointed out, would rather deal in things they can handle, see touch and feel. They don't quite grasp the concept that they have something stored in the soil, or can store in the soil that is valuable to the whole world.

MR. DUNN: Thank you Doug. We'll open it up now to the Advisory Committee for any questions or comments.

MR. COYLE: I'm curious. You showed quite a range of prices and different practice. I'm just curious can you give a ballpark of how many dollars per acre a farmer can generate by using these practices?

MR. MILLER: Yeah, it again is a function of the rate which is (off mike). You know that up front, what you don't know is the price. And different aggregators operate slightly different in terms of how they do that credit pricing. We operate, I'll call it a (off mike) basis. Think of it as putting all of the credits into a great big bin, selling off that bin, and everybody gets their pro rata share of the average price of the bin. Because the market's not (off mike) for me to sell Doug's credits ahead of your credits. Because we have pricing packs just on a daily basis.

So we are using average pricing so we think it's a fair (off mike) priority pricing. (off mike) it ends up being between about 50, depending (off mike) it could be as low as about 50 cents an acre or (off mike) grasslands. This year we had some grasslands that could be up in that $4 an acre.

On forestry, forestry can be (off mike) a function of species, location and age of the trees. And (off mike) is 15 years old would be almost eight credits per acre per year. In a $4 market that could be $30 an acre or more. So it ranges quite a bit. Hard woods (off mike) is probably nine-tenths of a ton per acre per year. So it really makes a difference as what the specifics of the project are.

MR. DUNN: Larry.

MR. MITCHELL: I've got a question for all three of you. Actually two questions and if you can't answer them that's okay. It's just something we need to get on the table. And we mentioned Lieberman- Warner.

What does that offer more? In another words, when we go to a mandated cap trade system versus what we have now, that more critical notice. One of the big issues surrounding that is what some would call a safety valve. It's a cap on the price of carbon.

Now, NRECA has already said they've got to have it or it's the end of the world. I just talked to the Fertilizer Institute and they

basically said if they don't have this safety valve, if they don't have this cap on the price of carbon in that legislation, we'll basically close the remaining nitrogen plants in the country and we'll be importing all of our nitrogen fertilizer.

I'm not choosing sides on this. Since I have all three of you here in the room, I thought I would ask, how does this impact this very young sector of commodity trading and what farmers can see in the future?

MR. FERRETTI: To the question of safety valves and particularly putting limits on prices, from our perspective we see potential danger in doing so because you put a cap on a price, you essentially have this situation where prices are just going to migrate to that point and the question is, what does that price then represent?

Does it really represent the true marginal cost of the mitigation activity?

So there are some potential, there's potential for market distortion as a consequence of having that kind of a safety valve cap on

price. We don't have one within CCX. We've got other mechanisms that attempt to address risk associated with, for example a company's growth in emissions. And we think those kinds of rules are equitable, but allow the price to find itself through the marketplace dynamics.

As to what more Lieberman-Warner does, it effectively broadens the level of marketplace participation than we have right now.

I mean, we have 380 members. It's not inconsequential group. That group represents 16 percent of total large stationary sources of greenhouse gases in the United States right now. But you would expect that that bill is going to bring in a whole lot more players.

One of the concerns that we do have about the bill, it is with respect to how it's dealing with agriculture. And we think most of the bills that have been talked about on the Hill right now don't fully recognize the potential that agriculture can play in helping to move towards these reduction targets that are being set out

there. And so that's an area that we and others of our colleagues in the agricultural community are attempting to advise members on the Hill about what those implications are.

MR. SOMBKE: I agree with Will when you put a cap on something, that's never good. Farmers have stepped up this voluntarily.

I think that shows a lot. For one thing, you know, they are already doing the practice so why shouldn't they capitalize from it.

And secondly, you know, this is our world and I think they realize the importance of sustaining life here on this earth. At the same time, the Climate Security Act, I think needs to be addressed and I think it needs to be addressed to that it rewards these participants, not penalizes them.

MR. MILLER: I guess what I would add to that is that both Will and Doug have said there are issues that do exist within the Climate Act that's being considered and they are issues relative to some of the terms, you know,

additionality, permanence, some of those types of factors. And agriculture is a little different than a smokestack in those regards. You know, people ask, can you guarantee that a ton of carbon sequestered in a field today will never in it's life be released?

The answer is no. I can't give you that 100 percent guarantee of permanence. But the reality is that I can probably give you a 95 to 97 percent probability that it will never be released, but I can't give you 100.

And so there's way in terms of -- the science would say that the actual sequestration in

Iowa soils is about three-quarters of a ton per acre per year, that the credit rate is six-tenths. So we've discounted that. And those type of approaches can deal with a lot of the issues that get raised. Relative to the caps - price caps to me. There's no record in history of them being very effective. That's probably my response to that. I think it's a failed mechanism that's been proven to fail over years and years of experience in markets.

That doesn't mean there aren't some needs for some safety valves. Agricultural is highly energy dependent. We understand some of these linkages, but price caps probably aren't the way to go.

MR. DUNN: Don.

MR. HEITMAN: I'm just curious and maybe this is a dumb question, but if carbon credits are trading for two or three dollars here and $16 in Europe, why can't somebody figure out some way to arbitrage?

MR. FERRETTI: They are. The participation in CCX is quite broad in terms of who, the members. We've got the naturals that have described the corporates. We've got the farm community involved in terms of off-set providers. Another segment of the membership, what we call liquidity providers and these are commodities trading firms and hedge funds who in fact are looking at the price differential between a mandated program in Europe and the voluntary here in the United States and are providing, not only liquidity in the market, but are in there buying on a speculative assumption.

MR. MILLER: In part it depends on for what purpose you're buying the credits. If you're buying credits to position a product as a carbon neutral product, having off-set its manufacturing processes to carbon. (off mike). And credits from medical sources are adequate for that. Compliance for the Kyoto requirements in Europe, the U.S. credits are not recognized, so you have a credit that's not arbitrageable into that market for the compliance purpose. So it really depends on what purpose the company might have behind those credits.

MR. SOMBKE: What Dave just pointed out, the Kyoto Agreement. The protocol. To my recollection there's only two industrial countries that haven't recognized it and that's the United States and Australia.

SPEAKER: Australia recognized it.

MR. SOMBKE: Did they? So we're the

last ones now.

MR. COYLE: Thank you Mr. Dunn. Will, I talked a little bit this morning about the differences that you've talked about, the dollars and it's actually $2 to $30 right now, not 2 to 60. So that's 15 to 1 difference and the primary reason is the mandatory cap and trade system.

But I'm curious about the difference between the program that we have and the program in the EU. For example, could you explain the differences do they include agricultural land or not? And are there any other significant differences?

MR. FERRETTI: Dave may be able to help me on this one, too. But my understanding is that right now the European program does not include agriculture. In fact, at one point we were talking to some European farmers about listing on CCX. I don't know if we ever, I don't think we ever got that far. Dave sits on our Off-sets Committee and so he deals with our off-sets protocol as well as applications for approvals to register off-sets on the Exchange.

Other differences that may be addressed and understand too, that what Europe is in right now is a pilot phase. Their pilot program ends this year and then they go into the so-called Kyoto Phase next year running from '08 to 2012 and things are likely to change during that timeframe. Right now during the pilot phase they only address one greenhouse gas, CO2. CCX addresses all six greenhouse gases, the entire family of gases.

The regulated community, if you will, the sectors included in the European program is rather narrowly defined to heavy industry, utilities, heavy manufacturing. Ours is multi-sectored, broad-based including as I've described earlier everybody from, you know, farm and forest to cities, universities, and light industrial as well as heavy industrial. So those are the immediate differences between --

MR. COYLE: So would you say that, I mean, depending upon you know, what Congress does and whether or not it gets signed into law, et cetera. Take that aside. But our models so far, do you think they hold more potential for a greater amount of good in the marketplace and for the world. I mean, given that we have ag, given that we have a broader base of folks covered.

MR. FERRETTI: We like to think so. And we also believe that we've avoided some of the pitfalls that the European program experienced, in terms of the initial allocation of allowances and the subsequent impact on pricing that that had. You know, they had a significant decline in prices that some people immediately jumped on and were saying ah, this is evidence that this kind of program doesn't work.

It's a failure. The reality was that it was a design flaw. I think we've taken a lot of that into account.

We were quite happy with the comment made by Senator Bingaman last year at a summit that he and Senator Domenici had hosted on the Hill where they were inviting input from a whole variety of parties about what the architecture of a U.S. climate mandate might look like and when my colleague Mike Walsh finished making our presentation the Senator said, it looks like you've done all of the work why don't we just make CCX the national standard. It was a hard opportunity not to say no.

So we think we've got a lot of experience that will contribute to the design of a well assembled program in the United States.

MR. COYLE: My last question for you Will. So is there something that you think that we can be doing? And there may not be. Maybe we are doing everything perfectly. But is there something that you think we could be doing here, the Commissioner, the staff could be doing, to sort of anticipate what might happen? I mean, other than looking at the law or looking at potential law, so that when we get this.

I mean, if you've got a better mousetrap and we may be getting a new law in the future, how do we avoid having you wait for us, other than use to do the appropriate due diligence, which of course we will do. Is there anything you can suggest?

MR. FERRETTI: You know, I will be happy to consult with my colleagues back in Chicago. I think the kind of open dialogues that we've had with the Commission over the tenure of our existence, I think, you know, bodes well in terms of how we, you know, how the Commission can stay on top of this issue and how we can provide advice and input to the role that you need to be playing ultimately in this particular marketplace. And so, we will continue to be of service and available to you.

MR. COYLE: I beg your indulgence, real quick. I want to ask Doug and Dave one quick question.

So I know it's difficult when you guys are doing this program, or North Dakota is doing this program, but you know, you are parts of national organizations too, which have overreaching policy. Have you all, your national organizations written in favor of the cap and trade legislation in the Senate?

MR. MILLER: At the moment American Farm Bureau has not taken any position on the mandatory cap and trade, they do have stated policy and have had it for several years. They strongly support the development of the voluntary market, but they have no position on the mandatory at this point. The American Farm Bureau policy session will be coming up in January and it could be something that may be addressed at that point in time.

MR. COYLE: And are you just in Iowa Dave, or are you other states too?

MR. MILLER: We started just in Iowa and as we moved into other states it became easier to spin this out as a wholly-owned subsidiary. I don't have to explain why is Iowa Farm being from Mississippi. We're an aggregate, it has become a vehicle for national implementation and we have contracts in 25 states.

MR. COYLE: Doug.

MR. SOMBKE: I guess, I'd almost say ditto. You know, we use North Dakota Farmers

Union because to set up another aggregator it takes a lot of assets. And if South Dakota was going to do it, we couldn't do it. We don't have that capability, so therefore we go through national through North Dakota.

MR. COYLE: And what about the support of the Lieberman- Warner proposal?

MR. SOMBKE: We look forward to working with them, but as far as the cap, no.

MR. COYLE: Have you guys written a letter, has national written a letter?

MR. SOMBKE: Yes. Yes, we've written a letter in support of working with them, yes.

MR. COYLE: Thanks for your patience for my questions. Thanks.

MR. DUNN: Excuse me. While I go back, because there might be something I missed here. For the land use practice, who certified it? Is it a self certification or the producer? Is it the aggregator or do you have an outside entity like Soil Conservation Service?

MR. MILLER: I can address that. It is

a third party certification or verification by third party, or self verification by a producer. We operate it really to a large degree, similar to how USDA operates the government program. In that a farmer goes in and certifies his activities and then they spot check.

We ask our participants to certify every year their compliance status with us, and then there is a third party exchange approved verifier, but it's a third party verifier that spot checks 10 percent of our contracts every year. Our compliance history is right between 98.8 to 99.7 percent compliance. So a very solid compliance record in terms of what that third party verifier is finding in terms of compliance.

MR. SOMBKE: That's a very good question. And I'm sorry I didn't talk about that because we do talk about that in the presentation we present to the producers. Producers are the only ones that can receive the payments. The landowner cannot. It's because of the sign up at the FSA office such as Dave alluded to, you need to present your 578 form which only the producer can produce.

MR. DUNN: A final question here from me. Has there been any impact then on the primary product that that producer may be involved in? Be it corn crop or livestock?

MR. SOMBKE: Not to my knowledge. The way we present this to people is, you're doing this already. Don't change your practice just because you're going to gain another buck or two an acre. That's not the whole point here. The point is to get paid for what you're sequestering now. Now, does that mean they won't change in the future?

I'm not going to say that, because if the price would get up to what the Europeans are getting, I think you're going to see a lot of changes.

And plus, you know, the fuel cost is getting more expensive and guys are going to start doing a lot more no-till.

MR. MILLER: I would probably position

slightly differently, in that we are rewarding early adopters as opposed to paying for what we're just doing because it's not business as usual. Continuous no-till is not the norm. The record would indicate that about 62 million out of 350 million acres a year are no-till, but probably a small fraction of those are continuously no-tilled every year. And then we take it a step farther and require a five-year continuous no-till contract with recovery if you fail for all five years, if you fail to honor that in any one of the five years. That's not business a usual. It's a fairly strict --t that we're putting into that contract relative to compliance requirements.

So while - they may be comfortable with the practice and in fact we position it, I probably don't want a brand no-tiller committing to five years of something he's never done before. I want them to have some experience with the practice before they commit to a long term fee that affects their whole livelihood. And so yes, we want them to have some experience with it, but this is not business as usual. It is substantially beyond that.

For a lot of people, what we are finding is the conversion to continuous no-till has - there are some issues that arise with that.

Some producers find some production issues that arise with that, but they tend to work through those and over time the reductions in energy consumption, the enhancements to soil structure, enhancements to tilth, and a number of other things in about three to five years give them positive payback to what they are doing.

And so we are seeing, particularly as energy prices go higher, more interest in no-till type of practices and adopting the types of practices for which credits can be granted. And it back to just because I sowed the soybean field doesn't mean I'm going to get a carbon credit. It goes way beyond that in order to qualify through the protocols.

MR. FERRETTI: Yeah, I will just echo Dave's point. Our purpose here is drive change and to drive farmers to undertake practices that are going to generate important environmental service. One more anecdotal evidence in that respect has been offered by one our members.

You may be aware that Senator Richard Lugar registered his farm in Indiana to participate in the program and he has a so-called back forty that's been unproductive for any other kind of use that he planted in hardwood trees and he's earning carbon credits from the sequestration service being provided by those trees. And he has become a rather vocal advocate among his colleague farmer sin Indiana about, here's a productive way to use an otherwise unproductive piece of land on the farm. So again, the idea here is to drive change and behavior and practice.

MR. DUNN: Chairman Lukken and I have had an opportunity to hear the Senator on this. Bob, question or comment?

MR. CASHDOLLAR: Bob Cashdollar, Farmers Organization. Are hardwood trees and no-till soy beans equal in carbon sequestration and, what about crop rotations and all of those other farm management practices. How is that dealt with?

MR. SOMBKE: As Dave said, forestry depends on the type of trees, the age of the trees and so forth. The no-till is all the same.

The no-till acres are all the same. It doesn't matter if you plant corn, soy beans, wheat. It doesn't matter.

MR. CASHDOLLAR: What about vegetable-type crops? Are the involved?

MR. SOMBKE: No. No. There was a difference. They did have alfalfa included in the grass before. Now it's no longer, now it's a no-till.

MR. FERRETTI: I've brought some packets with me that describe -- they have fact sheets, one-pagers that describe the credit rates for each of the programs that we have been talking about here. So you can get an idea of how many tons per acre in the case of the soil program and so on, for our different type of off-set programs.

MR. CASHDOLLAR: And the farmer certifies each year or just for what's on their contract?

MR. SOMBKE: No, he signs up for the contract for five years but he certifies every year through his FSC 578 forms.

MR. CASHDOLLAR: I'm a real baby at this stuff. I mean, a lot of this is really new to me. But what I learned last week is that in India, Europeans are coming in and buying carbon credits in the OTC market often at really low prices. And so the commodity exchange in CDEX wants to create a market much like you guys have, I guess. So the question I have is for all of the countries who have signed up under the Kyoto Protocol, is that one single market? I mean all over the globe, any country that signed up? So that's a single market and these carbon credits can be bought and sold across all of those borders?

MR. FERRETTI: The Kyoto Protocol allows for, has a mechanism called the Clean Development Mechanism. And what the CDM does is that it enables a so-called Annex One country, which is essentially are the developed countries, the industrialized countries of the world.

To use as part of their compliance under the Kyoto Reduction Cap, a certain percentage of compliance can be achieved through the access off CMS credits, Clean Development Mechanism credits. And the credits come from projects in non-Annex One countries. So countries like India and China that are undertaking fuel-switching projects or HFC destruction, or renewable energy projects can earn CDM credits that can them be purchased and used, delivered for compliance in the European program. Yes.

We recently just conducted an auction, by the way, for Tata Motors in India who had a whole portfolio of CDM credits from projects that it had invested in, renewable energy projects and had tried to sell those in the over-the-counter market and was not happy with the kinds of prices that they were being offered and so we conducted an auction on their behalf and were able to get them higher than over-the-counter prices.

MR. DUNN: Any other questions or

comments from the Committee? Anyone?

Mr. Chairman, any comments that you have?

MR. LUKKEN: No, but I just want to express my appreciation for everybody coming in today. This is a fascinating topic and something we're trying to closely follow as these markets develop. I know it's also something that we're considering in the current re-authorization. There is some mention of carbon trading and what category of regulation it falls in similar to our discussion of ethanol, whether it's Ag's or Energy's. So that's the thing I think we're going to keep a close eye on, but definitely this was useful today to understand better how the agriculture markets are using this and how it can be beneficial to the end user. So thanks everybody for coming in today.

MR. DUNN: Well, I would like to thank this panel. I would like to thank all the participants. This has just been a tremendous day. It seems to have gone a lot longer than it should have and I apologize for that, for not keeping better tabs on the time. But it went very, very fast for me because I learned a lot and this was tremendous. I'd like to thank the staff here at CFTC for putting this on, everyone from our technical people to the folks that helped you in and out and got your badges on you and all of that. And my staff in particular, Eric Juzenas who is my chief of staff, Jason Gizzarelli who is my legal assistant, and Nicole McNair. The three of them have really, really worked hard on putting this together and that hard work has developed into this, what I think was a really, really good Agricultural Advisory Committee.

Thank you all for being participants here.

(Whereupon, at 3:43 p.m., the PROCEEDINGS were adjourned.)

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