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COMMODITY FUTURES TRADING COMMISSION

AGRICULTURAL MARKETS ROUNDTABLE

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P R O C E E D I N G S

MR. LUKKEN: Good morning. My name is Walt Lukken. I want to welcome the --

MR. DUNN: You keep turning yourself off.

MR. LUKKEN: Okay, I'm turning myself off, I apologize. I want to welcome the roundtable participants and members of the public to today's discussion on the state of the agricultural futures markets. If everybody could take their seat, we do have cameras around the room, so if you're standing, you may be blocking one of the cameras for our web site presentation, so I appreciate everybody taking their seats as quickly as possible.

Specifically I want to thank Under Secretary Mark Keenum from the U.S. Department of Agriculture, as well as Board member Lee Strom from the Farm Credit Administration for their participation in today's proceedings.

We gather during extraordinary times for our agricultural markets. Commodity prices across the board are at levels not experienced in many of our lifetimes. In the last three months, the agricultural staples of wheat, corn, soybeans, rice, and oats have hit all time highs. During the last year, the price of rice has increased by 118 percent, wheat by 95 percent, soybeans by 88 percent, corn by 66 percent, and cotton and oats by 47 percent. These price levels, combined with record energy costs, have put a strain on consumers, as well as many producers and commercial participants that utilize the futures markets to manage risk and discover prices.

Protecting the integrity of these markets, as well as the public that relies on the accuracy of their prices, lies at the heart of the CFTC's core mission, and today we'll endeavor to identify the possible causes of these conditions.

This agency has brought together a broad cross section of the agricultural markets in an effort to learn from each other's experience and help to form a collective understanding of what is occurring.

During such turbulent times, it is tempting to shoot first and ask questions later. But it's exactly at such moments that government must endeavor to be informed and proportional in its response. It is critical that we understand the problem fully so we can get it right and ensure the cure is not worse than the disease. To do that, we must ask probing questions regarding the causes of these unprecedented market conditions. It is imperative that the affected industry serve not only to help us identify problems in the markets, but also partner with us in finding solutions should it be determined that the markets are not functioning properly. I know that the CFTC's Agricultural Advisory Committee, which serves under Commissioner Dunn's leadership, is in attendance today and may provide a vehicle for addressing issues that come to light today. Thank you for your service here today.

On today's agenda, the roundtable will first hear an overview from the CFTC and USDA staff on the fundamentals and composition of some of the key agricultural markets. Do supply and demand factors justify current prices, and if not, what other factors may be in play? Do contract terms and conditions need to be revisited by exchanges? What is the impact of financial players such as speculators and index traders on the functioning of the markets and the commercial players?

It is in the interest of everyone around this table that these markets have vibrant commercial participation, and I am hopeful that these presentations will result in an informative and lively debate.

Second, the roundtable will hear about the work of the University of Illinois, as well as supplemental analysis by the CFTC chief economist, on the lack of convergence between the futures and cash prices of commodities at certain times. Is this phenomenon increasingly occurring, and what are the most likely causes of these conditions? This issue is fundamental to determining whether proper hedging can occur in these markets.

Lastly, the Kansas City Federal Reserve Bank and the Farm Credit Administration will present an overview of the credit markets in rural America and whether high commodity prices and resulting increases in margin levels are causing problems for producers and agri-businesses during this credit crunch.

We will discuss the central role that margin or performance bond plays for exchanges and how higher margin levels are impacting market participants. The Commission is considering two proposals to raise the speculative limits for certain agricultural commodities and to create a regulatory exemption from speculative limits for certain risk management purposes.

While we have requested and received public comment on these proposals, given current market conditions and the uncertainty surrounding additional speculative money on these markets, I will be very cautious about moving forward with such initiatives at this time. I believe that before acting, this agency must be certain that additional speculative pressures will not exacerbate the anomalies we are experiencing in these markets. I look forward to any views that the roundtable may have on these proposals. Therefore, I'd like to announce that the transcript from today's discussion, as well as any written statements and subsequent public comments, will be added to the public comment file for each of these proposals.

We have a big agenda before us and we will do everything we can to try to hear the many concerns surrounding these matters. In maximizing the public's access to this proceeding, given our time and space limitations, as you can see looking around you, for the first time we are providing individuals access to this roundtable over the Internet and through toll free phone lines via our Web site, www.CFTC.gov.

In addition, last week we created an email address to collect questions from the public that we plan to post at the roundtable today. We also welcome written comments from the public for two weeks after this roundtable's conclusion.

The period for submitting such comments will remain open through May 7th. Public input is essential to ensuring that this agency is properly informed about these matters. After my colleagues on the dais have provided remarks, I will ask each of the roundtable participants to introduce themselves and their organization before turning it over to our presenters.

Don't worry, there will be plenty of time later to give detailed views, but for the sake of introductions, we want to try to keep things brief, and so I'd appreciate it. All written statements of participants will be made a part of the hearing's formal record. With that, I appreciate you being here this morning, and I'll turn it over to Commissioner Dunn.

MR. DUNN: Thank you, Mr. Chairman. And I commend you for calling this particular forum. This is the second time in recent history, once on energy concerns, and now on agricultural concerns, that you have taken a leadership role and stepped forward to ensure that the consumers know that this Commission is paying attention to what's going on, so thank you for doing that.

And I would like to thank our two fellow guests up on the dias today, Mr. Secretary, Mr. Board member, I'm delighted to have them here, as well. We're here really to talk about two questions, are the agricultural future markets working, if not, why not, and what needs to be done to fix them. These are some of the questions we'll be discussing today. Certainly there is concern that the markets are not performing their main function of price discovery and mitigation of risk.

If that's the case, who's responsible for fixing the futures market? Should Congress or the CFTC draft new legislation or promulgate additional regulations, or as I think is appropriate, can the market participants make the necessary changes to ensure that these markets are functioning properly?

We're here today to see if you, the

market participants, can agree on what ails the agricultural futures markets. We're also here to discuss potential solutions to those ailments so that the agricultural markets can continue to provide for price discovery and risk mitigation.

Each market participant will undoubtedly have a unique perspective on what they believe ails the agricultural markets. The producer is concerned with their ability to obtain forward delivery contracts and to hedge their production risk. The grain elevator is concerned with the rapid rise in price that is forcing them to make margin calls far beyond their line of credit and the expected cost of that credit. The providers of credit are wary of the demand on their resources in a single market area. Exchanges are concerned that limit locks do not allow price discovery and curtail the normal business of the exchanges. Clearinghouses must collect margin more frequently to ensure their financial viability, but constant margin calls strains business relationships.

Processors are concerned that managed monies, hedge funds, and commodity index traders are skewing the market. In turn, these non-traditional agricultural market users maintain they provide liquidity to the market that helps the market function.

Finally, end users and consumers complain that prices rose too quickly and too fast. Each of these concerns is legitimate, but may not necessarily be held by the other segment of the industry. Only by airing each person's particular difficulty can we see the broader picture and potential solutions.

Our agricultural markets do not operate in a vacuum. And recently there have been a number of extranalities that have impacted the markets, a weak dollar, low stock levels due to drought and other production problems, increased demand from developing countries in ethanol production, a flight to quality by capital, shortage of storage, and increasing energy and transportation cost have all contributed to an increase in the value of agricultural commodities.

We may already be working under or fast approaching a new paradigm of higher agricultural price. The way we did business in the past may not be the way we can do business in the future.

We've raised a number of questions for market participants to consider today, and many of you will undoubtedly have suggestions fixing the problems you've experienced. Your suggestions may alleviate your particular problem.

However, individualized solutions may cause bigger problems for the market as a whole. That's why you were all invited here today, so we can take a broad overview of the market and come up with solutions that take into account the needs of all the participants.

I don't think there's going to be a silver bullet or single solution for what ails the market place. And certainly the solutions that come up cannot be implemented overnight. But I firmly believe that the market participants are the best qualified to come up with solutions that will ensure that we have a viable, fair agricultural futures markets that will provide for price discovery and risk mitigation. I'd also like to thank the members of the Agricultural Advisory Committee that are here today. They are going to be listening to this and making suggestions to the CFTC on these and other problems in the future. I want to thank all of you for attending today, but most of all for being part of the solution.

MR. LUKKEN: Thank you, Commissioner Dunn. Commissioner Sommers.

MS. SOMMERS: Good morning. I want to thank Chairman Lukken for holding this event, and I want to thank all of the participants for being here today. I know this is a busy time, especially for agriculture in Washington, so thank you for being here.

In recent months, prices of futures contracts for many agricultural commodities traded on U.S. exchanges have been unusually volatile and have reached or exceeded levels that have not been seen since the 1970's.

Problems with convergence between futures and cash prices for certain commodities have also been observed. Fundamental economic factors such as the rising production of corn-based ethanol and other bio-fuels, tight grain supplies, and the declining value of the U.S. dollar help to explain some of these market developments. And while there may be many factors contributing to the lack of convergence, it appears that increased futures price volatility and uncertainty about basis relationships has raised the cost of hedging.

Some argue that increased futures market participation by investors is driving prices above levels that can be explained by economic fundamentals. Economists generally agree that high volume liquid futures markets provide substantial benefits to the public. These markets can provide opportunities for the public to diversify investment portfolios by adding commodities to the traditional mix of stocks and bonds through funds that track the futures markets.

I believe this is a positive development. So we should gather all the facts before taking steps that might discourage this type of participation. Our primary responsibility at the CFTC, though, is to make sure that the agricultural futures markets are discovering prices efficiently and are providing an opportunity for commercial entities to hedge price risk. This is a complex situation, and I think it is important that we consider all the objective evidence carefully before we reach conclusions about what, if anything, should be done. We have with us today an extremely distinguished group of presenters and roundtable participants who have a great deal of experience and knowledge in agricultural futures markets.

Your background and expertise will help us explore the topics that are before us today. I look forward to listening to the discussion and working with all of you on these important issues in the future.

MR. LUKKEN: Thank you, Commissioner. Commissioner Chilton.

MR. CHILTON: Thanks, Mr. Chairman. Good morning, everybody, happy Earth Day. I won't be redundant from what my colleagues have said, because I agree with most of it, but make no mistake about it, this is an issue which is really hitting hard at home in the heartlands. I'm sure Le can tell us, and I see some other farmers and ranchers in the audience with us here, so welcome.

To say that it's our responsibility to ensure that these ag markets are operated honestly would be a gross understatement. It's our sworn job to protect price discovery and to root out any fraud abuse manipulation, whether or not it's speculators or hedgers, people long or short in the market, that's our job. And finally, it's our job to use the Commodity Exchange Act, and the tools that are contained therein to ensure that these are viable markets, that they actually work for people, that they're efficient, and that they're effective, and that's -- not just important for hedgers and speculators, it's important for consumers, because these markets greatly impact what goes on in peoples' everyday lives.

It's our job to make sure these are honest markets. It's our mission, it's our mantra, and it's our mandate, and that's why we take it very seriously, all of us.

And that's also why it's important that you -- each of you -- are here. And one of the questions I have is, is there something that we may not be looking at, something that's off of our radar screen that is impacting these markets. I look forward to the issue expertise that all of you to this dialogue and the discussion. Thank you all who are in this room and the overflow room and people that are joining us on the Web. Thank you, Mr. Chairman.

MR. LUKKEN: Thanks, Commissioner. With that, I'll turn it to Under Secretary Mark Keenum from USDA.

MR. KEENUM: Thank you, Mr. Chairman. I do also want to join the chorus of commending you for conducting this very important agricultural forum to discuss market volatility, it's vitally important to all of our interest, and I again commend you and the Commission. We look forward at USDA to working with you as you address these very important issues.

As has been stated very clearly this morning, we are facing tremendous volatility in our agricultural market prices, most dramatically since the beginning of this year. Manufacturers are driving prices, including market fundamentals, investment, speculative market flows, and broader economic factors such as the value of the dollar, and even oil prices.

Also the declining global stocks have caused major importing countries to increase imports to -- figures of potential food shortages in the event of production shortfalls. Also to dampen domestic prices, some countries that normally export products are imposing trade restrictions, export taxes, or outright export bans to reduce supplies on the world market. While these policy actions exacerbate price run-ups, the eventual easing of these trade restrictions could contribute to sharp price declines.

As the department that's charged with assisting American farmers and ranchers, USDA is concerned about how market volatility and changes in the relationship between futures and local prices are effecting producers' ability to manage their price risk, both in selling their crops and buying feed for livestock operations.

Increased volatility in futures markets and sharply higher prices have led to higher margin requirements, increased cost of hedging. It has even ended forward pricing opportunities for some of our farmers. For example, cotton shippers and some grain elevators are no longer bidding for future delivery because of risk and cost associated with maintaining hedges.

Excess volatility combined with

increasing margin requirements based on options -- market closing prices rather than futures closing prices, has driven traditional market participants away from hedging in the futures market. We have seen baseball anility increase markedly, rendering traditional futures based risk management strategies less effective. This shifts risk, which translates into higher cost back to producers and across the food and fiber marketing system, eventually reaching consumers.

The increasing disconnect between traders with an interest in the physical commodity and speculators with little or no interest beyond speculative profit has also raised fears that cash in futures markets will face convergence problems if the trend intensifies.

One implication of the current market change is that some smaller producers, whether country elevators or small producers, will be squeezed out, adding to the growing consolidation in the food and agricultural system.

USDA's CCC commodity loan program has

not experienced any negative effects as of yet. But high and volatile market -- because high and volatile market prices, because of those high prices, the adjusted world price for cotton and rice and our posted county prices for grains and oil seeds are significantly above the loan rates.

However, if market prices collapse and cause loan repayment rates to near or below loan rates, there could be significant impacts on program activity and government expenditures. So these are some of the issues and concerns that we have at USDA, and I personally am looking forward to hearing your comments and input from all of the roundtable participants. This is a vitally important topic for the future of American agriculture. And we at USDA stand ready to work with this Board, this Commission, and all of you to address these important issues. Again, Mr. Chairman, I want to thank you for conducting this very important roundtable.

MR. LUKKEN: Thanks for your partnership, Doctor Keenum. With that we'll turn to Board Member Lee Strom.

MR. STROM: Thank you, Mr. Chairman, and Commissioners, Secretary Keenum. It is an honor to join you today on this very important topic. And I think I will probably be the most brief of the introductory comments here.

Again, the Farm Credit Administration, there are several staff here in the room also today, and I'd also like to make it a point to introduce the Chairman of the Board, Nancy Pellett. I believe, Nancy, if you'd raise your hand or stand. She's joining us after just returning from an international trip. And obviously, we're here to listen from and learn from the lending aspect on this also. Again, my name is Lee Strom, and I'm here today representing the Farm Credit Administration Board. I have been a member of the FCA Board since December of 2006. And prior to that, I served on Farm Credit Institution boards for over 25 years. I've also been an agricultural producer from Illinois, where I am a third generation family farm owner that produces corn and soybeans.

And having been a producer, I understand first hand the issues that the producers are facing today in this very interesting and dynamic agricultural market that we're living in.

I want to thank the Commissioners for this opportunity for all of us to hear and participate and have comments and share concerns during this challenging time for the agricultural industry.

I am pleased that a member of the FCA staff, Andrew Jacob, who is in the far end of the table there, who serves as our Director of the Office of Regulatory Policy, is a participant on that panel. Andrew will provide some additional information about FCA's roles as the regulator of the Farm Credit system. And again, I want to thank you for the opportunity to be here, and I look forward to hearing and participating in the comments today. Thank you.

MR. LUKKEN: Thank you, Lee, for being here. And thank you, Nancy. I know it's a long trip you've made to be here and we appreciate your partnership, as well.

So with that, we will go around the room and have all the participants introduce themselves, their name and organization.

I would ask that everybody, if you could, turn off your blackberries and cell phones during the day, that interferes with our equipment, and that would be useful. As well, when you want to talk during today's discussion, if you wouldn't mind just turn your placard on its end so we know that you're interested and have a comment and we'll try to do that in order as best we can.

Oh, and lastly, for our court reporter, if you wouldn't mind, before you talk today, to just state your name so that we're able to properly transcribe who is talking during today's proceeding. So with that, I'll start with Dave Lehman on the end and we'll go around the room.

MR. LEHMAN: Thanks, Mr. Acting Chairman. Dave Lehman, Director, Commodity

Research, CME Group.

MR. CAREY: Charlie Carey, Vice Chairman, CME Group.

MR. FARLEY: Tom Farley, President, COO, ICE Futures, U.S., formerly Nibot.

MR. TOWERY: Justin Towery representing the USA Rice Federation and USA Rice Producers Association.

MR. LIND: Luke Lind, member of National Cattlemen's Beef Association.

MR. DUNAVANT: Bill Dunavant, cotton merchant from Memphis, Tennessee, representing Dunavant Enterprises, I am Chairman of the Board.

MR. COLEY: Chuck Coley, Chairman of American Cotton Producers representing National Cotton Council.

MR. GREER: My name is Bob Greer, I am a Product Manager with PIMCO.

MR. ELLIS: My name is Rob Ellis, I'm managing partner of Ridgefield Capital.

MR. POPP: My name is John Popp, I'm Chairman of the Independent Bakers Association.

MR. BROWN: Dave Brown, Sarah Lee Corp, representing American Bakes Association.

MR. STALLMAN: Bob Stallman, President of the American Farm Bureau Foundation, and a rice and cattle producer.

MR. NIEMEYER: Gary Niemeyer, Director of the National Corn Growers Association.

MR. HARRIS: I'm Jeff Harris, the Chief Economist here at the CFTC.

MR. FENTON: I'm John Fenton, I'm the Director of Market Surveillance at the CFTC.

MR. KASS: David Kass, I'm a Senior Economist in the Chicago office, also in Market Surveillance of CFTC.

MR. BANGE: I'm Jerry Bange, Chairperson, World Agriculture Outlook Board, USDA.

MR. KUNDA: My name is Eugene Kunda at the University of Illinois at Urbana-Champaign.

MR. JACOB: I'm Andrew Jacob, the Director for the Office of Regulatory Policy at the Farm Credit Administration.

MR. McREYNOLDS: I'm Jerry McReynolds, a producer from Kansas and representing the National Association of Wheat Growers.

MR. WALTER: My name is Mike Walter, I'm President of the Commodity Markets Council.

MR. BYRUM:: Jim Byrum, President of the Michigan Agri-business Association.

MR. HEPWORTH: I'm Doug Hepworth, I'm Director of Research for Gresham Investment.

MR. EASTLAND: I'm Woods Eastland, I'm the CEO of a Cotton Marketing Cooperative and I'm representing AMCOT, which is a trade association of cotton marketing cooperatives.

MR. MILLER: I'm Sam Miller, I'm with M&I Bank in Wisconsin and I'm representing the American Bankers Association.

MR. WEIL: I'm Andy Weil, I'm a cotton merchant from Montgomery, Alabama with Little Brothers Cotton, Incorporated, and I am President of the American Cotton Shippers Association.

MR. BUIS: Tom Buis, President of the National Farmers Union.

MS. KLEMME: Diana Klemme with Grain Service Corporation of Atlanta, Georgia; we're a grain consulting firm.

MR. COYLE: Tom Coyle with -- Holdings in Chicago and I represent the National Grain and Feed Association.

MR. KOWALIK: John Kowalik, California Public Employee Retirement System, Commodities Portfolio Manager.

MR. CARLSON: Layne Carlson, Treasurer with the Minneapolis Grain Exchange.

MR. LUKKEN: Well, thank you very much. And I think we have Esther George in the back there. Esther, can you -- Esther George with the Kansas City Federal Reserve Bank. Thank you, Esther, for being here. So with that, we'll turn it over to Dave Kass from our Surveillance Team for the CFTC's presentation.

MR. KASS: Thank you. Let me outline how the presentation is going to go as far as I'm concerned. I've got some charts on fundamentals, but obviously we've got -- Doctor Bange here from

USDA is also going to talk about fundamentals. The folks in this room and those participating by web cast are living the fundamentals. So it would be presumptuous of me to say a whole lot about fundamentals.

But let me assure you that this is something we look at quite thoughtfully, we collect quite a bit of data as far as our market surveillance effort, we analyze that data.

I know I've talked to some of you in this room personally, and I'm sure some of the folks out there on web cast are attaching a face to a name that they've probably talked to on the phone, many of which over the last few months, as you can imagine.

The main focus, though, that I want to present is the data that those other folks aren't going to be able to give you, and that's market composition data. Market surveillance does have access to daily trading data for the largest traders in the market above reporting levels. Mr. Fenton here is going to talk about cotton, and he's going to show many of the same sorts of analysis I'm about to show you for the other markets, he'll show you that for cotton. So I'm going to talk a little, just slide through I guess literally and figuratively.

MR. LUKKEN: Why don't you try it again? There you go.

MR. KASS: All right. So I'm going to just kind of breeze through the fundamentals, but hopefully, like most things, and sometimes I think they call me a senior economist because I'm entitled to a senior moment now and again. But as you recall history, it's nice to actually see it in front of you. So some of the purpose of these graphics is to be able to see where we were on things like bases and convergence and some other things rather than have to recall it from memory.

We're going to talk -- clearly, spend most of my presentation on market composition, then I'm going to talk a little bit about price limits with an example. So let's proceed. And I might add, these are the sorts of briefings that we give our Commissioners and senior staff weekly, so I apologize. They're going to be seeing many of the things they've seen. As you can imagine also, grain markets have been the subject of continuous briefings each week. One or the other or a collection of them have been on our agenda for quite some time, so they've seen quite a bit of this already.

The first is a graph of some of the major markets. And you can see -- I apologize, cotton is not included, it was a little difficult because of the scaling, but rest assured, when Mr. Fenton presents cotton, it'll have its own price chart. As you can see from the little inset box, I guess you're not going to be able to see it.

MR. LUKKEN: Does everybody have the actual charts around the room? Here we go, I think we're -- here we go.

MR. KASS: All right.

MR. LUKKEN: All right, thank you.

MR. KASS: All right. So these are some of the major markets. Unfortunately, something like corn, you don't get to scale when you throw it on the same market as Minneapolis wheat and rice, but I think you get the concept there. We're going to show some individual price charts later. And, of course, the little inset box shows the dates of some of the all time record high prices that we've experienced recently. Rice is outdated even on that, which was through Friday, it set a new record high a bit above that; yesterday it closed a little lower. So this is, obviously a very fluid situation.

In fact, I think one of the panelists said that some of these prices are unprecedented, perhaps not in our careers or lifetimes. Unfortunately, some of that is not -- less true of me probably. I remember when soybeans hit 1290 back in the summer of 1973, and only recently eclipsed that price. So that gives you an idea of how long it's been since some of these prices have been around.

This is simply sort of a reference. I think the Acting Chairman referenced some of these price changes year over year, and it's true in a couple others. You can see there's a few negatives there, lean hogs and live cattle, and obviously we've got some producers here that aren't too happy about the relationship of corn being on the upper end and going very high and some of the livestock markets going very low.

Again, these are the fundamentals, I'm just going to quickly go through, because I know Doctor Bange has many of these same slides. This is corn stocks-to-use ratios and ending stocks. Corn actually, through this year, looks less remarkable than most of the others, except for this aspect, and this is corn used for ethanol, both in terms of billions of bushels, the green line versus percent of production, and you can see that is again, I'm preaching to the choir here, most of you know, over 30 percent of the U.S. corn crop this year is likely to go to ethanol.

World wheat, first looking at the world situation, and some of these are annotated, you can see world ending stocks are the lowest since

1977, better than 30 years ago. World stocks-to-use is the lowest on record, which I believe go back into the '60's.

U.S. situation, much the same, if not worse. You've got to go back to the mid '40's to see similar ending stocks low, that is, and stocks-to-use ratios when we were shipping wheat over to the war ravaged Europe as part of the Marshall Plan, and I wasn't around for that.

The soybean ending stocks, the remarkable thing is how we went from a record high ending stocks, the end of the -- '05/'06, and the very next year, of course, because of diversion of acres to corn, we went to one of the lowest sets of figures as you look back historically. Rice world ending stocks, lowest since 1983, stocks-to-use, lowest since 1976, again, very remarkable numbers. That was the world U.S. Situation, ending stocks down substantially from the last year, you see that big drop off, lowest since 1980, stocks-to-use ratio, lowest since 1974. These are amazing numbers. When you look back at that price chart and that little box of inset, it's not like we exceeded some of these prices by a couple of pennies or a nickel, in some cases it's literally dollars per bushel, which is just incredible.

Diesel average price, I show diesel price, we're all painfully aware, farm community particularly as they fill up their diesel for farm equipment and what not. Many of the rest of us see it in terms of gasoline prices.

But as you can see, diesel is, of course, vital to the agricultural community. Virtually every way grain and produce move uses diesel, whether you're talking truck, rail, barge, or whatever.

So you can see clearly we're in record territory for this time of year. And the last report in April, we're still rising. And if gas pumps are any indication, that's not going to change any time soon. And, of course, one aspect of diesel prices is clearly how it effects the Illinois barge freight rate, and I show barge freight rates, but, of course, the corn and soybean futures contracts are essentially an Illinois Waterway System contract for export using barge rates. And, again, you can see where we are historically this time of year, well outside. Oh, and let me show you the set up on these, because you're going to see this kind of a set up on a lot of other graphics. And I probably should have shown it on the last one.

The vertical bars that you see there are a measure of history, in this case 11 years, from 1994 through 2004, kind of a high/low during that 11 year period. The red line is the median over that time period. And then we'll often show the last few years in perspective, and then, of course, this year. And you can see these are monthly data and where we are. This spike here, of course, was the Katrina and its effect on barge rates.

And I will, by the way, just as point of know, this is -- for cost, bushels of corn, and I'll refer to this later, this is the March, and it was about 85 cents a bushel, and you're going to actually see -- reflecting that in the very next slide.

This is the corn basis in the fourth week of March, so a couple of weeks ago now. Again, the historical range of the basis in that week of March going back, and then the red is the median, and then the green represents this year, the blue represents the year prior. The Gulf basis is actually historically quite strong, and it looks like about 55 cents over.

Upper Illinois River, however, is outside the range, and even less than last year, which was outside the range on the down side at about 30 cents.

But, of course, if you take the 30 cents versus the 55 cents, 85 cents, it's no coincidence obviously that an 85 cent difference is going to reflect largely that 85 cent barge rate. And then you can see where we're at, some of the other locations. Some are within the range, most are weak.

Wheat basis separated this into the three variety -- main varieties of wheat, the spring wheat at Minneapolis, cash prices, hard red winter, traded on, of course, the Kansas City Board of Trade, and the soft red winter wheat, traded, of course, in Chicago, and you can see the relationships there of basis historically.

Gulf, the high end of the range; Chicago, near the low, slightly -- only slightly better than last year. Wheat in Minneapolis, a dollar over, cash, a dollar over, obviously very, very strong historically. Wheat, hard red winter wheat, again, very strong, but Chicago wheat has been somewhat -- Toledo, of course, being the major delivery point for this contract, and it's pretty much right in the middle of the range. Soybean basis, similar to the others, although here, again, most of this is different. In this case, it comes out to about a dollar, so it's not entirely explained by barge rates, but, of course, barge rates are going to be the bulk of that, but uniformly weak, and we're going to see that in some of my later graphics.

We're obviously approaching the expiration of the May corn futures contracts and the May contracts for the other major markets here. I certainly don't expect you to follow any individual lines here across the page, but this is how we end up.

This is matching the futures price to the equivalent of putting grain, in this case corn, on a barge on the Northern Illinois River, in zone one of the Illinois Waterway System, the northern most zone of the system. So a zero means that you are indifferent between the two. If the line here is weak, that's a weak basis, that means that you would not be taking futures delivery, to take delivery, because it would be far more expensive. It would be cheaper to buy it on the river rather than take delivery.

An interesting thing, 2000 was the first year of this Illinois Waterway System. You can see we had, relative to the other years, very terrible convergence during that year. Last year we actually had quite good convergence, 2007. One thing I would note, folks talk about, and I'm going to be talking about index trader's index funds very shortly, but we had very little index participation back here, and we had very heavy index participation, relatively speaking, here in 2007. 2006, another bad year for convergence, somewhere in the middle there. 2008 sits out here by itself, extremely weak corn basis.

This is new crop corn, that was May corn, this would be new crop corn, and how it looks historically. So -- and these are the calendar weeks. So, of course, new corn will go off in about the 50th calendar week, in mid December.

And you can see, regardless of where it started here, discounts of let's call it 22 to maybe 35 cents. We typically end up, on this new crop corn, we end up with a basis of about ten.

Now, this is north elevator -- in north central Illinois. So you can see where we start out, where we end up. This year it's a little hard to see down there, but there it is. We're obviously starting out at a much, much lower level, probably at least twice as weak in terms of basis as we've seen in the past -- instead of the normal sort of, you know, at least maintaining a weak basis, and then finally converging to about 20 cents under, sagged quite a bit, it never did converge as well as years before that. And again, this is what we're looking at this year, unprecedented, probably three times as weak as we've seen in years past.

We've heard a lot about new crop hedging in some of the commodities, and the fact that there are folks out there that -- local elevators and even some major merchants that are not writing fixed price contracts out more than 60 days, not against new crop positions, so we wanted to look at that and see if we could see the impact of that. It's clearly happening. We wanted to see if that was impacting some of the amount of new crop hedging in some of these markets.

We picked corn, for example. So this,

again, the bars represent a history of how much commercials were short in futures for, at this time of year, from January through August, in the December contract, and months beyond December.

So it would be even including perhaps another crop year further out. How much commercial short positions we saw, we could see, not surprising with corn, since it was a huge record crop last year, 13 billion in 2007, we had a lot of short hedging, way beyond what we'd seen in past years. This year, 2008, we're actually exceeding that. I think that's about 15 percent or so. Yeah, we're about 15 percent above.

So in terms of large trader data, we're still seeing -- now, whether, of course, a lot of this hedging came on earlier in the year, but we are seeing substantial short hedging, even though certainly some of it has been curtailed because of some dampening of fixed price purchases.

New crop wheat, again, a similar set up in terms of the graphic. Again, we're seeing in wheat substantially more than last year, which was more historically, at least up through this point in early April.

So we're not seeing a lack of short hedging in this market, even though we know some of that's being curtailed. Of course, we're talking futures July and beyond to be representative of new crop. This is Chicago Board of Trade, so we're about a third greater than we were last year.

Oh, I'm sorry. This is soybeans, which, of course, would be the November future, and again, similar to what we saw in the past. This one is actually up about 60 percent from last year, the amount of short hedging. So at least in terms of large traders and amount of short hedging in the market in new crop futures and beyond, we're not seeing -- we're seeing an increase over last year. Now, this is where we get into -- a little bit of that was market composition talking about short hedging, but this is where we're really going to get into the stuff that's our shop and market surveillance, and I think this is what

-- add in a little transparency to this discussion.

This graphic shows how this thing that we've all talked about and we've heard a lot about, index traders, who they are and how they find their ways into the market. This is a class of folks that want exposure to commodities essentially as a security, as another asset class, like real estate, stocks, bonds, precious metals, all these various things that they invest in.

Commodities as part of an index are part of this, and, of course, it attracts a lot of institutional investors.

I think the actual European investors and pension funds got into this bigger, earlier than the U.S., but the U.S. is certainly catching up. And, of course, you have some individual investors now that are seeing this. We've heard an anecdotal story. I know Dan Brophy of -- when he was representing Commodity Markets Council, was talking about a broker and settling the estate, I believe it was of his mother, talked about investment, put five percent or something into commodity, so it's prevalent. How do they find their way into the markets? And you can go through financial services firms, the Wallstreet type firms, the swaps dealers, banks, all these sorts of things, where they may give you a swap agreement, they will give you the return on an index, for example.

You might find its way to a hedge fund, a mutual fund, there's a number of them out there now, there's some ETF's out there available to anyone who wants to participate.

Certain wealth, financed folks may want to do it themselves and go in a replicated index. Most of the major -- how they work is not proprietary and you can replicate them if you want to go through that effort.

So where do they find themselves, where do they land in the markets? There's designated contract markets, the ones represented here today, CME Group, ICE Futures U.S., NYMEX, that sort of thing. There's over-the-counter trades, there's other exchanges that might be available.

For the ags and the softs, they primarily focus on designated contract markets. There's less developed here, but they are increasing all the time, so there seems some diffusion there, even over the last year or two we're seeing some more diffusion. Energies and metals, of course, have very highly developed over-the-counter and other exchanges available to them. One of the differences here is how you might be treated.

If a firm has done a swap, that's considered commercial activity in a policy decision made in the early 1990's, and that does gain an exemption, we require that it be done on application, it's not automatic, that it be non-leveraged, that it be passively managed, that it not be actively managed with a view toward price, and that it stay out of the spot month.

If you've come this way, these are considered non- commercial, either directly -- because you're looking for market exposure, you're not trying to cover an exposure, you're looking to gain an exposure.

Now, of course, is these folks run up against position limits or for some other reason, they could do a swap here, and then the swap dealer could hedge it. So there are various methods to get the money into the market. But it's certainly a lot of money, and I think we'll hear from some representatives of some of that money and talk about that. With the Commission, in response to hearing from a number of agricultural groups, they wanted more transparency in the market, so beginning January of a year ago, about 16 months ago, we began publishing more data for 12 particular markets in the agricultural sector, where we thought our data was quite good relative to some of the other markets, and where this type of trading was significant.

This is the way it looked before and it still looks. We still publish their traditions. This is the way the new report looks, and you can see this new column has been added showing index money.

For example, most of these are long only, so you can see all of a sudden we've got 215,000 contracts. Where does that come from? You can see it came out of in this particular week, which was April 8th, 184,000 of that came out of the commercial category, 30,000 contracts came out of the non-commercial category, so roughly a six to one ratio in terms of where those positions were in the traditional report and where they came from to find their way into this index trading report.

This little graphic shows the numbers of contracts. The blue line represents the numbers of contracts devoted to index trading on a net basis, it's the net long, and of course, it's almost all long anyway. And the red box represent percent of open interest. So you see, for example, corn, which is the largest has nearly 450,000 contracts net long on this particular date devoted to index trading, and that percentage which we read on the right scale was about 20 percent of the market.

So even some of these are very small markets, feeder cattle, Kansas City Wheat, but their percentages are comparable. Interesting to note, the markets right now are recently with the highest percentages, at what, just under 45 percent. If you'll remember back in those price charts, those were a couple of the weakest markets, in fact, had year over year negative changes. So, clearly, it doesn't seem to be related to percent of index trading in the market.

Now, I have heard the argument, well, these are not storage markets, and if you look at only storage markets you see a better pattern. But, of course, you've got things like rice which had more than doubled in price, you saw something like 120 percent increase, and the amount of index trading in rice is very, very small, it's not published by CFTC. And, of course, it you look at that volatility graphic, if you remember, I think my first data slide that showed Minneapolis Wheat going sharply higher and sharply lower, there's virtually no index trading in Minneapolis Wheat. So we find it hard to find a direct relationship between the amount of index trading by percent or otherwise versus some of the volatility and some of the price rises we've seen of late. At least there's no simple analysis.

This graphic simply adds all the numbers of contracts devoted to index trading in these 12 markets, and you can see them layered here and referenced over here, sugar, and cotton, and cocoa, et cetera. And if you add them all up, there's so many contracts of corn, so many contracts of cocoa, obviously we know we're adding very similar things. But I've seen this analysis done by others, as well.

You can see there's about a 38 percent rise, it's not really, it just happens that it seems to match this scale, but there's about a 38 percent rise from about January of last year through current.

Meanwhile, what is that percentage at least on an average basis, percentage of their respective markets, and you can see that's not nearly rising so much, it's been kind of in a range here and gotten up to about 30 percent. Again, no real simple solutions to some of this. This is part of the extra transparency. You're actually -- those in the room and able to see these or access these graphics later are actually going to get a little dose of additional transparency, one is this. When we publish the data, we publish it all futures and options combined. This is actually futures only. And as most know, most of the index trading is concentrated in futures, they do some options, it's not a great amount.

So here's the wheat futures position as actual numbers of contracts, very, very flat. In fact, it has been rising through it looks like about March or so of '06, and since '06 has actually declined in terms of numbers of positions.

Similarly, percent of open interest reached a peak. Again, this is different than what we publish, it's more transparent, at about 65 percent, but lately it's been channeled in this area at around 40 to 45 percent.

So the actual amount of index trading in wheat futures has flattened out and maybe even declined a bit over the last quite a few months, and the open interest is -- did I miss one? Okay. So this is another graphics, similar sort of data, and again, this is a little bit more than what we give to the public normally. This is daily data, and it shows the blue line is CIT, Commodity Index Type Traders, again, that type we've looked at. The green line represents managed money. This is actually a bit of a subset of the non-commercial speculative trading that we do publish. This is -- it's probably a little hard to read, but it's essentially commodity pools, which are like the mutual funds of the commodity industry, trading advisor, hedge funds, things where they're managing lots of accounts, not individual speculative type activity, it's group activity coming into the market, and you can see what they've done over this period of time.

The red line represents the price scaled on this side, and then the blue line represents commercials in the market. And you can see actually managed money has declined a bit. It's been fairly flat. Typically you'll see these sorts of things, where price does this, managed money does that, because they tend to be trend followers.

But we have noticed that even times when prices are rising quite sharply, as you see here, often times managed money has potentially reached its tolerance for risk in that particular market or exposure, and we often see it flatten out even though prices continue to rise.

Here's the similar data per week, again, commodity index type money as it should have been evident from that earlier chart I showed, very, very flat during all these volatile price movements, managed money, very relatively small, and again, relative flat, and then here's the commercial. And finally the soybean market, and again, I want to go through these fairly quickly.

But you're not seeing the sorts of things where you see this -- of a mirror image here to the price down here during that period of time, they look very, very similar, but as prices as soybeans sky rocketed to reach over $15, managed money did very, very little during that period of time.

Finally, this is my last slide, I wanted to point out one thing of a market that attracted literally I think the world's attention in the January, February, and at least a part of March, and that was the Minneapolis grain exchange wheat futures contract. I don't care where you were in the world, I think you heard about what was going on here.

Let me set up the graphic. The red line represents the March Minneapolis grain exchange wheat price.

The blue line represents a synthetic March futures price based on options. You can create, I'm not going to go into the details, but you can create an equivalent futures price by the appropriate use of options. The green price represents Minneapolis cash prices. And I've annotated here a couple of things. Don't normally see futures price behave this way, a very, very flat, straight line, but that was because they were literally locked limit up day after day after day, even though I think around this point, as you looked at the market about February 8th, there was about a $3 to $4 difference that futures price was under the cash price.

The synthetic futures price was right on top of it, as you can see. So it was providing some price discovery that the futures was not allowed to provide because of this artificial lock. And you can see, even though it may have traded on some of these days, it essentially closed at limit bid each day.

Then all of a sudden you see a different slope to the line. Beginning on February 11th, of course, new daily price limits took effect, what would rachet them up by 50 percent, and then again and again by 50 percent until they reached, I believe 202 1/2 at one point for the Minneapolis that was not -- the same sort of pattern of the other two wheat exchanges. So all of a sudden you see the market again move to a higher plane until finally, in about this area, we reached some convergence, where all three, the synthetic price, the cash price, and the futures price were finally free to trade due to these freeing of the limits, raising of the limits. And then here the options finally go off, so you don't have the options line past that date. And then finally, as you got into the -- very close to expiration here, we had very good convergence. And by that time, in the Minneapolis contract, there were just a handful of futures contracts left.

So that's a little bit about how we're reviewing that market and this a wide difference between cash and futures and how the futures market really wasn't providing its price discovery function at that point in time. Let me turn it over to Mr. Fenton and he'll talk about cotton.

MR. FENTON: Do you want me to switch?

MR. LUKKEN: While we do that, I just want to make a couple notes. We're trying to get everybody's slides, and I apologize we didn't get these beforehand, but we'll soon have all slides before all the participants so they can see them before them, as well as on the screens. Also, for the people at home that are watching, we're not able to put the slides up and broadcast the participants, but the slides are available to print out at home in case you want to follow along. So I just wanted to let people know. And also for the folks in the atrium, there are cards on your chairs to ask questions. Please fill those out and pass them to CFTC employees and we'll be sure to try to pepper questions throughout this morning's proceedings. So with that, back to Doctor Fenton.

MR. FENTON: Okay. Thanks, Mr. Chairman. The story of cotton has similarities to what Dave has talked about, the grain markets, similarities really in the problems or the symptoms of problems in the market, but it has a significant difference, as well.

Whereas the grain markets are fundamentally tight, there is low stocks and strong demand, cotton, there is plenty of cotton around, and so we've had a discreet episode during the last couple of months in cotton that doesn't seem to be explained by the current fundamentals.

If you look at this graph, until mid February, cotton seemed to be going along without a problem, it was rising fairly gently. In mid February, the market seemed to notice that cotton prices had risen less than other agricultural prices, competing crops. And the expectation that acreage would be down for a second year caused prices to start to rise. And so we saw a pretty sharp rise, a very sharp rise in prices from mid February to the end of February. And then beginning in March, we had some really strong price moves and very volatile trading, in fact, fairly chaotic trading conditions. The thing that ties cotton to the other agricultural markets, of course, is the competition for acreage. As corn acreage has gone up because of ethanol production, and acreage has shifted from other crops, they've certainly shifted from cotton.

So last year, cotton acreage was down from -- to 10.8 million acres from 15.3 the year before, that was a decline of around 29 percent. But there was exceptional yields for acreage, so we actually had a fairly large crop, 19.4 million bales of cotton. This current year, the current estimate is that the crop will be 9.4 million planted acres, and that would be another 13 percent decline in planted acreage.

Cotton's usage, there's been a long term decline in domestic use of cotton. The current USDA estimate is that for the current crop, 4.7 million bales will go to domestic use, and 14.5 million bales will go to export, so that's a total use of 19.2 million bales, and remember, the production was 19.4, so we've pretty much consumed what we produced, so ending stocks have stayed mostly unchanged, they were up slightly from 9.5

to 9.7 million bales. That's 50 percent or slightly more than annual use. So there's a lot of cotton around, and a lot of it has now moved into certificated stock, which I'll talk about in a few minutes. This looks at the futures price, which is the red line, and the green line is the synthetic options price, and then we have some cash prices to see how the futures were moving in relation to the cash.

The light blue line is the North Delta spot quotation by the USDA. The dark blue line is the East Texas price quoted by USDA. And then the orange line is the seam spot price, which is an average price. And some of our -- the members from the cotton trade here can talk more expertly about these prices.

But the point I think here is that as the prices were rising, especially starting in March, there was a significant disconnect between futures prices and cash prices. And this is looking at the basis relationship between some of these prices.

So the basis versus the North Delta price is the light blue line, that changed, it didn't change as much as some of the other prices, and I guess it's a question of how accurate this quote is of really the value of cotton in the North Delta. The East Texas price, obviously the differential between that and futures went to a significant discount, peaked at a negative 18 cents, and the seam price went to a negative 25 percent, 25 cents rather. Now, how accurate these prices are I guess, you know, one can question, but the fact that so much cotton has moved into certificated stock seems to be strong evidence that the best place to market cotton is to move it into delivery location, that's so that indication of weak cash prices.

This Dave showed you for some of the other markets, it's the positions of index traders in the cotton market. The absolute positions are the blue line, and you can see that they've been going up since the beginning of the period, which we started in January of '04, so there's obviously a long term trend that index trading positions have been increasing.

Their share of the market has stabilized and, in fact, has come down a little bit. They were as high as 50 percent of the market in late '05, and they're currently at just under 40 percent of the futures open interest.

Again, Dave showed you this chart for the grain markets, so the lines all mean the same thing. The light blue line is commodity index trading. The green line is managed money trading. The dark blue line is the commercial traders in the market, it says commercial merchants, but it's really all commercials, so it would include coops. And I'm going to show you a more detailed picture of the most recent two months. But you can see that index trading has risen gently, and certainly not dramatically over the past few years. Managed money trading can be much more in and out of the market, and sometimes they're short, and currently they're long, although off from their peak long position.

Looking at the period from February, beginning of February through the beginning of April, so it's during the period when the market was most volatile, you can see that around February 13th, prices started to rise. And during that period, the managed money traders positions also started to rise, from around a net position of 50,000 contracts long to as much as about 75,000 contracts long.

The index traders positions also started to rise. They went up from about 105,000 to 123,000. So the combination of these two financial type traders, the positions of them went from 155,000 contracts to around 200,000 contracts, so that's an increase of 45,000 contracts during a little bit more than a week. But they -- the positions peaked, and then for a number of days before the most chaotic trading conditions, they actually were not in that virus, they flattened out and were in the, in the days before the March 3rd limit up day, and then March 4th was also limit up. During these days, they were not buyers, and hadn't been buyers for several days. And, in fact, during the days of high prices, both groups were sellers in the market.

And the merchants or the commercial trade as a whole, during the period of the buying by the financial traders, they were sellers of futures, and during the period of the most rapidly rising prices, it was actually commercial firms that were buying back positions.

Now, I know that this may well have been in -- it was not voluntary in the sense that it was a result of having margin calls that couldn't be met and having to cover positions. But the point I guess I'm trying to make here is that during these days, the financial traders were not big buyers in the market.

I mentioned that certificated stock has gone way up, I don't think it's ever been this high. Over a million bales have moved into certificated stock. That's ten percent, more than ten percent of the carry over of cotton. And the spread relationship, which is the green line, the May/July spread, has weakened from 175 point discount made July to -- I think as of the close yesterday, it was 393 points. I think the Cottons Shippers Association, in their submission to the Commission, estimated the cost to carry it round 290 points, so we're 100 points beyond the calculated cost of carry.

And just one final slide, Dave showed you this for the grain markets. There's a lot of commentary, I presume it's correct, that the problems of putting on hedges in the futures markets has caused commercial firms both in grain markets and the cotton market to limit the amount, or in fact, halt forward hedging of positions.

And so we looked at our data to see whether we'd see in the data that there was less hedging in forward months than in the past, and as Dave showed you, in the grain markets, cotton is similar, that there is, in fact, more short positions in forward months than there had been in previous years, considerably more.

But in the past five weeks, there has been basically no additional short positions. So it certainly consisted with the story that people have stopped forward hedging, at least temporarily. So that's some of the background data that we've been looking at, and I hope it's helpful to the discussion here today.

MR. LUKKEN: Well, thank you, John. Before we turn it over to our discussion today around the roundtable, we've asked USDA to give a brief overview of some of the fundamentals that they're seeing in the agricultural markets. So with that, I'll turn it over to USDA, and I appreciate their participation.

We are running just a little bit late, but we will adjust the schedule to accommodate everybody -- there's time for everybody to speak. Thank you. I guess we need to get tech support to change the Powerpoint.

DR. BANGE: Good morning. Again, my name is Jerry Bange with the USDA. I want to sort of cover some of the same territory that Dave and

John have covered. They focused more on prices, we were going to look a little bit more at some of the fundamental underlying factors.

As Dave said, many of you are living these numbers, and who am I to give you more details about what you're already living. But I do think we can add a little bit to the conversation here, and I'll try not to cover the same ground that Dave and John have covered.

Under Secretary Keenum laid out some of the big picture in his opening remarks. What I'd like to do is talk a little bit more about the market fundamentals and some of the uncertainties facing the market that we think are contributing to the -- not only to the volatility, but to the very strong prices that we've seen of late. I'm going to go through a series of slides here. Some of them you'll probably barely get a look at before they're gone. But I understand that there's going to be copies available, and we at USDA certainly will put them on our web site so you can look at them later.

What I'd like to do is just focus on about six or seven points here that we think are really underlying the commodity situation. Again, I'm not going to go into the detail. Each one of these probably could have a discussion of its own for an extended period of time, we don't have time to do that. I'll try to keep my remarks, by the way, to less than about 20 minutes. So don't get worried if it seems like it's getting a little long here.

There's some factors -- the underlying factors that I would cite would be this very strong demand that we're seeing world wide for ag commodities right now. I think everybody would be in concurrence with that. Obviously, the rising petroleum prices and increased production of renewable fuels is adding to the situation. Along with that we have tight grain and soybean stocks, as been mentioned. I want to say a little bit more about world wheat when we get to that, because that did draw a lot of attention recently with the huge price run ups we saw, particularly on HRS. We've got -- world wheat consumption has exceeded production in six of the eight -- six of the last eight years, you may or may not know.

And then Under Secretary Keenum mentioned something about the restrictions on world exports of grains, I'll say a little bit more detail on that. And then John just talked about the U.S. cotton situation with regard to the lower area, so I won't say a whole lot about that other than to show it to you when we get there in graphic or tabular form, and then say a few words about the rising input costs.

As I said, we've seen strong demand for world ag -- world wide for ag commodities. We've seen very strong income growth in the developing countries, India and China, in particular. And it's also noteworthy again, as Under Secretary Keenum mentioned in his opening remarks, that some countries are buying very, very strong, despite the very high prices that we've seen, Japan, of course, being a case in point particularly with regard to wheat. And then underlying this whole discussion I think we're having this morning probably is rising petroleum prices as much as anything and the increased production of renewable fuels, notably using corn for ethanol in the United States and oil seeds for biodiesel in the EU.

The tight grain and soybean stocks again have been mentioned. U.S. wheat stocks are at a 60 year low. I was not at USDA when that happened, but I was at USDA when the 30 year low happened for the world wheat stocks, and so we're seeing remarkably low numbers.

Corn stocks are down sharply, likely to decline further in 2008 and '09, as most of you probably know. Soybean acres were down sharply in 2007 and '08, but fortunately at the beginning of 2007 and '08, we had very, very high soybean stocks which cushioned some of that 400 million bushel shortfall with regard to production.

On the South American situation, we kind of expected more soybean acres to appear in Brazil in 2007 and '08, it didn't happen. There's a variety of reasons for that which we could discuss. But be that as it may, the Brazilians did not increase acreage as much as we thought. Nevertheless, they are going to produce a record crop which is playing into the market now. And China's imports of forecast seem like they just go on ad infinitum, it seems like to be no end to it with regard to what they can import, and their imports are growing to record levels. The world wheat consumption, as I mentioned, has exceeded production for six of the eight last -- six of the last eight years. Yields have been below trend in the major exporting countries, you may or may not be aware of that, for the past two years.

Everyone is aware that Australia recorded two back to back crop failures, just a bismal of crops. Essentially they lost one full year's output and the two last -- in the two past years, just huge losses there due to drought. Hopefully the situation there will improve this year.

EU crops have been below par, U.S.

yields have been below trend, and Canadian crops have been below average.

So all of this has contributed to the -- certainly contributed to the wheat situation.

On the restrictions on world exports, specially Ukraine, Russia, Kazakhstan, have all curtailed grain exports in some manner. Argentine has shut off export registrations on corn and wheat and raised taxes on soybean exports. Vietnam, India, Egypt, Cambodia, and China have imposed various restraints on rice exports. The exporters are having difficulty securing supplies to meet their contracts. And again, Australia exportable supplies have been down sharply due to drought. The cotton situation was discussed in some detail by John Fenton, I won't go into a lot on that other than to say the cotton acreage lost to competing crops, as you well know. The 2007 export forecast has reduced; we have come down on that as the seasons have progressed due to diminished China purchases. And increased competition from India, you may or may not be aware, but India is coming on very, very strong in terms of cotton production.

The U.S. areas forecast to decline again in 2008 and '09. Projected net returns are expected to favor grains and oil seeds over cotton, so we would expect to see less cotton acres. Again, cotton -- competitor production has been growing very sharply, notably in India, it recorded a very, very large crop this year. There's other countries we could talk about also, but there is a lot of cotton coming from elsewhere in the world.

China has produced a series of excellent crops. We think that plantings in China this year will, at best, be the same as -- will, at best, be flat in 2008 and '09. The Australian crop has been reduced by drought. Hopefully that situation there will improve. This year Pakistan has had a number of insect infestation problems which have lowered the crop there. On the issue of rising import cost, again, we come back to the idea that rising fuel prices, fuel prices are up sharply, and again, underlying much of what we're talking about here today.

One thing that's not been talked about is, fertilizer prices are at record highs. What we're looking at now is very strong global demand, higher incomes, improved cultural practices, more cultivated area amid these rising prices for ag commodities, so you would expect to see more fertilizer usage.

At the same time, the U.S. dependency on imports is growing. Domestic production accounts for less than half of nitrogen needs in the U.S. right now. And, of course, the disproportion of that impact will be on corn, which is a more intensive crop.

Just a word about the balance sheets here. Balance sheets, of course, are sort of our life and blood at the World Agricultural Outlook Board. It's been mentioned a few times, the situation with regard to stocks on wheat, we see they're very, very low for that 2007/2008 column, very, very low ending stocks, 242 million bushels, again, a low by many, many years. Also along with that, we're seeing an average market price of 665 for the year, which would be far and away a record, nothing even close to that. You'll notice on that 2008/2009 column, you may say, where did that come from, that came from our outlook forum. And it so happens that at the outlook forum, the analysts at USDA did a pretty good job of guessing what the wheat area would be this year for the 2008/2009 crop at 64 million acres. If that comes to pass, and we have the S&D numbers correct, we're probably looking at another record price in 2008/2009.

I would hasten to add there, though, if you look at these numbers, you'll notice that the export number for 2007/'08, the 1275, was a high number by recent standards. Our exports have tended to wind down in recent years, but they came back very sharply this past year for the factors that I mentioned earlier.

However, we do think that there's going to be a significant increase in world wheat production in 2008/'09, leading to lower U.S. exports in 2008/'09. However, we still see a very strong price outlook, primarily because we expect strong prices in the first part of the year. I just wanted to mention here that one of the reasons that people sometimes do not understand our price forecast is, we look at the prices received by farmers, and what this graph or what this chart is saying here, by the way, there is an error here, this 81 percent marketed is not September/January, it should be for the June to January period.

My point here in this chart is simply to say that wheat marketings and most other ag commodities, as a matter of fact, are sort of front loaded, they occur very early in the year. That's one of the reasons that we see the kind of prices we see now. I'm sure that many of these people who sold early in the year, regardless of which commodity you're talking about, probably have regrets this year for having done so. It probably led to a few interesting discussions around the dinner table about why did we market the way we did given the prices that we're seeing now.

On the U.S. corn S&D, the 13 billion bushel crop has been mentioned. 2007/'08, again we see a record price there of $4.30. Now, this one for the 2008/'09 column, I must do some explaining here. On 2008/'09, we're showing a planted area of 90 million acres, that was what the analysts at USDA thought the acreage report would show. As you well know, the perspective plannings report, many of you well know, showed only 86. Just let me say that the year is not over yet, we'll see what the acres turn out to be. There's been a lot of discussion of what the corn acres are going to be versus what the soybean acres are going to be. I think that most USDA analysts, if they were left on their own, they'd say we think that maybe those acres, corn acres, may be a little higher than our perspective plannings report showed, but that's the official number, the department at 86, however, using 90, we still get a record price for 2008/'09.

Going through the balance sheet once again, we see this very large use for ethanol, 3.1 billion bushels in 2007/'08, 4.1 projected for 2008/'09, again, that's based upon an acreage, which is higher than what we're showing in the perspective plannings report, and still showing a record price again of 460. One can only imagine what the price would be if we were looking at an acreage of 86, so that remains to be seen.

Again, corn marketings, front loaded, 56 percent, so front loaded for corn, as well. I just would mention, in looking at the corn production in total use numbers here, while we had that record crop, that's that sort of brown color column there in 2007/'08, our consumption actually exceeded that number, that huge record number based upon that very large area. We still managed to consume more of that, again, largely because of the corn use, and also because of the very, very exports and domestic use. The soybean S&D I mentioned earlier, about the 2007/'08 year. I apologize, you'll be able to look at these in a little bit more leisure at some later time.

But anyway, 2007/'08 did show, we started the year with a beginning level of stocks at 574 million bushels, which really was helpful, because as already been mentioned here, the planted area decreased very, very sharply, looking at a very huge drop, between 67 and 78 in terms of the acres because of the shift to corn.

However, when we got to the bottom line here, we had the 160 ending stocks left over, primarily because -- which is a low number, but primarily because we started with a beginning level, which was so strong.

Now, on this one, we have the opposite situation, what we had on corn with regard to 2008 and '09. The perspective plannings report showed 74.8 million acres. Our analysts at USDA had been working with 71. That would yield a price at about 11.50 for the 2008/'09 year. Again, prices would increase, however, at 74.8, one would expect to see a lower price for soybeans in 2008/'09.

Again, soybeans are marketing a front load at 60 percent through January. The reason we use January here as sort of the point to take a look at how much of the crop was marketed. Much of the price volatility we're talking about here occurred in the February/March period. That's when the markets really seemed to, for whatever reason, get very, very volatile and take off in many instances. We'll talk a little bit more about that in a moment.

Soybean oil is another one of those crops. It's got involved, of course, in the biodiesel industry. The biodiesel usage here at -- for methyl ester, which is sort of synonymous with biodiesel, 2.95 billion pounds in 2007/'08, projected to rise to 3.5 in 2008/'09.

I'll just say parenthetically here that the 2.95 billion pounds is not as high as what we had thought about earlier. We had seen -- we had had some higher numbers when we projected this. The reason we came in somewhat lower is because of the -- the usage has been lower, we'll see here in a moment, has been because of the very sharp run up in the soybean oil prices that basically made it inefficient or economically infeasible to use it to produce biodiesel. We'll talk a little bit more about that in a second. We have seen a huge run up, a very sharp run up in soybean oil prices, at 52 cents for 2007/'08. Meal, I only mentioned here, primarily because, like other ag commodities this year, we've seen a sharp run up in that -- those prices. That's not of great consequence. It might be good for a soybean producer to see that, but it's not so good for a livestock producer to see that. So we get a lot of discussion on the other side of the ledger here with regard to the negatives associated with these sharp rising prices, that the livestock producers are feeling the brunt of that, and we do, of course, hear that at USDA and we understand their concerns.

Just a little bit about the 2007 Energy Act, again, just as a reminder here, everyone knows about the 15 billion gallon corn based ethanol starting in 2015, we're well on our way to that. The mandate calls for an ambitious start of nine billion gallons in 2008. We say ambitious here, but I can tell you that our capacity to reach that will far exceed that in 2008, so we're doing very, very well.

By 2016, all of the RFS increase must be met with cellulosic ethanol or some other foreign state -- non-foreign start biofuels, which really I haven't seen what that's going to be yet. A lot of research done in that area, but right now, corn looks like it's the only game in town with regard to ethanol production that makes economically any sense. The ethanol production capacity in this country has grown very rapidly. This chart simply shows what the capacity will be at the end of this September. We're looking at a capacity of about 11 billion gallons, a very, very sharp increase over time, and we're well on our way to reaching the mandated number.

Look at it in terms of corn usage, our projection for 2008/'09 suggests that more than 30 percent of the corn crop will be used for ethanol, once again getting up pretty high numbers. That number, as you can see, that percentage is growing every year.

You may be curious as to what the mandate suggests for 2015/'16. If you work through the arithmetic and using the present conversation factors, it would look like about between five and six billion bushels of corn would be used to produce ethanol in 2015/'16 to reach that mandate.

I will mention that the exports, even with one of the concerns we heard earlier on, with the growing use of ethanol would be, could we still maintain our exports. We did, in fact, or we will, in fact, in this year, 2007/'08, export a record corn crop. So even with the -- what we've done with regard to ethanol, we're still managing to export a record corn crop. Much of the discussion here has been around prices, I won't belabor that or talk about that anymore. Everybody knows the sharp run up in prices here.

I will just mention, though, look at how these prices have run up since September, September, $3, now we're looking at corn prices well over 5, well on their way to 6, in some cases even over 6, we've seen prices, so it's been just a sharp run up in prices.

On the biodiesel mandate, that one is written in a little bit different terms, that's written in terms of consumption. That one has been struggling a little bit for reasons I'll talk about in a moment. It says that we will consume a billion gallons of biodiesel within the next few years. And we're having some difficulty reaching that for a number of reasons, not the least of which is price.

One of the heavy consumers of biodiesel, more so than the U.S. really, in relative terms, of course, would be the EU. So much of the growth in EU, in biodiesel consumption world wide, much of it is right in the EU.

One of the reasons that soybean oil prices have not been a very -- soybean oil has not been -- we've not been using the capacity, the production capacity we have on biodiesel in the U.S., which far exceeds what we're actually producing, is because we've seen this very sharp run up in soybean oil prices. It appears that the vegetable oil or food use people can outbid really the people that are attempting to use soybean oil to make a methyl ester or biodiesel, and as a result of that, we've actually seen some negative margins here, and when the price gets up to 55 or 60 cents for soybean oil, you're basically looking at a $4 commodity that they're trying to make a $3 commodity out if, and that doesn't work too well. So the bottom line here is that we've seen some fits and starts in the biodiesel business.

On the soybean prices, again, like corn, we've seen a very, very sharp run up. Note the sharp run up in prices since September. The cotton S&D, I'm not going to talk about that very much. John has already mentioned the sharp drop in area that we've seen in 2007 and '08, owing to the fact that they're switching from -- to a more favorable profit. We expect to see that again.

When USDA analysts looked at this back in February, they were thinking in terms of 9.5 million acres planted; it turned out to be 9.4 in the perspective plannings report. I won't say more about that at the moment. Again, marketings are front loaded, 62 percent marketed here by January. Again, on this one, if January -- it was after January that we saw a very -- the very volatile market, and so much of the crop had marketed by the time that that happened.

Again, this is a graph that John has shown in another form with a very, very sharp run up in cotton prices, not for -- we don't understand the connection there, or there appeared to be a disconnect, should we say, between the market fundamentals and what actually happened.

And then another way of looking at that is this volatility. You can see that, it's just huge, it just shows up very well here, how volatile the market became. Now, let me say a little bit more about this area situation. These are the numbers I put in here, you can look at at your leisure, these are the planted areas -- numbers that came out of the perspective plannings report.

One of the things I would point to here is that the overall increase in acreage for the commodities I've listed here is between five and six million acres for 2008/ '09. Again, it shows the corn acres of 86, and it shows the soybean acres of 74.8, and there's that 9.4 million acres that John has talked about with regard to cotton. Just focus a second on the corn and soybeans acreage and some of the factors, we were looking at USDA. Even with the fertilizer costs being what they are, we see that the net returns outlook for the field props are very good. You'll notice the only one on here where it doesn't look great right now, of course, is cotton.

On corn and soybeans, we're seeing a continued increase in the net returns prospect for 2008. There's been, relatively speaking, a large increase in net returns for soybeans. However, if you look at the returns in total for corn, it's still favorable for corn, is one of the reasons why the USDA analysts think that maybe we'll see more corn than the perspective plannings report showed.

If you go to the next chart, it's a very, very interesting chart, because what this chart shows is, if you look at that red line, that red line is what -- is the ratio between soybean and corn prices. When you have a ratio that's in the realm of 2.5 to one, meaning soybean prices are two and a half times what corn prices are, generally that means you get more soybean acres. Farmers would prefer to go in that direction.

At the time the survey was taken on the perspective plannings report, and at the time, we're looking at the -- the farmers are looking at the perspective plannings report or deciding how to respond to that, the price ratio looked very good. Since that time, the price ratio has turned much in favor of corn. And what we've seen in the past when that has happened, and the reason that it did that is, when the ratio was in the realm of two and a half or 2.4 to one, it looked like farmers were so called buying soybean acres.

Then it became clear that we had the -- that the soybeans acres were coming, and the perspective plannings report confirmed that, we saw that price drop on soybeans relative to corn, and we saw that ratio drop sharply.

So this is what farmers are looking at now, and they're still in the -- still working on what crops they're going to plant. So they'll be looking at this over the next few weeks as they go out to the fields and plant whatever they decide to plant.

Now, in the past, the reason I mention that, we've seen a sharp change between the March perspective plannings report and June. If you look at the numbers at what happened last year, the outlook conference started back in February of last year, the USDA thought, well, 87 would be probably the corn acres, and then by the time the perspective plannings report came along, the report showed 90.5, and then when we saw the June acreage report, which is a key report to look at, that number had increased to 92.9, and what actually happened was 93.6. My only point here is, between March and June, farmers can make -- or March and June, or March and what they actually plant, they can make very large changes in numbers.

This year, I guess we're looking to the fact that maybe we'll see somewhat more corn acres than the perspective plannings report indicated. However, the big question there will be whether or not weather will cooperate.

So far weather has not cooperated, it has been too wet in the midwest, it is drying out a little bit now, hopefully it'll dry out enough for that to -- for the farmers to get in and plant corn. If they don't, then the soybean acres probably will be very large, as the perspective plannings report showed. So we'll just have to wait and see how that comes out. Okay, thank you.

MR. LUKKEN: Thank you very much, Jerry.

Before we turn to our roundtable, I quickly wanted to welcome and recognize former Commissioner Fred Hatfield who's here today, and we miss you, Fred, but we're glad you're back in this capacity. And also welcome to some Congressional staff that we work quite closely with, so thank you for coming down here today. With that, before we open it up for questions, I know people have a lot of questions based on those broad presentations, but I've asked the CME Group to lead off the discussion, to give us their views of what they're seeing in the markets, and then I encourage you to start asking questions by, again, raising your placard, and we'll try to call on you and start the roundtable discussion. So with that, I'll turn it over to the CME.

MR. LEHMAN: Thanks very much, Acting Commissioner. And again, thank you to the Commission for holding the Ag roundtable, the Ag Forum. I'd also like to thank many of our customer associations that are in the room for engaging in dialogue with us.

We've had a very constructive dialogue with National Grain and Feed, in particular on how our contracts are working. We've had a number of producer groups and other organizations come into the Commodity Markets Council meetings that were held in Chicago two weeks ago. It's a very complicated situation. We agree certainly with many of the comments on the fundamental factors that are effecting the markets today. And one that wasn't mentioned, I was a little surprised, and USDA may have some data on this, but the exchange rate volatility or the depreciation of the dollar I think is a major factor that we see in the higher level of commodity prices.

What we're doing in addition to this forum, the outreach that we did to Commodity Markets Council, we are implementing some changes in our contract specifications that will come into effect in July of this year for the wheat contract. We'll be changing the delivery instrument to a shipping certificate, which increases the capacity for deliveries on the wheat contract.

We're increasing storage rates in the wheat contract, as well as in the corn and soybean contracts in November and December of this year by about ten percent. So we think these changes will improve the performance of our contracts.

We've also looked at just how the contracts are performing and recent expirations. And we've run charts that I know CFTC is very familiar with, I think we have some copies here of the last nine expirations in corn, beans, and wheat. So starting with March of this year working back, the January soybean, December -- in September of '07 expirations.

And out of those nine expirations, we see good convergence to, in some cases, excellent convergence in seven of those. We see a couple of expirations where we didn't see as good a convergence as we normally would. And when we're speaking about convergence, we're really looking for an appreciation in basis or a strengthening in basis as we move toward expiration.

I don't think we ever see an exact -- I mean we do at times see futures and cash come right together at expiration, but that's probably the exception rather than the rules, and studies going back into the '80's that were conducted look at convergence as a band around the futures price, plus or minus.

In the '80's, it was six cents or eight cents per bushel, plus or minus, it's what the academics felt represented convergence. I think with the higher price levels, certainly you could argue that that band is likely wider.

So those are things that the CME Group is doing. We are making changes, as I said, to our corn, soybean, and wheat contracts that we think we'll improve their performance. We're very interested in the feedback from all of our customer groups, everyone here today, and I think Commodity Markets Council will be coming out with a summary report of the feedback gained in those meetings. And, again, we thank everyone for their participation, and certainly be happy to go through some of our convergence slides or pass those around if you thought it would be helpful.

MR. LUKKEN: Any comments from the group?

MR. CAREY: I'd just like to say that -- first, I'd like to thank you for the presentations, the opportunity today. I think it's important to have dialogues like these.

I think that -- the one thing we are unanimous on here in this room, and there's probably nothing other than this, is that it's a very challenging environment to manage risk.

And I think the historical perspective that was communicated to this group through the charts, when you look at low stocks, high volatility, and the challenges to the risk management function, you see people trying to downstream the risk management function.

You know, I'm here to say that when we became aware of this as an exchange, as the former Chairman of the Chicago Board of Trade and now Vice Chairman of the CME Group, we basically took it very seriously, we do, we conduct the meetings, we participated in the CMC meetings that were held at Chicago Board of Trade. A couple of things we've done, we requested the Commission to defer consideration of increases in federal speculative limits until we see really what shakes out here, because while we still support those increases, we understand the environment, and we don't want to be accused of making a situation worse, whether it is or whether it's perception.

We understand that the market place is at a tough spot, particularly the traditional risk managers, the elevators, the processors, those people that take on the inventory and are the short hedgers.

We also recommended that new risk management exemptions be delayed. And really, for our part, as a solution, and Dave highlighted some of the changes to the markets, but you know, we proposed that -- prohibition on the clearing of agricultural swaps products, training the OTC market, because we really think that one of the things that we're going to have to discuss and put on the table is innovation, because the markets, because of whether it be a shifting paradigm, whether it be a one time admiration, the fact of the matter is, we're going to require more products, better products, to really meet the needs of the market place, because grain flows are no longer just the Mississippi River, they're east and west, there's ethanol included, there's feeders included, and to address all those things, a one size fits all, may not help, but if we continue to innovate in that area, we think we'll go a long way to meeting the needs of the market place.

And when I looked at those charts, I remember my father -- I've been a member of the Board of Trade 30 years as of last week, and I remember my father told me that President Harry Truman blamed the Chicago Board of Trade and a bunch of speculators for the high prices during the marshall plan.

So this is not unique, it's a

challenging environment, it's important that we all get in this room and talk about potential solutions that will work for everybody.

Thank you.

MR. LUKKEN: Thank you, Charlie. Yes, John.

MR. POPP: I'd like to echo or at least --

MR. LUKKEN: I'll remind the group to introduce yourself and organization for our transcript.

MR. POPP: Oh, yes, okay. I'm John Popp with the Independent Bakers Association, also CEO of a bakery in the midwest, Aunt Millie's Bakery. We are about $150 million regional bakery. But I'm glad to hear that there seems to be some hesitation to increase the speculative limits. The current limit of 5,000, 11,000, the magnitude of those -- that much is -- I don't know if many people really understand, but our business, we're the third largest private bakery in the country, and we only use 780 contracts a year.

My friend, Sara Lee, who is a $3.4 billion company, only uses probably 10,000 contracts. So to increase those limits I think puts so much power and dominance in the hands of speculative traders. And we like to see all of the funds be under the same restrictions of those speculative limits. Thanks.

MR. LUKKEN: Doug Hepworth.

MR. HEPWORTH: Hi, Doug Hepworth from Gresham. I actually saw a few people smile when Mr. Kass mentioned commodities as an investment, but they do serve a very valuable role. We offer our clients long exposure to commodities through diversified baskets of fully collateralized commodity futures.

And there have been 196 rolling five year periods since we started doing this in 1987. And the addition of a five percent allocation to commodities to a portfolio that's composed 60 percent equities and 40 percent bonds would have reduced the volatility of the total portfolio in each of those 196 periods. And the average reduction in volatility would have exceeded five percent. This volatility reduction makes this kind of investment very attractive to pension funds, who are trying to protect their retirement incomes of their beneficiaries.

Our representative client is not a speculator, he's not a hedge fund owner making a billion dollars to build a new mansion in front of his mansion in Greenwich, Connecticut. A representative client for us is a school teacher, age 42, making about $60,000 per year, and I just want to make sure that they're represented, as well.

MR. LUKKEN: John with Calpers. I know that you're a large organization pension that may use our markets; can you give us a little overview of how pensions typically get involved in our markets?

MR. KOWALIK: Sure; John Kowalik from Calpers. Similar to what Doug mentioned is that we are slowly increasing our allocation to inflation linked assets, which for us includes commodities, in effect, to one of the major industries, and we expect to increase it from a small amount to a, you know, still a very small amount compared to our overall portfolio. The reason we're doing so is because it provides a great benefit for diversification. We're generally getting our exposure passively. We do not participate in the front end of the market or have anything to do with physical commodities in terms of our investments.

So in terms of asset allocation, from a big portfolio perspective, it is a great performing asset. And, in fact, it's the diversification benefits that make it attractive as opposed to, of course, we'd all like higher prices and gains, but the diversification aspect is really the most important part of it from our big picture portfolio perspective.

MR. LUKKEN: Thank you. Garry.

MR. NIEMEYER: Garry Niemeyer with the National Corn Growers. We would kind of like to have a reexamination of how you define hedgers.

It's NCGA's opinion that large hedge funds have an overwhelming influence on the markets and they really are non-commercial traders.

Frequently we see dramatic shifts in futures markets that have really no substantial fundamental drivers.

While we do not want to drive the index or the hedge funds from the market, they should be treated as they are, speculators. NCGA realizes that large index funds are selling a commodity index and then going long in each of their market basket commodities, which could be construed as a hedge. But they are selling a market basket of futures prices, not a market basket of physical commodities. NCGA proposes that the index funds no longer be afforded the same margin requirements as traditional commercial hedgers. Specifically to be classified as a hedger, the entity must have a cash position.

We're not suggesting that they have an equal or proportional cash position, but somewhere within the company they must be buying or selling cash grain to retain the hedger classification.

We believe this will have a very limited impact on the market liquidity. The large funds are still welcome to take their net long positions in each commodity market, but they will have a margin requirement just the same as any other speculator.

MR. LUKKEN: Thank you. David.

MR. BROWN: Just to -- Dave Brown with -- representing American Bakers Association. Just to jump on top of Garry's comments here a little bit around the definition of a hedger, actually I have that prepared and written down here today, and the definition of a hedger is, "an entity with a position in a futures market opposite to a position held in the cash market to minimize the risk of financial loss from an adverse price change, or a purchaser's sale of futures as a temporary substitute for a cash transaction that will later occur." And I think it comes down to really defining the definition of what a hedger is versus a speculator as we dig into this.

MR. LUKKEN: Andy.

MR. WEIL: Thank you, Mr. Chairman. In the cotton industry, we have similar concerns as the two previous gentlemen pointed out for their recommendations. We've never seen a market like this, not in Weil Brother's history of 130 years.

And we -- as you saw in the presentations today, cotton is a bit different in the way that our stocks to use ratio is much, much higher than the grains, and cotton, the divergence came from I guess what speculators look at on charts and perceive value there, where as the fundamentals, of course, is supply and demand.

We, you know, would like -- to require that an index fund with a hedge exemption restrict this position and a commodity to the dollar allocation or the percentage of funds allocated to that commodity as defined in the funds -- and recorded with the CFTC. Further, any variation should be subject to speculative position limits, and such funds should report the cash positions on a weekly basis. We'd like a requirement that the reporting of all swap and OTC contracts by market participants and that the CFTC determine the aggregation position from all sources, including the exchanges, ETF's, swaps, OTC, and all other trading entities, require that all non-traditional hedge accounts, those not involved in the commercial enterprise of physically trading bales of cotton be reported as a separate individual category, require that the ICE and its clearing members adhere to the practice of margining futures to futures settlements and options to options settlements, and that only those involved in the physical handling of cotton be eligible for hedge margin levels. Thank you.

MR. LUKKEN: Thank you, Andy. Mr. Dunavant.

MR. DUNAVANT: Well, I'm in full support of Andy's and American Cotton Shippers' position. We have serious problems in the cotton futures market, in the ICE exchange. I go back to March 4th, and cotton traded from 84.95 to synthetically to $1.09. That makes no sense. The market is broken, it's out of whack, and somebody has got to step in and give some relief. The cotton producer is being penalized, the cotton cooperative is being penalized, the cotton merchant is being penalized, the textile industry; we need to get back to trying to function as a futures market that has some stability, and we certainly don't have it now, and I think the traders, the commercial hedgers need to be treated on a totally different basis than speculators and commodity funds.

We need to be margined completely different, because we are physical users of the market, and we would ask you to review our feelings very carefully. Thank you.

MR. LUKKEN: Thank you. Woods.

MR. EASTLAND: I agree with what both Billy and Andy have said, and I might elaborate just a little bit. The purpose of these markets I think is to find very well in the act. And the strongest evidence as to whether or not the self-regulation scheme of the board and management of ICE and the regulation duty of the CFTC is being met, of course, is in the basis, not only convergence with the cash during delivery, but the relationship between cash and futures between delivery periods, trading in a historical, normal range.

And, of course, as we saw from the other end of the table, in cotton, it did not. And that by definition is a broken market, but probably more importantly by definition of the act, those sort of unwarranted price changes are defined in the act as an undue burden on interstate commerce, which puts it on your shoulders to make sure, and ICE's shoulders, to make sure it doesn't happen again. So I've got a series of suggestions, too, that I'll be filing with my statements with the CFTC all along these lines.

I would say one thing, I think a market the size of the cotton market, I think you need this one size fits all idea is incorrect, and a market -- the worse thing that could happen for cotton right now would be to increase the speculative limits. In fact, I think in a market our size, speculative limits should be decreased for cotton. Thank you.

MR. LUKKEN: Joe.

MR. NICOSIA: I am Joe Nicosia, CEO of -- Cotton Company, Executive Vice President of --

MR. LUKKEN: If you could try to get to a mike for our transcribers, it's helpful. And I'll remind everybody, even though I call on you, state your full name and organization. It's very helpful. Thank you.

MR. NICOSIA: My name is Joe Nicosia, I am a CEO of Allenburg Cotton Company and Executive Vice President with Louis Dreyfus, and I'm here today in my capacity as incoming President with the American Cotton Shippers. As opposed to regoing over what several of my colleagues have just said, I would like to touch a little bit on what we view as some of the problems that were caused in cotton, and maybe some of the solutions, as well.

I found it very interesting in the

opening comments that I didn't hear anything or any studies about the OTC market place, aggregate of positions, swap market, or any of those problems that exist. And it's no secret that it is a fully developed market place, one that is used to totally circumvent position limits.

Commissioner Chilton, you asked earlier today was there something that was out there that maybe you were not watching or something that you could more monitor to try to get a better handle on the situation. I would suggest that the inclusion of your monitoring and/or requiring reporting of swap and OTC positions would be a great place to start.

Today you may have an entity which may have five to ten times the spec limit, and yet you have no idea that that is even out there and existing. And they use these forms to totally influence price and change what is happening out in the market place without any recourse whatsoever. Also, I know that there is the idea that there's possible, passive investment word has been used several times, especially in conjunction with index funds. I would offer that that is -- passive is absolutely the improper word to use. When we look at the weeks that happened in cotton, the week before, the giant run up of index funds strangely added almost 13,000 contracts. And the week where we went up the equivalent of 25 percent in 90 minutes, they strangely exited 12,000 contracts. I would offer that's anything but passive.

Also one of the problems that we have, I noticed we had the report that came through that showed forward hedging, and it showed that because open interest was up, that the relationship to that was that there was not a lack of forward hedging that was taking place.

Because if we had moved away from the whole loan economics that existed, the entire crop must be hedged. Therefore, the open interest demands for increased hedging is substantial, probably 300 to 500 times what you have seen. So a small increase in the open interest of the hedger is totally non-representative of the amount of demand for forward hedging that's necessary.

So when we see a percentage increase in the open interest from the commercial, it really needs to be three to five times that amount as being totally restricted. I have several other remarks, but I'll hold them until the other sections that you have. Thank you.

MR. LUKKEN: Thank you, Joe. Any other comments? Tom?

MR. COYLE: Thank you, Chairman. First, before I make a couple of comments on both the participation in this new capital in the agricultural markets, and also on the terms of the CME, I want to thank the Commissioner and -- Commissioner Dunn for all the time you've spent with the National Grain and Feed this year. It's really been quite impressive, the time you've spent with our association to understand the issues.

I also want to compliment Mr. Kass on your charts; again, you've outdone yourself. So later, when we talk about convergence, that will be quite helpful. Going back to some of the comments I heard from Dave Lehman and Charlie Carey, you know, our association has done a lot of work on contract terms.

We had a task force last summer to talk about contract terms, what could we do to respond to the imbalance that we're seeing in the market. We had a lot of participation from a broad group of participants, from funds, to professional traders, to mills, to grain elevator operators, to country elevators. In the end, we didn't come up with a silver bullet, which we were hoping for, but we did come up with some recommendations for the Board of Trade, which were intended to increase the utility of the current delivery system, and the Board of Trade did listen to those recommendations, had an industry forum, made the recommendations to the Commission, and so I understand they'll be adjusted in the fall; we really do appreciate that.

So we certainly can say that the CME has been responsive. We spent a lot of time with you on this, as well. As it relates to this new capital that's participating in our market, the National Grain and Feed feels pretty strongly that despite the charts that right now show that there's actually maybe some reduction in the share of these passive participants in the market, if you dig in the -- well, first I'll say that we do believe that it's having an impact on the market, it is creating an imbalance, and while there are more contracts that are being traded, it's not increasing liquidity, it's actually reducing liquidity, because if you have in the case of wheat, if you look at the long open interest, take out the spread trade and just look at the longs and shorts, 60 percent of the current market is owned by an index fund. If you look at the net positions, it's 50 percent, the longs and shorts. Clearly, that's having an impact on the market.

Our view, again, like Mr. Popp said earlier, that we're -- we weren't in favor of an increase in spec limits at this time. Today we'll talk more about convergence and forward contracting issues later.

But as it relates to the new capital in the market, we believe, as I've heard a number of the previous speakers say, that the margin issues for these new participants should be changed, that we would recommend 100 percent margining.

If, in fact, as I heard clearly, there's going to be more money coming into our markets, that's not a bad thing. However, if it's supposed to be a notional value and it's a long term passive investment, then it should be margin dollar for dollar, as opposed to -- which may happen today with a couple of the approved hedged exemptions, but if you're coming through a swaps dealer, well then you don't have one for one margining. We think that might actually create some balance in the market.

The other thing we think is, something that should be considered, is a moratorium, much like the CME said on the hedge -- the speculative limits. The idea of a moratorium on hedge exemptions for this new capital is something that ought to be considered, because for right now, the market is out of balance. I'll talk a bit more later about convergence and forward contracting, but that's our position.

MR. LUKKEN: John.

MR. KOWALIK: I'd just like to point out that --

MR. LUKKEN: Again, state your name, if possible.

MR. KOWALIK: Oh, sure, John Kowalik. I'd like to point out for Calpers, and probably most likely for other pension fund investors, that all of our dollar amount of commodities exposure is, in fact, back to 100 percent by collateral, so there's no -- we're specifically, by policy, prohibited from having any leverage in our commodities position.

So for every dollar of commodity price exposure we have, we have 100 percent collateral behind that. And I -- I want to emphasize, it's probably the case for a lot of the pension fund asset money coming into these markets.

MR. LUKKEN: Bob Greer, we haven't heard from PIMCO.

MR. GREER: Thank you. My name is Bob Greer, I'm with PIMCO, a couple of comments. First, as I listened very closely to a lot of the economic data that was presented, I did not see a convincing case, a systematic case that index money has significantly changed the major objectives that were stated of these markets, and that is price discovery and risk mitigation.

Second, I would suggest that as we consider the volatility as opposed to price levels, as we consider volatility in these markets, we make a clear distinction between an index investor versus a hedge fund investor, because, indeed, their activities are different in these markets.

The third point I would like to make is that I can remember reading textbooks before there ever were commodity indexes that indicated a long only investor is assuming some price risk that producers and others in the commercial interest, in the commodity business, would like to shed themselves of.

There are now over 200,000 individual investors in this country that are offering to do exactly that, and I would think, though we can probably not measure it, that they have reduced by their collective efforts the amount of risk premium that a commodity producer must pay as they mitigate their risk in these markets. Thank you.

MR. LUKKEN: Thank you. Down on the end, John Popp.

MR. POPP: Yes, John Popp with the Independent Bakers Association. I think we have a new situation that has not existed until now. I think I heard in the presentation the concept that the index funds and these large funds are not effecting the volatility. But I think what we've done is, under today's conditions, we have a much different supply situation.

We've taken 22 million acres out of the food supply and put it in the fuel supply. And so now suddenly we have -- we're not faced with the surplus problems that we have been for 50 years, we have now a limited supply, and we've got a lot of dollars chasing a tight supply, and I think it's time to take some of that CRP land that we -- conservation reserve land and put it back into production, because we need -- we're going to need more supply of tillable land.

So I think that it's related, and that's not the main purpose, but as we talk about supplies, I think that tight supply has made these huge investments by these funds have a much different effect than it used to when we had surpluses. Thank you.

MR. LUKKEN: Tom.

MR. COYLE: Again, Tom Coyle, Chairman of the National Grain and Feed. A couple of observations, one, so as not to be one sided, I would say that we have noticed, because we got your report that has a breakdown in the participants in the market, as I analyze it for this meeting, the one thing that is interesting to note, that in the two years since we -- the two years of data that we have, from the breakdown in the report today, the commitment of trader's report, it does show that there's ten times more index fund shorts today than there was two years ago, and that's still not significant.

But I think in the wheat contract, that might be 30,000 contracts, and it was 3,000 contracts or something like that two years ago. So what that does say is that the market is adapting, and we would assume that over time, people would participate.

And I think I heard the Deutsche Bank was coming up with a short only fund, so that you would like to think that other participants would help provide some balance, as well. The other comment I would make is, the association feels pretty strongly about the importance of this new commitment of trader's report, but we think it's important to make sure that the numbers are accurate. And I say that in that there may be some confusion in terms of where participation shows. If you are commercial, but you also happen to have accounts that are actually index, you're providing some kind of a role there, I think what would happen is, in your reporting, it would show up as a commercial trade.

On the other hand, if you're a hedge fund that also has a portion of your equity that is actually a long only fund, where does that show up? Would that actually be in the non-commercial, which would be where a hedge fund would show up, or would it show up in an index fund? How does that really get broken up?

I'm not sure that when you fill out the form, right, you get put where your primary business is. It may make some sense to make sure that there's an adjustment in that, so you actually do know which contracts are going where. The numbers are quite big.

MR. LUKKEN: Okay. I know Andy had a question, and then I'm going to turn to Jerry, and then I'm going to ask my colleagues on the dais whether they have any questions for the group. So

Andy.

MR. WEIL: Thank you, Mr. Chairman. In terms of the requirement for margining futures to futures settlements and options to options settlements, this is really necessary in terms of valuing our collateral at the banks, the banks to market every day, and when the market did what it did, the banks -- not only did we lose confidence in the market, but our banks certainly lost confidence in the market and didn't understand what was going on. And as you well know, the banks are our life blood in this industry. Thanks.

MR. LUKKEN: Jerry, did you have a question on the end?

MR. MCREYNOLDS: Yes, I did. Thank you for this briefing and this opportunity to share some of our comments.

I'm a producer. Speculators are extremely important in this market system, they're important to each of us producers, but we all come in with a little different -- from a little different background, a little different perspective.

One of the concerns that we may need to look at is to examine some of the index funds, the position limits. There could be some tweaking done that would I think help the situation, but we want to keep in mind that speculators are extremely important. We have to have a way to lay off risk to someone that's willing to accept that risk. Concerning the CRP ground, of course, that gets my attention, because you don't want my CRP ground to go into production, it needs to be in graphs, so I'm not sure that's where we want to go.

I think there's an opportunity here in the way of crops, some genetic improvements that can continually improve, they are continually improving the production, and that's a direction that we need to continue to develop.

It's extremely important that we allow these markets to function with as many players in a very controlled, but yet not overly regulated environment, because I'm very sensitive to those excessive regulations, because as a producer, I know we don't have a way to pass it on. Somehow that risk gets kind of put down the line, and we're at the bottom of the heap, and so we don't have a way to pass that on. So I'm very sensitive to excessive regulation that's going to cost producers dollars. Thank you.

MR. LUKKEN: Thank you, Jerry. I'll ask any of my colleagues on the dais whether they have questions for the group before we --

MR. CHILTON: Mr. Chairman, I have just one quick one. I was interested, Mr. Coyle, in your analysis of our charts, and I want to make sure that we get this right. So I thought maybe Mr. Kass could comment on your comments and we could sort of figure out where we are here. David, would you mind?

MR. KASS: Well, I think, and as many have said, clearly, index trading is a very substantial part of these markets now, not only the ones we publish data for, but other ones, as well. I think I showed in that one graphic that showed total number of open contracts for each and their percentage.

We don't see a clear relationship between the holdings, either in terms of absolute number of contracts or percentage in some relationship either to volatility or to, for example, year over year price move, or even price moves over small time frames.

But this is an area, clearly, that's right for research. One of the motivating factors for us to put out these data was to engender the sort of research that might result from people now having these data, and we put out a year's worth of history, because we're still studying the situation. It's new to everyone, and now at least there's some data out there. In terms of classifying traders, we do obviously have to classify traders one way or another. You can't split hairs day to day to day on which part of which position is this. So we have to look at where the preponderance of their trading. So there is some slippage in either direction, but it's not just all in one direction that all the slippage goes from non-commercial to commercial or vice versa. There's clearly slippage.

They're better than anybody else has, it's where we feel very confident in the data, we spent a lot of time doing it, and we're reviewing it constantly. Thank you.

MR. FENTON: I think -- just to follow up on that. Tom, in answer to your question, I think if a hedge fund is doing index trading, they'll end up as an index trader in our supplemental report. And I think we're confident that we're getting that portion pretty close to right, because they leave a pretty distinction footprint in the type of position they have.

So I think they are being moved from, on the traditional report, they're in the non-commercial category, they're being moved into the index trader category in the supplemental report. For the other and the more -- the larger portion of the index trading community, it's the swap dealers who are being moved -- on the traditional report they're being shown as commercials, they're being moved into the index trader category. Now, the swap dealers may be doing things other than index trading. One of the reasons why we felt like we could publish accurate data for ag markets is because, in the ag markets, they weren't, and I think still aren't doing much other than index trading.

They certainly -- we interviewed them a year and a half ago when we were working on this project, and they were -- pretty much their futures position matched up with their index trading book. The short side positions that you've noted that have grown over the past year and a half may be an indication that other things besides index trading is coming into the market.

Now, you thought that it might represent short side index trading, and that's possible, but I think it's probably more likely that those are outright swap positions that are being held in the book of swap dealers.

MR. LUKKEN: Tom, did you have a follow up?

MR. COYLE: Well, yes; I would say, first, I wouldn't want to give anyone the wrong impression. We think the report is spectacular. We just want -- I mean we use it.

And I was really quite intrigued when I spent time over the weekend checking it out to see what does it really tell me to make sure I wasn't off base. And what I noticed was that there were 3,800 contracts in January of '06 that was shown as the CIT short, and today it shows 31,600. I thought that was a nice change to see. It gives you some hope that the market is evolving.

Also, as I kept hearing comments about the fact that the index funds really weren't growing, I wanted to see, well, what is growing, because the open interest is going up.

And as I looked at it, it showed that, in the case of wheat, for instance, in the two year period, the index length, net index position is long, 16,000 more contracts, but the non-commercial, so either a hedge fund or a speculative interest are up 33,000 contracts.

Now, that's offset by, I presume, our members being short, because there 41,000 contract increase in the short side. So it gave me a sense of who was doing what. But, no, I think the report is great. I just -- we're pretty passionate on using it.

MR. LUKKEN: Anymore comments from the dais, or questions? Under Secretary Keenum.

MR. KEENUM: Thank you, Mr. Chairman. I want to follow up on a couple of points that were made.

Mr. Weil mentioned, when he was making his comments, talking about the index fund should be restricted to speculative position limits, and then we heard Mr. Dunavant, and also Mr. Woods, to an extent, talk about how the cotton market is broken, and we talked about the 84 cent run up to $1.09 cents, and the synthetic options price.

Mr. Woods talked about the negative effects this is having on interstate commerce and that we should consider speculative limits, it should actually be reduced. Mr. Nicosia talked about how the open interest of a hedger must be considered.

I guess my question is, from a USDA perspective, when we were looking at the tremendous run up in prices that we saw occur from mid February into early March, about a 25 percent increase in cotton prices, and we really saw no fundamental bullish news, at least from a USDA perspective, as Doctor Bange described when he was making his presentation.

In fact, during that time period, we saw our export sales decline tremendously from 484,000 bales in the end of February to only 66,000 bales by mid March. So we saw declining exports. And then also, according to USDA, we estimated that our ending stocks were going to raise from 8.2 million bales in February to 9.7 million bales, the highest ending stocks for cotton in 40 years. So during this time period, when we saw a very sharp increase in prices, contrary to anything bullish in the market, it was very barish. And you all made some very revealing comments, and I'm just curious if anyone of you who were involved in this -- would like to comment on what you're seeing in the market and what we saw during that time period.

MR. LUKKEN: Tom with ICE futures, I don't know if you have comments about what ICE was seeing at the time and describe some of the things that you're trying to do in this area.

MR. FARLEY: Sure, thanks, Chairman Lukken, thanks -- pardon me. Thanks, Chairman Lukken, thanks, Commissioners Sommers, Dunn, and Chilton, for having us today. Thanks also to the members of our cotton contract committee who are here today, who have worked very closely with us over the last month or month and a half as we've looked at this issue.

I just want to say, it's somewhat intimidating to address your question directly and talk about cotton fundamentals with four leaders, global leaders of the cotton industry sitting about five feet from me here. We have taken a look at cotton fundamentals and didn't find any secret answer as to exactly why we saw the activity on March 3rd and March 4th that Mr. Dunavant described as out of whack, which is a characterization with which I agree. We did, however, take a look at our market overall and look at the composition of index funds and look at the composition of speculative traders and the composition of the merchants over a short time period, I'll call it a month, three months, six months, even two years, and what we've seen is that, on balance, the contribution of those various asset classes has remained fairly constant.

So, again, no answer really jumped out at us. And so we're left as an exchange, looking at some more global macro factors. And we went and we looked at the volatility of markets, not just the domestic ags markets, which are the subject of this conversation today, but, in general, specific assets or asset classes, whether it be oil or large cap stocks, small cap stocks, the euro dollar, and what we found is that the 12 assets and asset classes we selected, ten had higher historic, excuse me, ten had 60 percent higher historic volatility on March 31st than they did on September 30th. All 12 had much higher volatility. So what jumped out at us was, wow, there's a global volatility phenomenon that also happens to be specific to our market, which is cotton. And then second, we looked very specific to cotton, at the cash markets, and we spoke to some of the gentlemen who are around the table today, and what we heard was that the cash market effectively shut down. It wasn't just really a basis differential, which is what Mr. Kass and Mr. Fenton discussed, but it was really a shut down of the cash market.

And then third, another global macro factor was, as we all know, we're in the middle of a liquidity crunch, and so what happened is, the price of cotton was rising over a several month period, over a several week period it was rising very, very quickly.

The lines of credit that many of these cotton farmers and coops and merchant firms had in place expired, and when they went to say, hey, it's a very volatile environment in cotton globally, the futures price is rising, we need to get some additional capital to be able to make these margin payments, the answer was, no, or the answer was, give us time and let us research that from the lending community.

So as an exchange, that's kind of our view as to what drove some of the out of whack fundamentals -- Mr. Dunavant characterized it as, and I'll have some more comments later on about margining in the third section.

MR. LUKKEN: I know Commissioner Dunn has a comment.

MR. DUNN: Well, just a comment on Mr. Lehman's comment about the weak dollar.

I was at a meeting a couple of weeks back with the Farm Bureau, and Jeff Hanniman from Advanced Trading was there and presented a chart to us, in which he compared the U.S. dollar to a basket of foreign currencies, and he said the dollar is about 68 percent of its 2002 level, and he translated that into corn, saying $6 corn then to the foreign currency would be $4.08, and for $12 beans, would be $8.16.

So that is, to me, explains a lot of the volatility there, even with the demand. As that dollar gets stronger, I expect to see some movement in that direction. Let me ask a specific question on the cotton, because that's the one I am having the most difficulty understanding what went on there. And I've heard this explained, it's like being in a card game, where you've got $100, and the other guy has $100,000, when he goes all in, you're in a lot of trouble. And this is what I've heard, that it got to the point where those folks that had the shorts had to begin selling just to make margin calls. Is that what happened out there;

And did it become a self-generating thing?

MR. NICOSIA: I think --

MR. LUKKEN: Behind you.

MR. NICOSIA: Thank you. In response to that, about what happened in the cotton market, a couple of things.

I found it interesting in the discussion we just had a minute ago about the percentage of open interest that was showing that the index funds are relatively on a slow increase, but that somewhat self-perpetuates itself. As they get bigger, open interest increased. Try looking at a percentage of open interest as a percentage of the crop and you'll get a very different view of what it is that's taking place.

Mr. Fenton mentioned that the open interest was 200,000 contracts of spec longs going into that week, which is roughly -- it doesn't take a rocket scientist to do the -- it's larger than the entire United States crop. I think there's a word for that, when someone buys more than everything that exists, and that's what happened in our market place. So, yes, you can call it a poker game, but fundamentally what took place is, there was a systematic approach to push prices higher. At night sessions, you saw a larger volume than ever existed, you saw larger price moves while the industry slept, so that you came in the market with extreme pressure.

As the pressure rose for more margin, you saw that continuously happen, and you saw it on an accelerated level.

The problem is that the tools to look at what went wrong and who did it, you don't even have, and you don't ask for them, and you don't look at them, because so much is taking place off the exchange that you're not able to look at it.

So as we try to even reconstruct to say certain entities had multiple times their spec limits and continue to push, you don't even have the idea to look at it, because you don't even require it.

Yet as a real hedger, as the hedger in the cash business, you require us to give you massive amounts of information, what are our cash sales, we report them all the time, how many bales do you have, what are your limits to do that, and yet you give freedom to all these other people with no requirements to you. You should at least ask for all those people to put forth their swap and/or cash activity so that you can see if there's any offset, if there is any reasonable reason they have those size of positions, and they don't have to do that. So what took place was exactly that.

Mr. Fenton mentioned that, on the day of the huge spike, where we went up, you know, prices moved ten limits in 90 minutes, that the trade was a buyer on March 3rd and 4th, which was absolutely true because they had been run out of the market place. They weren't systematically buying on the way up, they were forced out at the top.

Witness what happened three to four days later, the prices ended below where all of this started. And so, obviously, something was broken in what happened, and the shame of it is that we don't even -- you can't even construct it because you don't even have the information to look at it to see how it took place.

MR. DUNN: It reminds me of some of the testimony we heard during the various energy hearings. Let me end here by asking the two Presidents of the General Purpose Farm organizations, Bob Stallman and Tom Buis, what your members are telling you, because we saw on the charts that there is a lot of folks, more than usual, in open interest positions, but how does that translate to the farmer and rancher out there?

MR. STALLMAN: Bob Stallman, American Farm Bureau Federation -- it gets back to using the futures market as a risk management tool, as having the price discovery and using it as a risk management tool. And what is happening as we've diverged from a market that was fundamentally based on supply and demand fundamentals over the years, and now being used as an investment vehicle, that the dynamics of that market have changed to the point that the tool is fundamentally no longer there for the average producer.

You know, producers still haven't had as much direct involvement in the market as many of us in agricultural have said they needed to in terms of direct involvement in the futures market for risk management, you know, they've done it through their elevators, they've, you know, done it through other mechanisms with those parties relying on the futures market.

And as, you know, pricing has been removed as an option basically for producers because of what's happening with the volatility in the futures market, they find themselves trying to struggle to deal with price risk management at the same time that their input costs are, you know, rising rather rapidly. And all that is creating a problem in terms of the utility of the futures market as a mechanism for price risk management.

MR. LUKKEN: I know Lee has a question, but then I'm going to get to --

MR. DUNN: Let Tom Buis --

MR. LUKKEN: Oh, I'm sorry, Tom.

MR. BUIS: That's okay. Thank you for the opportunity and, Commissioner Dunn, for the question. We started raising these concerns in March, after hearing from a number of producers who have been shut out of being able to forward contract their grain by local elevators and coops because they were exceeding their credit limits to meet the margin calls.

And I think, as Mr. Stallman just mentioned, this is really critical, because we all know that gravity works in markets, and what goes up can come down and come down with a thud. And if a farmer cannot forward price these commodities at higher prices, they're at greater risk today than they've ever been.

As input costs have tripled over the past two years, they've got more money invested, they have a safety net and a farm bill that's the lowest percentage it's been since the mid '90's, and if they can't market that crop at these high commodity prices, we've got a train wreck coming that's going to be greater than any we've ever seen in agriculture. For those who say that everything is working right, I'm sorry, maybe I'm wasting my time here, but there's problems out there, and I think it is incumbent upon us all to address these problems sooner rather than later.

MR. LUKKEN: We're going to break here shortly, but I wanted to give Lee Strom an opportunity, and Diana, and then Doug, who's been waiting patiently, too. We're going to take a short break and let everybody get some coffee and use the restrooms, and then we'll come back and do our presentations on convergence. But these are all related subjects, so don't -- hold your questions, we'll get to them in the second panel, as well. But with that, I'll turn it over to Lee.

MR. STROM: Thank you, Mr. Chairman. I just had a quick question. I mean there's been some reference already at this point to the credit and lending industry. I know we're planning this afternoon to get into this more thoroughly, but I had a question of Mr. Farley.

You referenced the cotton exchange and the very volatile time, you said when I think -- your constituents that were using the market place went to their lenders, and there was an answer of no or we'll get back to you. Did producers, do you know, did producers, were they forced from the market, from existing hedges, because they -- of their margin issues?

MR. FARLEY: It is my understanding, yes, the answer to that question is yes. However, I think that Woods might be a more appropriate person to answer that, because that's Woods' constituency, is the producer community.

MR. EASTLAND: Since we are -- we're hedging for producers because they are a marketing coop, in our case the answer was yes.

MR. LUKKEN: Diana?

MS. KLEMME: Diana Klemme; I'd like to step back for just a moment and look at the bigger picture, if I could.

The new issue of the economist magazine has, on the cover, about the tsunami, the global food crisis, which is what we're in.

Whether you look at it from the fact of souring food prices, rice at $1,000 a ton, which unless my math is off, that's somewhere around $45 a 100 weight, which we're not even close to that in the futures price, and we have declining, plummeting global stock, so we need more production, we need more acres, farmers need to benefit from these higher prices, investment capital is going to flow into the market one way or another, and I don't mean to -- I'm not speaking for Calpers or PIMCO, but I'm guessing if you want commodity exposure, you'll find it. Maybe you'll find it in London, maybe you'll find it somewhere else in Europe, maybe in Asia, but you'll find it. And we don't want to see a market that we're so hand strung because of liquidity and financing issues that the farmers can't benefit from the higher prices because it's going into other markets out there.

Your land costs are up, your input costs have soared. We need high prices right now. And

I don't know that that's $15 beans or $8 beans, I'm not going to say what that is, but we need prices that will generate the acres here and abroad to address the global food crisis, the problems we see everywhere out here, and I think if we distill everything out to just one issue, it has to do with the ability to finance these markets.

There would be new crop bids, there would be 2009 crop bids a plenty in about every commodity we can think of if the elevators, grain companies, and everyone else up and down the chain could feel confident that they could meet the margin costs. Basis would widen because of increased risk, especially on forward crops, but they would be there, up to a risk comfort level. But if you don't have the financing, credit lines, or you're afraid the credit line won't be there, they don't dare go down that road, and then the bids disappear, the farmer is in disadvantage because your input costs and land costs go up, and you can't market the cash grain, which was just addressed.

Maybe it's a little bit less than cotton, I'm not an expert in cotton, I can't speak to that one at all, but I think we're about two rainy weeks away from a potential crisis right here in this country in corn if we can't get the corn acres in.

People are scared to death to hedge right now, to short hedge, because they have no idea where we could be in two weeks, four weeks. Maybe God will be burstful on us and we'll have perfect weather from here out. But as a risk manager, I can't advise my clients to bet on that.

MR. LUKKEN: Do you have solutions? I mean financing is clearly outside of -- financing is clearly outside the CFTC's purview, but we do have the USDA, which has some financing elements, we have bank regulators in the room, and bankers; are there thoughts on what might help the situation?

MS. KLEMME: Commissioner, you're absolutely right. You know, the CFTC does not have a solution, and they wouldn't, and my letter to you hit on that is, right here at this table, and in this room, we have some of the best resources that we could bring to bear. It's the money sector, it's the exchanges, it's the producer groups all together, we can't put that burden on CFTC to solve an issue.

But I do ultimately think, at least in the short term, convergence is an important issue, basis levels, forward contracting tools, but the root of it all right now is liquidity, the ability to finance these kinds of new markets that we're in, and I don't think they're going to go away in the short term.

So somehow if the financial resources are out there, or at the very least, if we know what the limits of those financial resources are, then perhaps we can make some different decisions, or hopefully better decisions out there.

MR. LUKKEN: We're going to end with Doug Hepworth, I think he's our last question before we break. But, Doug, I'm curious, too, there's talk of limiting exposure to index traders in our markets; where would that go? I think there's thoughts we're limiting demand, but where would that go potentially if you were limited in your ability to give it exposure in the commodity markets?

MR. HEPWORTH: Thank you, Chairman. Well, actually, I'll make a couple points and then come to yours, if I can. The first is that we run fully collateralized portfolios that are subject to position limits, so we get a dog in this fight. And we're never in spot months. I think our compatriots are never in spot months, as well. And I have never yet understood the mechanism, how people who are out of a market a month before trading ends could be impacting a convergence.

There was a comment that now we've seen this world where the commercials make up a preponderance of the short open interest, I think that describes the futures markets since their dawn.

And also, I want to point out, just in

terms of the -- reiterate, just in terms of the food inflationary component, that the biggest move in grains was in rice, which is not a liquid future, and it's not in any passive strategy.

The biggest movement in protein was eggs, which also, not a liquid future and not in any index strategy. In fact, when I listened to the discussions around this table, the one thing that's clear to me is that even people who are saying that position limits shouldn't be raised should be arguing that speculative position limits should be raised, because, in fact, what that will do is no longer force investment dollars into the unregulated swaps world and keep them in the well regulated CFTC futures world, I think that's a positive.

I do not think anybody in this room would like to see all of the long investment interest suddenly force to dump $40 billion worth of agricultural futures onto the market, I do not think that's in anybody's interest.

What would happen is, there probably

would be a dislocation, and ultimately the solution would probably involve non-U.S. exchanges that would have contracts that would be benchmarked to U.S. agricultural products. We're a very significant player in the agricultural world.

But I do not think it's in anybody in this room's interest to have these markets become less regulated either by trying to end this long investment or by allowing it to move even more so into the non-regulated space.

MR. LUKKEN: Thank you. We're going to take a short break here of about 10 minutes, if we can, and meet back here, and we'll take up our University of Illinois study. Thank you.

(Recess)

MR. LUKKEN: Thank you. While everybody is grabbing their seats, we're going to turn to our presenters.

I know there's a coin flip. Are you going first, Jeff, or -- okay. Jeff Harris, the CFTC's Chief Economist, will give first on some of their analysis on convergence, and then we'll turn it over to the University of Illinois, where I know they've done a lot of good work. Eugene Kunda has done a lot of good work in this area, as well, so we welcome your presentations, and we'll turn it over to you. Thank you so much.

MR. HARRIS: Thank you, Mr. Chairman. I am Jeff Harris, the Chief Economist here at the CFTC. I'm here with Doctor Kunda from the University of Illinois to discuss and focus more closely on issues related to hedging and agriculture of future markets.

The Office of the Chief Economist, of course, works closely with our colleagues in the Division of Market Oversight, who just presented this morning, and we provide analysis and advice to managers to the oversight of these markets. And we have seen from John Fenton and Dave Kass' presentation this morning, the CFTC is actually keeping close contact with agricultural futures markets on a daily basis during these unprecedented times. My role here today is basically to introduce the topic of convergence in futures markets. Along the way I will focus a short discussion on the convergence between spot in futures prices and how forward contracting in agricultural markets allows this.

Although I could surely talk for at length on each one of these subjects, I will keep us closer to schedule, not quite on schedule perhaps, by relating the futures convergence to price discovery in these markets.

While functioning markets serve that price discovery role, and because futures markets are publicly available, private agents can make decisions by observing futures prices in our markets, incorporating any information in the insights from a great number of experts who trade in these futures markets.

The textbook example of this convergence perhaps is the farmer who makes his or her planting decisions at the beginning of each crop year. In those instances, the price signal that's conveyed from futures markets is useful in allotting the acreage to that crop, and we've seen some of that information on planned and responsive to acreage planning this morning. Similarly, cooperatives can use these price signals to committing purchases from producers, or from the produce of their members. Such forward contracting alleviates the price risk, of course, that individual farmers would otherwise bear.

Likewise, futures markets enable dealers to offer swap contracts for risk management needs of large scale commercial operations. Each one of these very valuable services depends on an efficient price discovery in our markets.

Convergence between spot in futures markets is an issue, because many believe the lack of convergence is symptomatic of a poorly functioning market. A quote from one of the many members or letters that the Commission has received on this topic, this comes from Advanced Training in Bloomington, Illinois, which stated, "The less that futures serve as an accurate proxy for cash, the greater risk for elevators and others involved in the grain business."

I agree that incomplete convergence of the futures and cash markets as expiration approaches can indicate a poorly functioning market. But an apparent lack of convergence can also indicate other issues, as well. After all, convergence is really a matter of the law of one price.

That is to say for identical items at the same place, at the same time, the price must agree with each other. That law is fully operative in our futures markets, and, in fact, at the moment of contract expiration. The contract delivered according to a futures -- the commodity delivered according to a futures contract can commend no more or no less than the current spot price at expiration.

Prior to expiration, however, convergence is a matter of four variables and actually one activity. The four variables are the spot market of the commodity at that instant, the cost of storage of that commodity at that instant, the value of having immediate access to that commodity perhaps, and the cost of delivering the commodity according to the contract specifications.

The activity involved is actually arbitrage. All of these are crucial to obtaining convergence in these markets. I'll admit the discussion perhaps of immediate access to the commodities, because most of our letters to the Commission actually indicate that convergence on the positive side is really not a problem. But the DMO charts that we actually saw this morning do highlight that there is a positive basis at many of our Gulf Coast delivery points. So locations -- highlighting sort of the fact that location is important when we look at -- discuss the issues of convergence. High storage costs such as that can be expected when the storage facilities are scarce actually widen the cost, or the gap between futures and cash prices, as well. Likewise, what we saw this morning, the high cost of delivery can create an apparent convergence issue. And I say apparent because delivery in the contract incurs the cost both of storaging the commodity and delivering it to the future delivery point.

As noted by my colleagues, Dave and John, this morning, diesel costs and Illinois freight costs are at historical highs for this time of the year, in fact, greatly exceeding what the historical prices have been in these markets.

The futures prices, because they reflect these costs, will appear to converge less strongly as a result if these costs remain high. Despite that, appearance to -- still does apply. The all end cost of the futures contracts should converge to the cash price at expiration. And I emphasis storage and deliver costs because our reports indicate that both of these costs may be contributing to the weaker convergence in these markets. Lastly, but also crucial to the convergence, is arbitrage activity. Arbitrage consists of examining the four variables I mentioned for the profit potential. If the futures price lags above the spot price, then shorting the futures contract and delivering on that contract is an arbitrage activity that would alleviate the differential in the spread and the basis.

I have a -- if we could put up my figure here, just demonstrating an example from the soybean market -- just similar to what we had seen this morning, this is a soybean basis plotted over time for the most recent -- I guess last year's 2007 contracts, and point out that the basis, as you see, is not converging to zero in the soybean market last year.

And I just point out the differential there, if there is a cost to actually storing and transporting the beans from the point of the cash market to the future deliver point, that could reflect the costs of arbitrage or the arbitrage activity in the markets, people that recognize that this is an apparent mispricing.

The negative basis results for the futures prices that exceed spot prices in this particular market, and if this represents true mispricing, arbitragers would short the futures, like I said, and deliver by buying in the spot market and deliver that product. Any costs of buying the spot market deliver against the futures position, however, will impede the arbitrage in this market, and may result in a relatively weak basis. Increases of freight and storage costs, like I mentioned, and those that are at historic highs, like we've seen this morning, exacerbate the situation.

Of course, the prospects that arbitrage is impeded by some other factor is a concern to our market participants and to the CFTC in general. And the CFTC has been closely monitoring new entrance into these commodity markets, like index traders, hedge funds, and other managed money traders in the agricultural markets.

As highlighted by our presentations earlier today from the CFTC participants, the 2007 and '08 price increases in ag commodities have occurred largely under relatively stable participation by managed money traders, and we've had a number of opinions on that subject this morning.

As noted earlier, we do witness an increase in net long positions by index traders. This index trading entries has only marginally occurred over the last few months. And since overall open interest has been growing concurrently, their market share has remained relatively stable. Profit opportunities, of course, result from the buy and sell pressures in our markets that bring about convergence. Increased cost of executing arbitrage trades inhibit arbitrage activities. Absent evidence that any particular traders might artificially or intentionally impede arbitrage in agricultural markets, the Office of the Chief Economist would simply caution against policy decisions that might further sort of exacerbate or raise the cost of conducting that arbitrage.

Such policies could have negative consequences for convergence. And among the more crucial policy choices are regulations to raise trading costs are those that may limit the extent of arbitrage that could be conducted. And since we have an expert here who studied this convergence for the last couple of years, I will turn it over to my colleague from Illinois, Doctor Kunda.

DOCTOR KUNDA: Thank you, Jeff. Mr. Chairman, my name is Eugene Kunda and I am here today to provide a statement based on research conducted at the University of Illinois regarding the recent convergence behavior of CBOT, the CME Group, corn, soybean, and wheat futures contracts. In this testimony, we focus on the nature and consequences of recent convergence problems. We also briefly comment on proposals for changing the contracts to address the problems that have surfaced recently. Please note that a comprehensive set of charts related to convergence performance is provided in the appendix, but in the interest of brevity, we'll only refer to a few of the charts in the statement today.

To begin, it is important to note a few basic points about the delivery process. It is the essential component of futures contracts with physical delivery, as it ties the futures price to the cash price at different locations.

In a perfect market, with costless delivery, at one location and on one date, arbitrage should force the futures prices at expiration to equal the cash price. Otherwise, a violation of the law of one price that Jeff mentioned would exist.

In reality, delivery on futures contracts is not costless and is complicated by the existence of grade, location, and timing of delivery options that have demonstrated value to sellers of the contracts. So a more realistic approach is to think of a zone of convergence between cash and futures prices during delivery periods with the bounds of convergence determined by the cost of participating in the delivery process. The following charts show the difference between cash and futures prices, the basis, on the first and last day of the delivery period for corn and wheat futures contracts expiring between December, '01 and March, '08, and for soybeans contracts expiring between November, '01 and March, '08.

Note that with a negative basis means that the cash price is less than the futures price, and the positive basis means that the cash price is more than the futures price.

For these calculations, grade and location adjustments are made to cash prices where they're appropriate. The convergence patterns in the presented location are representative of the convergence patterns at the other locations.

For each of the three commodities, convergence generally is within reasonable bounds through 2005, ignoring the problems created by Hurricane Katrina in September, 2005 expiration. The convergence weakness first surfaced in July, 2006, in the wheat contract. Non-convergence was extremely large by historic standards, reaching a low in September, 2006, when the Toledo cash price ended up 90 cents below futures on the last day of the delivery period. This weakness in wheat persisted through the July, '07 contract. Convergence was relatively good for the September, '07, the December, '07, and March, '08 contracts at Toledo and at Chicago in December, '07, but was poor in March, '08 at Chicago. Convergence in soybeans was poor beginning with the March, '07 contract, especially for -- in the September, '07 contract, improved to almost acceptable in November, '07, but returned to a very poor performance in January and March, '08.

In general, convergence performance since July, '06 was much better for corn than for wheat or soybeans. Convergence performance was weakest for corn in September, '07 and March, '08.

While the recent convergence failures are dramatic, in isolation, each episode is not necessarily damaging to the overall economic functioning of markets. Real economic damage is associated with increased uncertainty in basis behavior, as markets bounce unpredictably between converging and not converging.

And as first noted by Holbrook working many years ago, this is damaging because basis in storable commodity futures markets should provide a rational storage signal to commodity inventory holders. A wheat basis should be a signal to store, and vice versa. However, this depends on the predictability of the subsequent change in basis over the time, thereby earning the carry for someone holding stocks of the commodity and simultaneously selling the futures. The reliability of basis signals can be quantified by measuring the level of basis at some point before the delivery period and comparing this initial basis to the change in basis from that point forward through the delivery period.

Perfect delivery location predictability is illustrated in the chart. Note that when delivery location basis is perfectly predictable, the relationship between the initial basis and the change in basis has a slope of negative one and runs through the origin.

In other words, if the basis is 50 cents per bushel two months before expiration, the change in the basis over the subsequent two months should be a positive 50 cents per bushel as it raises to convergence.

Additionally, all points lie directly on the line, which indicates that the hedges over the interval are perfectly effective in eliminating price risk. The next three charts will show the predictability of delivery location basis for CBOT, corn, soybeans, and wheat, before and after 2006. Each horizontal access in the chart measures the level of the delivery location basis on the day after the preceding contract expires. The vertical access measures the change in the delivery location basis from the day after the preceding contract expires on the first day of delivery.

Note that all the observations for all delivery locations and expiration months for a given commodity are pulled together in the analysis. And the observance of new crop, December and November contracts for corn and beans, start on the first trading day of October, so as not to be influenced by the transition months of September.

The chart before you is the predictability of the CBOT contract and the basis for corn. The charts indicate a sharp decline in basis predictability for all three markets since 2006. In corn, the upper right regression line indicates the futures market, performs reasonably well in terms of basis predictability before 2006, as the slope and the intercept are near the negative one values and zero.

And the hedging effectiveness is measured by the R square is a respectable.87. The lower left regression line shows the precipitous drop in basis predictability over the last two years in corn. While the decline in the slope is not large, the intercept increases considerably, and the hedging effectiveness drops to 37 percent. Basis predictability results for soybeans are even more dramatic. The lower left equation line indicates delivery location basis since 2006 changes are far less than the initial basis, as indicated by the slope of a negative.36, and the hedging effectiveness drops to only 19 percent.

The results for wheat are different from corn and beans in that the basis predictability was unimpressive before 2006. Nonetheless, the predictability since 2006 has followed the pattern of corn and soybeans and deteriorated substantially relative to the earlier period.

The bottom line from the predictability analysis is that location basis in corn, soybeans, and wheat generally is weaker and far less predictable post 2006 compared to pre 2006. This has far reaching implications for hedging use of these futures markets if the situation is not corrected.

An obviously important question is what caused the convergence problems observed over the past couple of years.

A relevant observation in this regard is that the nature of convergence problems was inconsistent through time and across markets. For example, convergence in wheat was weakest during 2006, but recovered somewhat in late 2007 and early 2008, while the convergence in soybeans was weakest in the second half of 2007 and early 2008. So this makes it difficult to identify a single cause and difficult to accept a one solution remedy.

Solutions to convergence issues suggested to date have tended to be one dimensional and focus on, one, encouraging longs to liquidate before first notice date by changing delivery rules to force takers to load out, this sometimes is called the demand certificate, or by increasing the maximum storage charges to make owning delivery instruments less attractive, the assumption being that forcing the longs out before delivery would drive down the nearby contract and improve convergence.

A second proposed solution is to change the terms of the futures contract to a cash index rather than the certificate market that currently exists, thereby forcing convergence to a cash index by definition.

Thirdly, to manage the influence of passive longs and perhaps other groups by limiting hedge exemptions, thereby forcing these groups to trade with spec margins and spec limits. This solution follows from the assumption that these traders are artificially and permanently forcing futures prices above the fundamental value of the commodities in the cash market. Fourth and lastly here is the proposal to expand delivery capacity in order to accommodate more arbitrage of cash and futures prices during the delivery period and thereby force convergence.

Without a consensus to the cause or causes for poor convergence performance, it may not be advisable to make substantial changes in contract specifications at the present time. The unintended consequences could be worse than the poorly designed remedy, particularly if market conditions change in the near future.

The tweaking of some of the contract

specifications like storage rates and delivery capacity and monitoring performance make sense, but may not be palatable to market participants who would like an immediate fix.

As a final point, it is important to note that convergence problems at delivery locations are not necessarily identical to non-delivery basis performance issues. Basis in some non-delivery markets may be influenced by lack of convergence, but it is not uniformly the case. Corn basis at interior processing markets, for example, is less influenced by the Illinois River basis than corn markets tributary to the river. Basis at non-delivery locations is influenced by transportations costs, storage and ownership costs, the supply of and demand for storage in the local market, and the merchandising risk or the margin risk that's been alluded to, as well. All of these factors have likely contributed to the weaker basis at many of the non-delivery markets. Thank you for considering this statement, Mr. Chairman.

MR. LUKKEN: Thank you very much. I'd now like to turn it over to Tom Coyle to kick off the discussion on convergence. I know he's done a lot of thinking in this area. I would note, one of our atrium participants, Michael Brown, has asked about this idea of cash settlement of contracts, so as you go through this, if you wouldn't mind addressing some of these ideas that were brought up in Professor Kunda's presentation. Thank you.

MR. COYLE: Thank you, Chairman Lukken, and I'll be happy to touch those. What I'll do is go through each of the key questions for the segment of the discussion. Have had a lot of data presented earlier, and charts, in the current presentations.

I'm going to walk through this a bit more like a commercial operator. I represent the National Grain and Feed, but I manage a business that's entire role is delivery convergence, it's all we do, 24/7, every day of the week. It's in Chicago, so it should be.0, so we have some perspective. First, what is convergence? We've heard a couple of comments. From our perspective, convergence is at point when cash equals futures. Essentially, if you want a perfect convergence, you would get to a point in time where there would be no incentive for the maker to make delivery or for the taker to take delivery.

Someone suggested that we should have convergence every day. But the fact is, we have a system that allows us to do that during the delivery expiration process, and there are a lot of things that can impact the convergence. But you're counting on it during the expiration of a contract.

Traditionally, we've had reasonable convergence. Today, as Mr. Kass' charts show, we don't have that. We do get convergence at times. Even this year, with the very wide basis levels in wheat, we did get the convergence in Toledo in the fall.

At the same time, of course, we could not sell bushels in Chicago for 50 cents a bushel cheaper than Toledo.

But then in February, we actually got to convergence. Of course, it only lasted for about two weeks, and now we're -- three million bushels of wheat, we're going to carry in a new crop. So it isn't as dependable as it was before. So the question is, what happened? First, the calculation for convergence has changed. There really was a point in time, and it wasn't so long ago, that you could calculate within a half a cent a bushel what is convergence. And I can recall many discussions with the investigative arm of the CME or calls to the CFTC that, you know, someone is doing something that's uneconomic, for half a cent a bushel. In hindsight, it almost seems kind of silly to have those discussions.

But the fact is, as I've heard someone mention earlier, there is -- I think Dave Lehman made the comment, convergence is a band, all right, yeah, you can calculate, and since we do it all day, we really know what is the cost of loading it, what are the assumptions in terms of how much storage you're going to have to pay, and what is the real shrink, and what are your inspection costs.

But the fact is, there's a band, there's a bid and offer in the barge market, there's a bid and offer in the barge freight market, there is -- and guess in terms of how long you're going to have to pay storage. So you really want to figure out your costs. Those numbers have changed dramatically in the last ten years, most of it I would say in the last four or five years. Today, you might have a five cent spread between the bid and offer in the barge market for a loaded barge. It used to be a quarter or a half a cent. In the barge market, it used to be easily a five percent spread between bid and offer in a barge freight market. In fact, often times you would trade two and a half percent of tariff, that would be what you'd be negotiating. Today you wouldn't even get a counter. The spread might be 25 to 50 percent of the tariff in the bid spread. What does that mean? That's nine cents a bushel out of Chicago.

So what happens is, now you have this huge band of what convergence is, and that's without any influence from an index fund or this new capital. The fact is today, with wider transportation -- higher transportation costs, much more volatile transportation costs, this convergence is harder to calculate.

Now you throw in the influence of new capital that's entering the market. A question was asked earlier, how is it that an index fund that doesn't even participate in the delivery cycle, the expiration, how could that impact convergence? Well, in the case of wheat, if you look at the net open interest in wheat, excluding spread trade, 50 percent of the open interest is actually held by a passive long that isn't going to sell it at any price. Well, that, by its own nature, elevates the price of grain. There's no doubt that prices would be higher today because of all the global comments we heard, the real supply and demand issues we heard earlier. We do have biofuels, we do have growing population, we do have inflation, so there's no surprise by that.

But if you've got a percentage of the market that is not for sale at any price, that accentuates the problem. And if you look at the other charts that were shown earlier about the farmer's tendency to sell, when he sells, a greater percentage early in the crop year, well, what happens as the crop year progresses, and that grain has already hedged, and now you've got new participants buying it?

Well, what happens is, you end up having more speculators on the other side of that. And at this point, the numbers show that you've got more speculators actually buying the market, as well. So there is an impact, but it is clearly not the only reason why we have a convergence issue.

We spent a lot of time in the last year in the National Grain and Feed analyzing the issue, trying to get ideas. Each time, in fact, it's gone beyond the last year, we've made recommendations to the CME, they have implemented the changes, the shipping certificates in July for the week -- is going to increase utility of that market, because an elevator doesn't have to move grain backwards or pay transportation costs, so they shouldn't pay at the wrong time, because they can buy grain in the country knowing that they can tender a shift certificate. It's a powerful tool.

We have some track record here in Chicago to be able to see what happened in corn and beans. We also asked for an increase in storage rates, partly because the costs of storage have gone up. The costs include your shrink as the prices go up, all right. It's no one's fault, but the fact is, you having a shrink running your grain over, so now your cost of storage goes up. Your aeration as you're maintaining the crop, the quality of deterioration, there's a cost of that, as well. If you store grain for a long period of time, there's a cost of that, as well.

The insurance on the grain that you're storing, all of these factors add to the real cost. So aside from that, you actually have the value of storage which varies at the time of the year. We've made a recommendation to the CME after our task force to increase the storage charges and load out fees, which increases the utility of the current elevators, and it better reflects the storage. The current recommendation you're going to see from us, despite the fact that the Commission has just approved those increases, is we think that you ought to take another look at them immediately. A lot has changed.

So you've done your poll before, repoll the industry and find out what the storage rates are, because they should reflect the cost and value of storage, and today they clearly don't.

If we built a lot more storage, convergence would not be a problem. We'd store the grain longer, as long as we had the money to do that. If people could make a lot of money storing grain, they wouldn't ship the grain, and you'd get the basis to recover.

The recommendations that we have related to this issue, we'll talk about the funding in a second, one is the storage review. It's not going to be a major thing. I think if you survey, you may find that they're a little bit higher, we think that would help the situation. But it's not -- you're not going to find major differences from the changes that you've already made. Second is the idea of agriculture swaps that opens the door to new innovation. We think that that's something that does make sense. How exactly? Well, the Board of Trade -- the CME is already working on, you know, basis swaps that could -- that they could clear, that provides an opportunity. We talk about the liquidity issues, if somebody can clear a swap that actually has financing embedded in there, and that can go through the CME, that's a benefit.

We understand that the Commission staff may be considering adjusting the ATO rules, again, another tool that we can engage and try to provide better balance in the market.

We considered, as you mentioned, we considered a number of things during our task force, some of which you've already heard, and so I'll address some of those issues. One of the -- I would say the most widely supported alternative would be a dramatic increase in storage charges. Instead of making five or six cents a bushel, why not make them nine or ten cents a bushel?

If that happens, you know, sometimes the market will get to fully carry, like during harvest, but other times it won't. So the market won't get to full carry, so you'll get convergence. And there is a contingent of our association, we'd love to see that. And as an elevator operator, that's a good thing. The problem is, I like it, but if you look in the market, the problem is that it becomes imbalanced. Now you have a situation where, if you have high storage rates, and then later in the year, when storage is not quite as valuable, well, I'm a delivery elevator with a -- certificate, and if the market -- if someone is going to pay me too much and give them shipping certificates, I'm going to give it to them.

So what happens then is, the market doesn't respond the other way, so that the long, the other side of the hedger, the miller that's counting on the market to respond when they can't buy grain, all right, they don't want the basis to have to go to 100 over either, they want to get to that point where the market gets imbalanced, the futures market responds.

If you have storage rates that are too high, then the futures market can't respond there either. So it's been an ongoing, I would say debate within our association, but our task force concluded it just wasn't balanced.

Another thing that was considered was alternative delivery points. We used to have Toledo deliverable for corn, beans, and wheat; today they're not deliverable. We've gone through that, and, in fact, you could add Toledo again, and maybe you add delivery elevator in Lincoln, Nebraska, where they have lots of storage, as well. What that would do would provide better basis convergence in those local markets, because those -- there would be guaranteed sales in those markets.

But the problem, again, is that you have a disadvantage to the long. If there's really tightness in Toledo, you're not going to get any corn in Toledo. If there's a tightness in Nebraska and you really want it, you're not going to get anything there.

The way the system is designed today, grain kind of flows in and out. It's almost like the export market is the buffer. If there's too much ethanol demand, grain will not get to the Illinois River, and if it doesn't get to the Illinois River, the market will do its job.

So the idea was that while it may provide some better basis management in the areas which you put a delivery -- you actually would not get convergence because you would be harming consumers that were counting on getting Nebraska.

The fact is, if there's grain in -- if they see it in Nebraska, you'll probably get it in Toledo. But it is something that can be considered. The second -- the other issue that got a lot of the debate in our association was compelled load out, where the maker of delivery can actually -- I can make a decision to deliver grain and then force the taker, the long, to load it out, and when space is tight, that's a really good thing. You know, we have a guaranteed bid on our Chicago elevator for 11.3 million bushels. But the minute we are full at 11.3 million bushels, we've got, like every other elevator, we've got to find something else to do.

If we're in a situation where we could compel load out, well, clearly the basis loaders are going to go up, because we could force some long to load the grain out, and that would get convergence, at least from our perspective. The problem with that is, it imbalances the market. Who wants to be long in a market where they could be forced to take the transportation risk when it's the maker of delivery that already has the luxury of making delivery?

So I have one benefit, and now I can

force them to load it out; all of a sudden I've really imbalanced the market. So we debated and decided that it really didn't provide the balance that is required.

We did talk about the idea of an index contract. It was a recommendation we made to maybe look at the idea of an index. The problem is that there is no -- while it sounds like an interesting theory, and we brought it up, and we thought, well, maybe -- we had a lot of interest in the room.

I mean literally there were hedge funds, and there were professional traders, and millers, and county elevators, and terminal elevators, and delivery elevators. It sounded like a neat idea.

The problem is that if you do that, that's no guarantee that you're going to get a convergence anyway, and now you've created a new problem. You're somebody in Iowa today that at least knows that there is a price at which you can put a real -- sent it to Chicago to a delivery market, or if, worse case, you put it in a truck and take it to the Illinois River.

You can figure those values. But what happens if you change that, so now it's a basket? Well, there is, first of all, there is now, from a country elevator perspective, how do they now figure out what their basis risk is? How is my basis relative to a basket? You basically have the same problem, but in a more complicated way.

And you give the one thing that you have today in the market, you have a guaranteed place to go with grain. There is -- there's a -- where the -- I would say your worse sale should be to a delivery elevator, all right, because if you can't sell it to anyone around you, a consumer, and you have to direct it against flow to a delivery elevator, we can get a bid, but -- because there is a bid that we can buy it and deliver it to the market.

On the other hand, if you're a long, right, there is a price at which you'll get it. You may not be on the river, you may be in a place that's a -- but you sure can take a barge, take it some place, unload it, and bring it to you. There is at least today some place you can get grain if you must have it.

That goes away if you have an index contract. The futures market in the system was never designed so that the delivery market would be the easiest source of cash. It's not really supposed to be your easiest source of cash.

So we looked at a number of different issues in terms of convergence, we've made some minor recommendations, we'll make -- and you'll see the letter that we -- our recommendation today is that you'll quickly take a quick look at your storage rates to make sure the ones you're implementing are appropriate.

We don't anticipate there will be a major swing, but you have the opportunity to do it now, it's a good time to do it. And again, we're supportive of the ag swaps and the trade options, as well. The next item on here was the forward contracting of elevators, and that's the one that probably has been the scariest for our association and our members. I recall being in an Executive Committee meeting in January, and I saw blackberries going off. Normally they're not even on in an Executive Committee meeting. But people turn white as a ghost. You could tell that they had their customers calling them saying they're running out of money.

Our little company in Chicago bought grain from one elevator in store because they just had to have a bid. They needed to sell 300,000 beans, which was $4 million. So I visited them, and they said, well -- I said, what do you need, well, they needed a total of $11 million to get them through January. So we found a way to get our bank to approve them, and we got in the middle between them, and by the way, the consumer, and funded their inventories.

Before the month of January was over, that was up to $70 million. We're fortunate the way it actually had access to that capital. I can only imagine people that hadn't thought ahead. And then the phone is ringing off the hook, people saying they're going to get out of their futures contracts because they can't afford the margins. They just don't have the liquidity. So what do they do? So if you've got inventories, I mean what caused the problem? Well, first of all, you have greater inventories, you produced a lot more corn last year.

Secondly, you have a lot more -- you have higher prices. So that's for your inventory. Your need for capital has gone up. For the most case, you're able to get that, the banks will give you the money for your inventories, you have collateral, as long as you're able to manage your inventories, that's probably not a problem. And the banking industry, frankly, has done a great job of servicing our industry.

But when you get into deferred contracts, that becomes a different issue. They're willing to give a certain amount of dollars, but not dollar for dollar. And what's happened with the high price of commodities, and we've seen it from the charts that Mr. Kass had put up, there is a lot more forward hedging.

And now you have this tremendous need for capital to fund your margin calls. And the result, well, interesting, is that this is typically the most attractive bushels for a grain elevator. If you buy deferred bushels, first of all, you can manage your business better. Now I know I've got the origination, I can manage my transportation, and in this environment, that's something you'd like to do. If you need to buy storage capacity or build storage capacity or find some creative storage like grain on the ground or, in our case, a storage boat, you'll do that if you've got that time.

So traditionally, you've always had this margin risk, but you didn't think of it. If it's going to cost you one or two cents a bushel to do that, fine, it's more than offset by the benefit of managed logistics and running your business.

But what's happened is, the money has gotten so significant that two things happen. First of all, you are literally getting -- the bank says, I don't have it anymore, they're getting more selective, there is a liquidity issue.

As the prices went up, you first could say, well, my costs are going up. So I used to give it away, I wasn't even including that as a cost of business, that was offset by my logistic benefit. So now what you do is, you widen your basis levels, you widen your basis levels to cover your cost.

All that makes sense. But at some point you get to a time and you say, it isn't a function of cost, it's a function of availability, and there is no price at which a grain elevator operator can run out of money, all right, they can't run out of money in the fall when the farmer says, I want to deliver the bushels and I want to get paid. The farmer wants to walk out the door with a check in their hand, if necessary. If you ever get in a situation where you can't do that, the farmer goes away.

On the other hand, you can't be in a

situation where the CME calls and says, you know, or your FCM calls and says, I need to get -- I need the margin money, then you can't make it. So if you get to the point where you're not certain that you're going to be able to make that margin call, you have no choice but not to bid.

So it's a giant step backwards. I mean the Commodities Exchange Act and the exclusion for forward cash contracts were specifically designed so that our industry could literally buy grain for farmers, that was the whole point.

And now we're in a situation where we are concerned, and some people just said I can't do it, I cannot estimate the cost because I don't know it, the futures market may go up $10 a bushel a corn, who says we can't be $15 in corn. There are some compelling issues. Maybe that does happen. And secondly, I can't determine whether or not I actually could be in a situation where I cannot come up with the money, and a very profitable organization is gone overnight. And I can tell you that our association was genuinely concerned that we'd come in some Monday morning, after Friday, when a number of our members were unable to make a margin call, the next thing you know is, they're all blown out of their positions, and then, of course, the market would turn and go down, and then we'd have a serious problem.

So it's clearly not a situation where elevator operators don't want to buy deferred grain, they really, really want to buy grain. But I mean that's our primary role for servicing our farm customers. But it was a risk that was not manageable.

So how do you deal with that? As an association, we had a conference call with our banking members. I think there were 14 members, including presidents of banks, I think the President of -- bank may have been on there. It was amazingly well attended, to find out, how are we doing. They've done a great job of servicing -- do they have the money. And what they said was, you know, we're -- they have the money today, and they're, frankly, trying to take money from other parts of their balance sheet so they can service the industry, but even they're starting to get some heartburn, because what happens if there's nothing else on the balance sheet that they can steal from Peter to give it to the grain industry? Well, then you have the problem. So they clearly were putting the yellow flag up and saying they were going to be more selective with their customers.

The next call we had was with either members that are funds or funds that we are aware of to say, is there a way your money can get deployed in the market different. I mean, think about it, we have people chasing the agriculture, and we're saying stay away, that just doesn't seem right.

I mean think of how good it is for implement dealers, for seed dealers, for farmers, I mean -- but at this point, they're creating an imbalance, because what they chase now are futures contracts and not real bushels. So we ask the question, is there a way that you would be willing to deploy your money by buying deferred contracts.

Think of a fund that bought deferred bushels from country elevators, and if -- right before delivery, the day before the shipment period were to start, the contract either gets converted to physical inventories, now the fund that wants money in the ag space gets it, or it gets converted to Chicago futures and everyone is fine. The answer we got, and it was unilateral, is they simply don't want the counter party exposure. And they're not structured to be able to handle 500 customers. They're very happy to go to the CME and to trade futures, it's quite easy, it's low cost, they don't have the counter party risk. So they made it clear they were unwilling to do that.

So the next question is, how do we do that? I think it was Commissioner Dunn that suggested, well, is there something in the USA, is there some tool that's available. Well, there may not be today. But who's to say that the CRC insurance coverage couldn't be changed so that there's actually an extra premium if the farmer wants the fall protection, and if that happened, then you would be able to securitize those forward contracts, because there is no risk, because it's backed by the U.S. government, and someone is paying a fee for the insurance anyway, and now you find another way to get all these billions of dollars of capital -- industry.

We just haven't got there yet, which is one of the reasons why we suggested a moratorium on the new participation from these long onlys. It's not saying that they're going to go away, because they're not, they want to get in our space, and we want to find a way to get them there. We're just not ready today, and we can't afford that, before we're ready, that we have grain elevators that go bankrupt.

Good, you know, conservative grain elevators go bankrupt because they didn't -- they couldn't manage the capital. So that kind of answers the question in terms of the last question for the second one is, what do we see for swaps.

We don't really know. But if you open the door so that you can clear an ag swap, then what happens is, the industry, instead of the Board of Trade coming out with new products, the industry brings products to the Board of Trade, things that they can clear.

Maybe some of those products actually have financing embedded in there. We won't know like it started, but it seemed like it is a possible solution. That's it.

MR. LUKKEN: Thank you very much, that was great. Are there any comments to Tom's -- Mike Walter from the CMC.

MR. WALTER: I'm Mike Walter from the Commodity Markets Council. And as was mentioned earlier, we did hold a session a couple weeks ago where we invited people from all aspects of the user side of the commodity exchanges to come in and talk to us about a variety of issues, and one was convergence. Clearly, they told us that they didn't want to see any radical changes to the way business was being done.

And to echo what Tom was talking about, they were very amenable to raising storage rates, they understood what that would mean and what that could do, also expanding daily capacity through shipping certificates or maybe some in line delivery areas that currently are not available for delivery now would help with the convergence issues.

We did see a variety of them that came up with ideas, like the cash settled way of handling this. It really didn't get traction, nobody wanted to see that. Shipping certificates were very unpopular. I used to trade when we did have shipping certificates, and it is very unfair to the taker, so I think that was out.

But ag swaps, certainly they're very interested in, and thought that that would be very helpful. So just to give you a proxy of what the users of the exchange would like to see happen with respect to convergence, again, they don't want to see any radical changes, but they would like to see some tweaks in there. And with respect to the funds, they just really did not understand the funds impact, you know, in terms of delivery and convergence, because as Doug mentioned, you know, they're out of the markets through that period of time, but they certainly think that that warrants more study on the convergence side.

And with respect to what we're hearing on the finances, certainly there's a lot of stress and strain out there on the farm community, as well as the elevators, and what's really happened is, you know, the major, or not the major, but just grain companies in general, and the big grain processors used to absorb all that risk. Two or three years ago they took it all on, and it didn't bother them.

And to Tom's point, buying deferred grain or making deferred sales to food manufacturers, those kind of things were -- that's where a lot of money was. And there was never an issue with respect to counter party risk.

Now the counter party risk is enormous,

and the amount of money that these larger concerns have to put up with respect to large and daily maintenance, it's becoming very onerous for them, I think particularly the publicly traded ones, because it shows up as debt on their books, and they're just -- they're just backing away from it. They're saying, okay, we're not going to take that risk anymore, we're shoving it out to the food manufacturers, and we're shoving it back down to the grain elevators, and ultimately the farmers, who now have to figure out a way to deal with it. And who knows, maybe a whole new industry will develop, somebody will come in and guarantee these contracts, maybe a new insurance industry will develop as a result of it. But there's a real reason, you know, this is happening, but the solution is going to be a little bit difficult.

MR. LUKKEN: I think the entire Commission is interested in hearing more about cleared ag swaps. As well, exact trade options is something we've studied, and whether that program can be improved. I know, Dave Lehman, you have some views on all of this.

MR. LEHMAN: Well, and first, thanks, Mike, for a summary of the Commodity Markets Council meetings. One clarification, I think you had mentioned lack of interest in shipping certificates, I think that was demand certificates --

MR. WALTER: Demand certificates, I'm sorry.

MR. LEHMAN: -- that we really didn't find a lot of traction within the industry. And if I could, before we talk about swaps, I'd like to just follow up on a question to Tom and/or Gene about convergence. And, Gene, I think you mentioned the January soybean contract showed poor convergence, and I guess it's in a relative sense what we looked at, the data that we have for January soybeans showed the that Northern Illinois River, back in September, was a $1.50 under the January futures, and at first delivery day, it was 50 under. So we look at that as $1 strengthening of the basis, or $1 appreciation in basis during that time period, and to me, that's convergence.

Now, I know it's not reaching zero, and Tom, you mentioned you're -- in Chicago, that your basis should be zero in Chicago, but isn't that contract working for the short hedger when you see that kind of a basis appreciation? So that's one comment.

On ag swaps, and Commissioner, thanks for that question, and our Chairman mentioned it this morning, we are very interested in clearing ag swaps. Many of the commenters in the cotton market this morning, I noticed, are suggesting that there needs to be more transparency in the over-the- counter market, and that's one of the benefits of clearing OTC products, that we believe that does bring more transparency to the market.

We're doing it now in ethanol, today we're clearing a calendar swap, as well as three basis swaps and an option on a calendar swap. These are OTC instruments that are traded off exchange directly between counter parties and then entered into our clearinghouse. When they enter that position into our clearinghouse, we then report that volume and that open interest, we report it every day on our web site, we report a price that that product is margined to, a settle price, if you will, so we feel that allowing clearing of agricultural swaps in the same way that it's allowed in energy products today is a way to bring additional transparency, to bring this activity onto the exchange, and to allow the kind of coordinated surveillance that was suggested as needed in the cotton market, where now the Commission and the exchange regulators will be able to observe more so what's going on in the over-the-counter market and how that might be impacting the exchange markets.

Obviously, it's not the entire picture, but we did formerly submit this morning, Mr. Chairman, a petition to request CFTC's approval for corn basis swaps. We think these are tools that will help manage this basis risk, and then also for corn, wheat, and soybean calendar swaps. So thank you.

MR. LUKKEN: And the clearing of those products for our surveillance purposes allows us to see certain large trader information as they come into our market, so it is beneficial from a surveillance point of view. I know Joe had talked about this this morning. And if we can get a mike for Joe Nicosia.

MR. NICOSIA: In regards to, you know, convergence, as we tried to look to see what went wrong, and obviously it went wrong in the cotton market, as well, but even on a more general picture, it was mentioned at the end of our last session, and I think very properly, that one of the major problems that we -- it all boils down to financing that we have and the liquidity that's available to it, because the people in the market place know how to cause convergence, if they're able to take the risk and have the liquidity to do so and have the financing to do that.

So we find ourselves today in an industry that essentially is under capitalized or that needs to reliquidify, and the market will slowly adjust to this over time, and banking lines will slowly adjust to it.

But one of the problems that we have with this, and if we look at it is, again, if we go back, and I'm not picking on index funds or on large funds, but it is the root of the problem here, because they're able to come into the market place, establish positions as five to ten percent of margin money that comes through. On the opposite side is a traditional hedger who pays $12 for beans and puts up a short sale. The amount of money that they have when they come to meet on a transaction is ten to one against the traditional hedger.

You allow the non-traditional hedger to put up one-tenth of the amount of money, or smaller in some cases, and drain the liquidity out of the industry. Now, if, at that same time, you were to require people who want to have substantial positions above speculative limits that have no cash against that, to require them to maintain their exposure to the industry by having a physical presence, that money in and of itself reliquifies the industry.

So instead of being able to use a ten to one or a to one leverage, if they were, wanted to continue to have a broad based exposure to the industry, and they wanted to own an extra 50 million bushels of corn, or 100 million bushels of beans, after the speculative limits, would need to go ahead and either -- it's the same thing as actually requiring them to say put up a higher margin or 100 percent margin, but if they were involved in the actual physical commodity, like buying gold bars, that money reliquifies the industry. So it does boil down on the convergence side, is that the lack of it today is because the traditional hedger doesn't have the ability to continually fund and/or provide the funding to go ahead and to make one session, which is essentially delivery, which is the only point to try to draw that convergence in, and it only happens once every 60 to 90 days. And in between those 60 to 90 days, they're fully exposed. So that's one of the answers, you said, does anybody have an answer on how we try to reliquify the industry, that's one possibility.

MR. LUKKEN: Bob Greer from PIMCO.

MR. GREER: I'd like to clarify, if I could, the way that the typical index investor operates, whether it's an investor like a pension fund or whether it, indeed, is a fund that represents, as I mentioned before, as much as 200,000 individual investors.

Those investors typically put up 100 cents on the dollar. If you want a dollar's exposure to wheat, you will have $1 in that index. They do not use the leverage that was mentioned just a moment ago. And so that is point number one. And you heard two other people describe the same thing.

I hope you understand that index investors are not leveraging their positions.

MR. NICOSIA: That's not what I said. I said you're leveraging the financing, a very different term. I think ten times the position against the money -- have to put up ten percent of that versus a hedger, who has to use his financing at 100 percent, two very different situations.

MR. GREER: You are talking about the amount that might be deposited with the exchange versus the additional collateral backing that, which is held an owned unlevered by that investor. We might deposit, if it's $100 of exposure, maybe $10 is deposited with the exchange, but there's another $90 sitting right there with it, so there is a full $100 backing it. We're not taking advantage of any kind of leverage in our total position.

MR. NICOSIA: No, I understand that. You're not leveraging it to the multiple. But if, for example, it would be a very different situation if you took that $100 and bought a bushel of beans with it. Now you would take that off of your balance sheet, you wouldn't have that on there at all, you would own a bushel.

That money would come back into the industry, on the other side, and that would be money that would be available to provide additional purchases of beans, additional delivery economics, additional storage, it would reliquify the industry, because today convergence doesn't take place, because the amount of capital that is necessary to fund our positions is substantially different. There's a substantially larger drain on the traditional hedger than there is on the index person.

MR. GREER: I think that suggesting that an index investor should take delivery might distort the markets more than what they are doing right now, which is before you ever have that first delivery month, that investor has sold his nearby position and simultaneously bought a more distant position, so that they are, again, they are looking to have exposure to changes in the price of that commodity, they're doing it, as we described, for portfolio diversification reasons, they're doing it because those people have to buy gasoline, they have to buy bread, other things that relate to inflation.

Those are the reasons that they're in the market, and it so happens that they are --

MR. LUKKEN: I apologize, go ahead. Repush your button, there.

MR. GREER: Did I say something wrong? Again, understand their motives, which are, for investment, for diversification, for risk reduction, and a byproduct is providing liquidity and assuming some price risk from the other participants in the market. That is why they're there, they are there on an unlevered basis, and their activities are very clear in the market as far as what they do. As a matter of fact, you don't have to worry about index investors suddenly standing for delivery for -- in your grain markets.

MR. NICOSIA: But actually, the -- what I would say is, you don't have to worry about it, I don't think that that's a concern. As a matter of fact, part of the answer is going to be, the industry is going to make you take delivery, one way or the other, that is what's going to happen.

Spreads are going to get wide enough that the convergence is going to have to take place with outside money, outside of the industry, and that is what -- whether it be -- come from alternative bank financing, but the easiest way to solve it is by increasing profit margin, so that it becomes so attractive that it attracts capital to the convergence, and that's what's going to begin to happen.

And as those spreads widen, index funds largest exposure are the spreads as they continue to work, and that's how the market place will try to solve that. So whether you physically take it or not, or whether the interest -- the spreads widen to make you have to take that or make you feel that pain, convergence will have to take place one way or the other, it's just a question of how are we going to reliquify the industry.

MR. GREER: If the market moves in that direction, index investors will respond to market forces. But that, again, is different from saying that you must physically take delivery.

MR. LUKKEN: Let's turn to Doug Hepworth. I know Doug with Gresham has some views on this. And we're going to have to shortly break for lunch, so I have time for about three more questions. I know Jim has been waiting patiently, and Layne here on the end with Minneapolis Grain Exchange, that's about all we can probably do before the break. And, Garry, we'll try to get you in at the end, too.

But let's start with Gresham Capital first, with Doug.

MR. HEPWORTH: Hi, Doug Hepworth, Gresham Investment. Actually, first to Tom's point, I still do not understand the mechanism of how an index or passive positions in December wheat impacts September convergence, but maybe come back to that later. I guess in terms of the work that Doctor Kunda and the group did, one point that David made earlier which I thought was interesting is, it might make sense to look at some of this basis and convergence in percentage terms. I mean you have very different prices than you had several years ago. And the other point I would make is, following your methodology backwards in time yields other periods, where we saw similar failures of convergence.

In fact, the December, '06 non-convergence was actually less than the September, '99 wheat convergence, which was less than the May, '93 wheat convergence. And you saw similar things in September, 2000 soybeans and corn. It just seems to me that we might use the lessons of those periods to maybe help address these, and perhaps not focus so much on some people who own the futures that aren't being delivered against.

MR. FENTON: May I just respond to that, to get back to Dave, too? And in the full statement, we have the charts, Dave, that go back, as well, and Doug, too, show some of the historical patterns. So to answer Dave, the convergence itself has these two elements I portray, and I sometimes call them the verb and the noun, and the noun convergence is during the delivery period, when the futures market becomes the spot market, it has no more future, so it is the cash, convergence at a point, and that's when we talked about the ability to have them at a delivery location if it was perfectly one location, one point in time. The other consideration, and the reason that that may not have that convergence as been discussed in some of these costs of participating in the delivery process, and so as been mentioned, have surely increased, even on a percentage term.

If you look at what Tom Coyle offered in terms of the costs in shrinkage, for example, that's a complete percentage number. The other way that we looked at convergence, and to bring up your point about some of those, again, as convergence as a noun and the delivery point, some of those examples were prior to the change to the Illinois Waterway System, which did have congestive periods at the terminal markets.

And again, I think that Tom could probably relay some of those situations in the past. And that's why moving to the shipping certificate I think helped to alleviate those congestion issues, so that grain weren't moving opposite of the flow that they should be.

Now, to sort of get to Dave's question about, okay, it started at, you know, a dollar some under, did you say the November soybean, and then it moved up to about 30 under, and that is the convergence sort of as a verb. It's how it acts through time. And so now you look at the issues again of the costs of the storage and the supply and demand for storage in local -- in the local market. So that basis, yes, in fact, then attributes itself to its predictability. And so the second set of research dealt on the convergence as a verb, its predictability.

If it started a dollar under, would it move a dollar to come up? Well, if it's, you know, so that would help to address pretty much the slope of that analysis, if it were $2 under, $1.50 under, and moved to $1 or 50 cents under, yes, you had a one slope, but then that would effect that intercept on it, and that intercept, again, relates back to the costs of the delivery process.

So if, you know, I guess to -- we're looking at both convergence as a verb through time, because we need to have predictability in the basis, as well as we're looking at convergence in that noun sense, because now we want to be able to make the interaction occur where that linkage now meets the cash and the futures markets. So we need both types of convergence.

MR. LUKKEN: Jim Byrum from Michigan Agri-business.

MR. BYRUM:: Thank you. I want to be a little more basic and speak about what we believe, from a country elevator perspective, may be the gorilla in the room, and that is the next six months. And it's interesting to talk about speculative investment looking forward in future contracts and storage changes and things like that.

But if one considers the economic

situation of country elevators, and I can't speak with cotton or for cotton, we don't do a lot of that in Michigan, but if one looks at the situation with credit availability, liquidity, we have a near term issue from now until harvest, about three months for wheat and about six months for corn and soybeans, that if we have an upheaval in weather, we have a huge issue.

Margin calls, and I know this is probably more of a segue to the next section, but it's an issue that can't be lost when, in this section we're talking about forward contracting and our members, country elevators in the country side can't offer instruments, forward contractibility, they can't even offer current cash sales if the market is not open, that's effecting rural America dramatically today and potentially in the next six months as I suggest is the gorilla in the room. Changes in instruments are certainly something that obviously is going to be examined and looked at. We encourage transparency and we encourage tweaking as opposed to major overhaul. It's significant that the market essentially, at least in corn, soybeans, and wheat, seems to be reacting to demand, and certainly infusions of cash, maybe from non-traditional sources, but the challenge is, in this period of uncertainty and volatility, dramatic change is not the rule and certainly not what we should be looking at. Thank you.

MR. LUKKEN: Layne Carlson from the Minneapolis Grain Exchange.

MR. CARLSON: Layne Carlson from the Minneapolis Grain Exchange. Thank you, Commissioner Lukken. I just want to comment a little bit on Doctor Kunda's -- one of his proposals was to change the terms of a futures contract to a cash index, and I just want to comment.

There's been some others within this -- around this roundtable and mentioned and discussed, Tom was one of them, about the cash index, and I think the Minneapolis Grain Exchange actually offers cash settled index contracts on three wheat contracts, on corn contract, on soybean contract, and the topic has been discussed a little bit about the cash index, and I thought I'd just kind of run by a little bit about what we see as some of the terms of these contracts and kind of review a little bit what we see as the advantages of these contracts, specifically we've had these contracts out there for a couple of years, this is something we developed, we saw the potential option that we wanted to provide the industry, for those who didn't want to get involved in the delivery process, that they could avoid that, and looked for alternatives, and we provided something off a regulated contract market, and that was the cash sold contract.

We got the information from a very reliable source called DTN, whose -- I think everybody in here knows who they are, and what we offer is an opportunity where an individual can get into the cash -- get into a futures position, and there's no reason for them to roll out.

It doesn't matter going into a delivery

month or having to roll out of a position. There is -- they can hold simultaneously futures and options until the last day of the settlement month. Options don't expire before the end of the futures trading day.

So, in essence, there's simultaneous expiration. There's no need to exercise options on a whim. Convergence, the advantage that we see on these cash contracts is that there has to be convergence. Doctor Kunda mentioned that in his presentation there, that we believe you have to force convergence into these -- a settlement process. There's no delivery concerns, there's nothing to do with convergence concerns, there's no storage cost to pay, there's no differentials on grade factors when you load out the grain, there's actually no concern on position holders.

It doesn't matter who you are long, it doesn't matter who you are short, it doesn't matter how many positions are open going into that last month or even into the last trading date. No one can use inventories at any specific location in order to try to manipulate markets.

Again, I just -- these are the type of things that we believe we've been looking forward -- we're forward looking as an exchange trying to offer something else into the industry. Each of these contract markets are cash sell contracts, trade each month, so there's opportunities besides a few months out of the year, we offer it every month of the calendar year.

I just think if there's a risk management option that people are looking at, the cash sell contracts should certainly be one, and they factor that it's on the grain exchange, on a regulated contract market, should provide a lot of that certainty.

MR. LUKKEN: Well, thank you. Unfortunately, we're going to try to break for lunch. So we're going to try to make it a short lunch to try to get a little bit back on schedule. But if we could try to reconvene here 45 minutes from now so we can have our last session on margin, for which we'll have the Kansas City Fed, as well as the Farm Credit Administration talk more on the financing side, which was a big part of our discussion this morning. So let's try to meet back here in 45. Thank you.

(Whereupon, a lunch recess was taken.)

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

MR. LUKKEN: All right. We're going to go ahead and get started here. First off, we have the Kansas City Federal Reserve Bank, represented by Esther George, to give a presentation on what they're seeing in rural credit markets. Welcome, Esther.

MS. GEORGE: Thank you very much. As Walt said, my name is Esther George, I'm a Senior Vice President with the Federal Reserve Bank of Kansas City, where I head their Division of Bank Supervision and Risk Management, which includes our discount window, our lending to financial institutions. And I, too, Walt, want to thank you for the opportunity to be here, and to the Commission for having this important session. It's been most interesting to my colleagues and I from the Federal Reserve to listen to the discussion this morning. The Federal Reserve Bank of Kansas City closely monitors financial developments in the agricultural sector given the concentration of ag industries in our region, which includes the states of Colorado, Kansas, Nebraska, Oklahoma, Wyoming, and parts of Missouri and New Mexico.

As a regulator, the Kansas City Federal Reserve Bank supervises approximately 170 state chartered commercial banks and nearly 1,000 bank holding companies in that region.

And emerging from our monetary policy responsibilities, we also monitor broad agricultural and grain market conditions.

In my comments today, I want to focus on the availability of credit from commercial banks to the ag sector by providing a general overview of current banking conditions, and then highlighting the results of your most recent quarterly survey of agricultural credit conditions in the region.

Among the issues we've been monitoring are grain elevator operations and financing. The first signs of financial strain began to emerge in January, when bankers were telling us that some grain elevator customers were low on cash as they anticipated higher farm input prices, particularly fertilizers and chemicals, and has pre-purchased crop inputs for spring planting.

As these grain elevators became financially constrained, some began to also require pre-payments of their customers to bolster cash balances. Since mid February, the surge in commodity prices has further strained the cash position of grain elevators.

As some elevators face growing margin calls with record prices, business contacts in our district began to report that grain elevators were requesting additional lines of credit. More recently, some grain elevators have limited, and in some cases eliminated their offerings of forward basis and other contracts to limit further strains on their cash flows.

With grain elevators requesting larger credit lines and the deleveraging underway in some national credit markets, it is natural to wonder about the capacity and willingness of commercial banks to extend credit in this environment. To answer that question, let me describe the general state of the banking condition briefly. Overall, the U.S. banking industry is sound, with $1.3 trillion in capital. However, in 2007, net operating income for all banks fell. A decline in income was more prevalent in larger banks and was a result of higher loan loss provisions, especially in regions with severe contractions in the housing market.

Likewise, net operating income for banks in the Kansas City region declined in 2007, but remained above the national average, feeling margin pressures squeezing those profits. We have seen among regional and other small banks with large concentrations in real estate, particularly construction and land development, increases in problem loans, although the current levels remain below historic ties. And on the whole, capital levels remain well above regulatory minimums.

Agricultural banks in general have faired better than other banks of comparable size. For ag banks, the rate of return to assets remains at the historical average, although we have seen the rate of return on equity edging down to its low in 2001.

Return rates at ag banks are stronger than other small banks, and their net charge-offs have remained relatively low. Overall, the condition of the banking industry suggests it remains well positioned to extend credit in today's environment. But beyond the ability to lend, one might ask to what extent do banks remain willing to lend and under what terms. We look to the respondents to our district's agricultural credit survey, which surveys over 300 bankers in our district each quarter, to give us a sense of current credit terms.

At the outset, I should note that our survey indicates that the farm credit system has more direct exposure to grain elevator financing than commercial banks. In March, roughly two-thirds of the respondents indicated that local elevators were receiving funding from the farm credit system. Less than a third noted that commercial banks were involved in funding local elevators.

Because of the price volatility in the commodity markets, we asked a series of special questions in our March, 2008 survey, and learned that only a quarter of the respondent banks were, in fact, actively engaged in grain elevator financing. Of these banks, 40 percent of them reported that grain elevators had enough cash to cover current margin calls. And over a third of them reported that local grain elevators had not only enough cash to cover current, but expected future margin calls. Fewer than a quarter of those reporting on this survey reported that local grain elevators were struggling to meet margin calls. Those that did report customers with financial strains were generally concentrated in the wheat growing regions of our district, eastern Colorado, western Kansas, parts of Oklahoma and New Mexico, and even there reports of struggling grain elevators tended to be heavily localized.

One survey respondent noted that the

line of credit for a single elevator had risen eight fold and required participation of the credit with three other banks.

Contacts with our larger commercial banks indicate that bigger grain elevators are also tapping and asking for additional lines of credit.

With larger demands for credit, banks are reporting increases in the number of participation agreements, where two or more banks will extend credit to these grain elevators.

So how are banks responding to this increased demand for credit? Across the country, commercial banks appear to have funds available for such loans. Federal reserve agricultural credit surveys for the Kansas City district, as well as those in other federal reserve districts, continue to report that funds available for loans expanded over the past year. In fact, the availability of loan funding in the Kansas City district reached its highest level in four years in March. And conversely, the number of loans refused due to shortages of funds continues to fall. The amount of funds available for loans has risen as agricultural banks experience record high loan repayment rates and a continued contraction in loan renewals and extensions by farmers. At the same time, farm loan demand has declined in the past six months, freeing up additional funds at agricultural banks.

The interest rate environment has also been favorable for ag credit. Recent declines in national interest rates have led to steep cuts in agricultural loan interest rates. In March, our district banks reported that farm interest rates dropped to their lowest levels since 2004.

On the other hand, we have seen growing attention on the part of banks to underwriting standards. For example, collateral requirements appear to have edged up, although they remain well below 2003 levels. As a result, given current market conditions, and as grain elevators seek additional lines of credit, they might well expect increased scrutiny by lenders of their business operations, risk management practices, and financial statements. Let me close by saying the banking industry remains sound and able to provide credit as grain elevators in other parts of the ag sector increase their credit lines as a result of margin calls. To date, creditors appear to be working effectively with these elevators to ensure that financing needs are met, and there is no indication that this should not continue to be the case.

That said, while credit is available, banks are likely to pay careful attention to the strength of risk management of these elevator operations when deciding to advance additional credit. That concludes my remarks. Thank you, Walt.

MR. LUKKEN: Thank you very much, Esther. We now turn to Andrew Jacob with the Farm Credit Administration.

MR. JACOB: I'm Andrew D. Jacob, the Director for the Office of Regulatory Policy at the Farm Credit Administration. I want to thank

Acting Chairman Walter Lukken for inviting me to speak with you today on the topic of agricultural credit from a financial regulator's perspective. We do also appreciate being here today listening to the earlier discussions, very informative. Today I will briefly provide comments about the Farm Credit Administration, the farm credit system, and agricultural credit conditions. The Farm Credit Administration is the independent safety and soundness regulatory agency for the farm credit system and the Federal Agricultural Mortgage Corporation, also known as Farmer Mac.

The farm credit system and Farmer Mac are government sponsored enterprises. The Farm Credit Administration has broad regulatory and enforcement authorities under the Farm Credit Act of 1971, as amended. The agency's examination and policy development programs are directed by a full-time, three person board. Board Members are appointed by the President of the United States, with the advice and consent of the Senate.

As a safety and soundness regulator of

the farm credit system, we strive to be proactive in our examination and regulatory actions considering the trends in the agricultural credit market place.

We understand that the current environment of high commodity price volatility and input cost includes risks that must be appropriately and prudently identified, monitored, and managed. As a result, we are closely watching the changing dynamics in the commodity markets and the potential attendant risks to lenders that provide credit to the agricultural industry. We also continue to monitor the general agricultural economy. The agricultural economy has experienced several favorable years with strong net earnings at the producer level. Earnings were supported, in part, by high commodity prices and strong exports. Exports, in turn, were helped by declining U.S. dollar and strong foreign demand.

However, a weakening general economy, growing biofuels industry, rising input costs, increasing feed costs, changing farm land values, and evolving government, farm, and trade policies are contributing to the potential future uncertainties in the agricultural economy.

These uncertainties have been noted with agricultural producers across the board experiencing increases in operating costs. Increases have been particularly significant for livestock producers.

The farm credit system is a network of 103 borrow owned, cooperative financial institutions and affiliated service organizations serving all 50 states and the Commonwealth of Puerto Rico. It is established under the authority of the Farm Credit Act to provide credit and financially related services to farmers, ranchers, residents of rural communities, and agricultural and -- cooperatives. Entities that can borrow from the farm credit system include credit worthy grain elevators and other processing and marketing entities that meet statutory and regulatory eligibility requirements.

The farm credit system is a $186 billion lender to U.S. agricultural and rural America. At year end, it had a total loans outstanding of $143 billion. Lending to cooperatives and processing and marketing entities totaled about 26 billion, which is diversified among various types of entities.

While the farm credit system is a significant lender to the grain industry, loan portfolio concentration in all grains and cotton was only about 13 percent of the total lending portfolio due to commodity diversification.

The farm credit system is fundamentally safe and sound with adequate capital, strong credit quality, good agricultural loan portfolio diversification, proven and seasoned management and governed structures, strong earnings, and good liquidity provided through access to the agency debt markets.

For 2007, the farm credit system again posted strong operating performance. As a result, it has the ability and willingness, given the statutory mission, to meet the financing needs of credit worthy and eligible customers.

As a financial regulator, the farm credit system, I'm sorry, as the financial regulator, the Farm Credit Administration considers the current commodity markets and agricultural economic situation from the perspective of its safety and soundness oversight responsibilities for the farm credit system.

Looking back over the first quarter of 2008, we have seen a significant increase in credit provided to elevators and other processing and marketing entities. They have drawn down existing loan commitments or expanded credit lines to cover the margin requirements from using commodity futures to hedge their positions.

As you know, margin requirements have increased significantly as a result of higher commodity prices and changes imposed by the commodity exchanges. The farm credit system has met the increased credit demand of elevators and other processing and marketing entities. It did so by obtaining funds through the sale of securities in the agency debt markets. Debt securities outstanding increased by about $10 billion over the first quarter of 2008, or about six percent. Debt outstanding fluctuates based on seasonal credit demand factors. This year we are seeing seasonal credit demand increasing to a new level in light of higher commodity and input prices. Along with increased credit demand, we observed that the farm credit system did not materially change its underwriting standards. It has prudently stepped up, though, its risk management and credit controls to closely monitor and perform due diligence on borrower's assets that collateralize their loans.

As part of their underwriting and credit practices, we expect the farm credit system to carefully evaluate the risk management practices and capabilities of its customers, particularly in light of recent commodity price volatility.

Looking forward, we do expect the farm credit system will continue to see strong credit demand. From the regulator's perspective, we presently believe that the system is well positioned to continue to meet the credit needs of elevators and other processing and marketing customers.

Obviously, the issues that we discussed this morning have resulted in greater risks and uncertainties, particularly given the future market issues that you were discussing earlier. And this has resulted in more leverage seen at some elevators and processing marketing entities. Given this dynamic commodity credit situation, customers are closely evaluating their future borrowing needs. And faced with significant demand and working capital, we have heard that some elevators and other processing and marketing entities may be modifying their marketing options offered to agricultural producers.

It appears that entities that are making changes are doing so to manage the financial risks, borrowing cost, counter party exposure, and leverage given their specific circumstances and management objectives.

Therefore, some entities may not be offering producers the same longer term forward sales and hedge to arrive contracts. As a result, this situation may lead them to make changes in risk management practices and marketing practices. These changes might include, among others, using options based hedging, requirement revenue crop insurance, and increased equity capital, and I think we talked about another one, about the use of agricultural swaps.

These changes may further result in risk transference to individual agricultural producers who may increasingly need to manage the risks of commodity price volatility by hedging directly in the futures markets and obtaining funding for this activity. We further recognize the importance of risk management practices at the producer level and the importance of the industry responding to the dynamic market place environment.

The Farm Credit Administration continues to ensure that the farm credit system appropriately maintains internal controls, financial capacity, expertise, and underwriting requirements. We have stepped up our examination and systemic risk analysis activities to remain proactive in our oversight of the farm credit system.

We also continue to provide the farm credit system the flexibility, balance sheet, and capital management. Flexibility is needed so that lending capacity remains available and risk exposures stay within the farm credit system's risk bearing capacity.

Examples include raising capital through third party sources, managing loan exposures through participations within the farm credit system and with other lenders, increasing system wide coordination efforts, and working with agricultural producers as they adjust their risk management strategies.

In conclusion, competition in the agricultural lending markets remains robust with the farm credit system, commercial banks, and other lenders, providing liquidity to the agricultural industry. As a significant financier of the agricultural industry, the farm credit system has met, and we believe will continue to meet the increased credit demand resulting from higher commodity prices, input prices, and farm land values.

From our perspective, the farm credit system has the financial strength, industry expertise, and mission focus to play a significant role in meeting the agricultural industry's credit needs going forward. I thank you for the opportunity to address the Commodity Futures Trading Commission's agricultural forum. And with that, that concludes my remarks.

MR. LUKKEN: Thank you very much, Andrew. I'd ask Samuel Miller from the American Bankers Association if he has thoughts from the banking side of things.

MR. MILLER: Thank you, Mr. Chairman. Again, Sam Miller, I'm with M&I Bank in Appleton, Wisconsin, representing the American Bankers, and work with both farmers, producers, and grain elevators in our agri-business -- production ag and agri-business banking activities. And I think you've heard from a couple of the regulators what the situation is like out in the field, and that is that the financial community is supporting the efforts that our grain elevator customers and our farm customers are finding. There's no doubt that increased credit limits have occurred.

We've had to increase lines of credit for our grain elevator customers, we saw it in 2006 and 2007, and we thought we had done that, seen that picture, and then it got worse this year, so certainly those issues have continued to occur.

What we have done, again, is increased monitoring. We're asking a lot more questions of our customers. We want to understand the circumstances that they're in, what they're doing, who they have contracts with, whether or not they're signed, how much is based on inventory, how much is based on future delivery, how far out, and all the proper and appropriate things to do when you're lending somebody quite a bit of money.

For the most part, our customers have done what they have seen as appropriate for their circumstances. In many cases, farmers have said, with the rapid increases that they've seen in crop input prices, they haven't wanted to take some risk out in future years, in other cases they have.

So, again, we see the market places working, but everyone is questioning, where is it going, and when is it going to come back kind of into "normal times."

MR. LUKKEN: Well, I know there's lots of discussion and concern about margin levels, and we've asked Tom Farley from ICE to talk a bit about what his experience has been in recent times for margin calls. And I know people have strong views on this. A couple folks that have emailed us over time, are wondering about differentiating between speculators and hedgers as far as margin and whether that's useful.

I know we have Ken Morrison out there

that's asked that in our atrium. He is interested in that issue, as well as Mike Sezullo from the Midwest. So if these are some of the issues that we might be able to address today, I think that would be useful for the people listening here today, as well as over the Internet.

MR. FARLEY: Thanks, Chairman, sure, I'd be happy to comment on those issues and one other issue, if I can, regarding margins and determination of margins in a significant price rise environment.

With respect to the direct answer to the question from the gentleman in the atrium, distinction between margins for hedgers and speculators, we do that today pursuant to CFTC regs, and we think that that's appropriate the way we have it right now. We haven't been looking into modifying our initial margin requirements as they relate to those two different classes of traders. I just wanted to spend a minute or two, if I can, talking about the determination of margin in an environment where prices spike, or they rise dramatically.

We've talked a lot today, Diana made a very eloquent speech about what's going on in the market, and ultimately, Diana's conclusion was there's a financing issue where, you know, who's going to wear the risk of posting margin when prices move dramatically. Tom Coyle brought it up, as did Joe Nicosia.

And I think financing around margins is something that we need to continue to talk about and work with industry and work with the banking industry to figure out how the industry is going to be able to post margins in these environments.

But I'd like to distinguish between a gradually rising environment, even if it's -- so, for instance, in cotton, going from say 50 cents to 80 cents over a period of three or four months, that allows -- the three or four months allows people to have a little bit of time to put in place additional credit capacity to be able to post margin. That's one type of financing, and that's -- in this day and age, we all know we're in a credit crunch, it's not particularly easy to line up financing even for that. Then there's a separate type of financing requirement, and that's what we experienced in our cotton market in early March. That's where, in a single day, the price of cotton rises 12 cents or roughly 15 percent.

In that situation, overnight, you're going to have to find financing to be able to post margin against your short futures position. So I'd like to talk about how we determine margin in that environment and some of the issues that that raises.

Before I do that, I'd just like to talk about the role of a clearinghouse at a futures exchange. We've operated this cotton exchange, I say we, but the cotton exchange has been operated for 138 years, and the role of the clearinghouse has remained relatively constant, it's to act as the counter party for every cleared trade while preserving the integrity of the clearinghouse.

And the way we do that is, we require, among other things, initial margin and variation margin, which is calculated using the best available price, not always necessarily the perfect price, but the best available price approximating market value. At our exchange, as I mentioned earlier, we have a cotton contract committee, it has about 20 representatives, many of whom are here today, and that cotton contract committee is made up of what I'll call natural longs, and what I mean by that is, they have to sell futures or go short futures to hedge a physical exposure.

These folks, when the price of cotton rises, they have to post additional collateral. Well, the price of cotton has been rising, it was 68 cents at the end of the year, it was 94 cents on March 4th, an increase of roughly 40 percent.

And in the beginning of March, the price of cotton rose very, very quickly, it went from, if I have my statistics right, I believe 78 cents on February 27th, 94 cents on March 4th, so this is the type of environment that I'm describing, this significant price spike environment.

And at the same time, the cash market for cotton shut down. Why is this important? Well, at a very simple level, one way of creating financing for yourself is, you sell your physical cotton. If you can't do that, that's -- well, that's one less source of cash. And so at the same time that this price is rising, margin requirements are rising, the ability to sell cotton was going away. And this combination meant that growers and coops and merchants had to borrow in order to meet their margin requirements. And given that we're in this liquidity crunch, that was very difficult.

In fact, we've heard sad reports of farmers and other operations who went bankrupt. During this period, the cotton committee came to the exchange, and there was an ongoing dialogue, which we're very grateful for, and we learned quite a bit, and they came to the exchange, and they said, well, one way you can ease the burden of the industry is, you can -- the exchange can use an upper bound to determine margin prices, and the suggested -- on a day-to-day basis, and the suggested upper bound was three cents.

And in effect, what this would do is, it would put a cap, a daily cap on margin requirements in these price spike situations. We held individual calls and group calls with -- and meetings with the cotton industry to consider this.

And, you know, we wanted to help the industry. As I've said before, we don't make money by collecting margin, we don't make a dime. But we have to remember to protect the integrity of the clearinghouse. And so we talked to our exchange board, as well, and our clearing board, the CFTC, and ultimately we decided that in a severe price spike environment such as we saw on March 3rd, we need to use some -- a value for margin calculations that approximates the real value of cotton as opposed to an artificial price limit. And for us to use a price materially different would put our clearinghouse at risk and put our company at risk, and at the risk of maybe sounding like I'm exaggerating, potentially put the U.S. financial markets at risk.

And just to put it in perspective, on March 3rd, if we had chosen not to margin at the true value, but instead to margin using artificial price limit, we would have collected $600 million less of capital into our clearinghouse, which is six times our default fund. A default fund is what I call the rainy day fund at exchange.

I mean just to give you an idea of the magnitude of the dollars, and we operating at clearinghouse feel very uncomfortable with that.

A complicating factor, and I think a very important factor, not just for our market, but for the markets that we're discussing today, wheat and corn and beans, is the absence of trading in the futures markets in these severe price spike environments.

So we have a price limit structure that halts all futures trading when the price of futures goes up by three cents. These price limits in most markets are set, they're triggered once a year, once every five years or ten years. In our market, we've actually hit this price limit 18 times this calendar year along, in the first quarter of this calendar year alone. And on March 4th, the value of cotton increased by 25 cents versus the three cent limit.

So on March 3rd, a complicating factor is that the only market where we had trades was our options market, which isn't a suitable market for everyone, but it was very active, it had a lot of volume, and so we looked towards that market for price discovery.

On March 3rd and 4th, just to put some statistics to it, the futures markets were not open because we were above the limit, but we traded over 120 -- we averaged 120,000 options a day. And somebody mentioned this earlier, but if you buy a call option, you sell -- at the same price, essentially you're buying a future, not exactly, but it's very close. And the opposite is true, and you'd be selling a future.

We had tens of thousands, dozens of

thousands of these transactions on the 3rd and the 4th, so it was actually quite easy for us to discern the price that was being discovered in the options pit. And using those prices, we calculated our margin requirements. Now, that's all context.

Notwithstanding that, we had, as I said, a lot of conversations with many of the people around this table, and we have agreed to alter our margining policy somewhat. Beginning on March 11th, in fact, we began a new procedure where we'll use this futures limit up price, the three cents, we'll use this limit up price in a price spike environment to margin our futures, and we'll use the price actually traded in the options pit to margin options.

However, similar to March 3rd, if we had another day where there was a 12 cent move, we need to reserve the right to be able to use a price that's greater than the limit up price. And our current procedure is, we'll use the limit up price until it gets another four cents above the limit price, at which point we're going to use some greater figure for margin. As you can see, we're creating a bit of a half of a solution here.

And I just want to note quickly a couple of the short comings. First, because there will be certain days where cotton will trade above the limit up price and we will margin at limit up, we have to have an artificially high initial margin, and that's how we're going to maintain our initial margin. Second, this introduces an interest situation where you might be long a future in the futures pit, short a future in the options pit, and yet you'll owe some margin, even though you have absolutely no risk from our perspective. And third, and I think this is most importantly, and I wanted to bring this out to the forefront for this group here, we're only committing to use this limit up price when the price of the futures trades somewhat above limit up. If there is another very drastic move, we're going to use a higher price for margin, and we'll have some of the same pressures that were felt on March 3rd and

March 4th.

So, you know, in short, as I said, I don't think this is the final solution. We've learned a lot today, we look forward to continuing to work with our cotton committee.

And we're also going to continue to evaluate our price limit structure. As determined in 2008, are these limits appropriately set, are they a contributor to, or, in fact, a defense against volatility that we saw in early March.

Finally, I'd like to conclude by saying that there's a vexing factor here where some of my colleagues in Chicago, they actually use a different approach for margining, where they more typically do use the futures limit up price and limit down price. We as an exchange, we're open to ideas, we're open to information sharing, and we would wholly support if the CFTC wants to look into this, we'd be happy to work with you on this to see if there are shared best practices among exchanges.

MR. LUKKEN: All right. We'll open it

up for discussion. Mr. Dunavant.

MR. DUNAVANT: Could I go back and talk a little bit about the basis that we were describing just before we adjourned for lunch?

MR. LUKKEN: You can do whatever you want, that's fine.

MR. DUNAVANT: Thank you. I want to go back to that infamous day, March 4th, when cotton made this dramatic move, and traditionally, on the basis in cotton, if you'll take a ten year average, the basis for our base quality is about 350 off the near month. On that day, the basis on the near month, just to prove the point of a broken market, was 2,200 off, and traditionally it's around 350 off.

No sense whatsoever, and you can imagine the implications and the margin requirements that were generated through this type of movement. There was very little cotton traded during this period time at this 2,200 off -- were not willing to accept that price, but some cotton did trade at 2,200 off, and some even a greater level than that. And that, again, to me, tells me the New York Cotton Market, the ICE market, was broken, the option volatility was humongous.

I think the volatility at that one day got to 80 percent, 80 percent volatility, and you can imagine what that does to your margin requirements.

Tom, I would certainly ask the ICE Exchange to revisit some of their programs that they've got in place for the industry. The industry really has suffered, and ICE is certainly not totally to blame. But I think you guys have played some part in some of the defamation and margin problems that the industry had, whether it was producers, coops, or merchants.

The other thing that I'd like to mention is, if you will translate what futures did during that short period of time, that day, it was like the Dow Jones going from 12,000 to 15,500 in one day, or a 3,500 point move. Never happened, never will happen. But that just gives a comparison of how dramatic cotton's problems were during that short period of time. Thank you, Mr. Chairman.

MR. LUKKEN: Thank you. Woods.

MR. EASTLAND: Since Billy talked about margin, I thought it might be a good time for me to digress a little bit in time. Before lunch I was going to say this. It seemed to me, from listening to the comments around the table and also the comments from some of the presenters, perhaps a consensus that something went on in cotton that was not understood.

And I would urge the CFTC to investigate in depth what went on in cotton, because once this happened once, it very well may happen again, or it may happen in some other market. And I think it would be very important for you all to come to an understanding so whatever regulatory regime needs to be put in place to keep it from happening again, if you can do so. Thank you.

MR. LUKKEN: Thank you. Diana.

MS. KLEMME: Thank you, Mr. Chairman. I want to put something in perspective. Our firm works with largely country elevators, we are a futures firm, and in 30 plus years, more years than I care to admit precisely, I've never spent as much time as I have this year hand holding with our customers how they're going to get through to the next line of credit, how they're going to manage, looking at what they're doing for their farm strategies, which bids they pull, what service charges they implement, what credit lines are going to be available to them. We have some that have switched out short futures into put, pardon me, put call combinations. I'm spending, on a given day, it can be from ten to 90 percent of my days working on financial issues out there. So I went back -- because I thought, if somebody calls me on this, I better have some numbers available.

So I went back and I, to be objective, I took six of our customers, coop, private, large, small, in soft wheat areas, non-soft wheat areas, and I looked at every single one of their financial ins and outs, wires in and out, every day for the first three months last year and the first three months of this year.

The largest single call that we had in Jan, Feb, March of '07, out of that pool of just six elevators was $392,000, I'm sorry, the largest out of the three months was $1.2 million. This year the largest was $2.95 million. So that's one statistic.

Now, you can, you know, they may have different size positions on, but one thing a lot of them have done this year is, they've tried to get their positions down, especially in soybeans, by selling inventory, so the calls wouldn't be bigger. So they've already taken defensive measures to keep their needs from their lenders lower than what they might have wanted to do. But this year I also went back and I looked at the cumulative out of those six accounts last year versus this year, as a percentage, the cumulative in and out wires was 583 percent of what it was a year ago. It was $40 million, and those six firms alone at one point had pushed in $79 million to Chicago. Last year that peak was 32 million, so there's a huge difference.

And I do commend the banking sector. I think they've been extremely alert, they've been very proactive working with the borrowers. But it's also like patching pot holes out here, you know, the road is still working right now, but we're trying to stay one pot hole ahead of a real crisis.

If we get into something like you've seen in cotton, with that kind of a spike, I don't think there's enough asphalt to fill the pot holes out there. I mean there's just so many things you can do, you know.

They've sold inventory, they've extended credit lines, they've cut back their forward bids, I don't know where -- we've had a lot of our borrowers say that their banks have told them, we're with you now, but, you know, and that but varies depending on what bank and what customer it is, certainly. We can't go much beyond here, we can't go beyond some other number, and that's my concern, is that if we may be facing a low probability of something really bad occurring. We've managed it so far, largely thanks to the banks, but I don't know how much further we can manage it. And if we would see the elevator sector and the commercial grain sector start bidding aggressively on new crop grain again as we get closer to harvest, once the crops are planted, and then the markets explode, we've just exacerbated the problems all over again.

So I'll go back to sort of my areas right now, it's an issue of financing, and then we can also deal with contract terms.

MR. LUKKEN: Thank you. Steve Wellman with American Soybeans.

MR. WELLMAN: Thank you, Mr. Chairman. As we've gone through the day here, we've identified a lot of factors, and I think we've gotten to the point now with the financing and the funding, at least from a farmer's perspective, of the amount of risk that the producers have.

It's been the past tradition of commodity producers to set off -- lay off some of those risks using the heads of the futures markets, and now those same markets have turned into a product that creates more risk for us. So that's where we're at, and what we need to do is, find out -- continued discussions like this, and open, and very outright thought process, and consider what really has to be done and how we can reduce the risk that's out there in the futures markets, and turn this back to a market that can be used by a small investor, a small producer, and is not just an investment for the farmer, it's our livelihood and it's our business, and our success depends on being able to use these financial commodity markets. Thank you.

MR. LUKKEN: Thank you. Justin Towery from the Rice Federation.

MR. TOWERY: Thank you, Mr. Chairman. The rice industry is also living through over a longer period of time what the cotton industry went through in a brief period of time. The company that I am with handles many different grains, so we have felt this cycle all along.

Just for comparison to Mr. Dunavant's numbers, in the past, traditional rice basis on old crop would be 60 to 80 under at this time of year. Right now, the cash market is roughly 200 to 300 points under. Traditional new crop basis this time of year would be about 60 to $1.20 under. Right now, if you had to compare it to the futures market, you would be about 300 to 400 points under. So much risk has been taken on by country elevators, by producers, by the industry as a whole, that we have had to prudently say, we can't take anymore. Volatility has been the cause of this, and assessment of that risk has gotten to the point that, as of this past week, there was only one commercial player in the rice market with a bid index to the Board of Trade.

In summation, about that point, I would say that volatility has got to be reduced in some way or the other. One proposal that I would have would be to expand the delivery system for rice, as it's very isolated and small at the current time. Perhaps alternative delivery points, as were suggested in other crops earlier.

But the base of all of the problem is that we are losing opportunity for our producers, for our commercials, and for everyone involved in the system at this time. And the cost of that right now can't be quantified, but it will be real and realized as time goes on if these volatile times continue. And so we would ask any measures that could be taken to reduce volatility and allow commercial hedgers, producers, anyone else in the rice industry to participate in the futures market again would be taken.

MR. LUKKEN: On the delivery point issue, I know there are others in cotton that would like to see more western delivery points. We heard a lot of comments from Texas growers about those issues on the Internet, and if anybody has comments on those, we'd welcome those, as well. I know we have Garry with the Corn Growers.

MR. NIEMEYER: Thank you, Mr. Chairman. I represent 32,000 corn growers here today, and I am a farmer.

I just had a phone call that my neighbor was planting corn. I know better than that, there's water standing in his field, but it sure didn't make me feel any better. I wanted to -- he's that kind of a guy. I wanted to thank Jim Byrum, I wanted to thank Diana Klemme for their comments, and I'm leaving with these two people right here, Esther and Andrew, because the whole problem is convergence.

The elevators can't get the money from the banks because we don't have convergence.

We, as farmers, can't sell our grain because the banks don't allow the elevators to have money because of convergence. But I'm not really sure we've resolved any convergence issues. And like the gentleman that spoke just about rice, I would think that we ought to come up with some kind of a delivery system, we've had delivery systems that -- the current delivery system really doesn't work necessarily for farmers, and I think that we ought to have some form of a compelled load out, and I think it should be a fixed percent of load out on each expiring month, randomly distributed, with arbitrary rules, only if futures are above cash, but that's the only way you're going to resolve bringing the cash and futures together. The gentleman who sat across from me was wheat, and the gentleman with rice, and the cotton, I've heard all about it. We really haven't had the problem in corn yet, but it's just around the corner, I think, and we're very concerned about it.

It doesn't make a lot of sense to have $2.50 basis on wheat, $2.50 below futures price, and then we get beat up in the newspaper that people are starving to death. Who's making the money?

But my real point is, we've got to get back to some form of resolving the convergence of this whole issue. And we also have the opportunity in our area, because we have a lot of trains, train loaders, that there could be train load outs for corn moved to any place that need be.

In the 1990's, I think there was a Minneapolis and a Duluth, Minnesota on track delivery, maybe that could be revived. Again, most of the people I represent are from 26 different states, and they want to have the delivery system that makes convergence work. Thank you.

MR. LUKKEN: Jerry with the Wheat Growers.

MR. MCREYNOLDS: Thank you; Jerry McReynolds. This kind of hits right home with me. A particular elevator in -- well, I'll back up just a little bit. Kansas has had some serious problems, they've lost some elevators because of the credit crunch, partially margins, partially just the requirements of supplies and inventory and all those things, good, solid businesses, and I'll give you an example of one that has not been lost, but the dynamics of what's happened.

This business is a cooperative, a very solid, owes no money, you know, historically, so it's in good shape, several locations, used to get by about three -- with about a line of credit about $3 million, then it did go to 5, last fall it went to 15, which was a big jump, and thought maybe sure that that would be all right.

I talked to the general manager in March, he said he was negotiating a 50, I used to serve on that board, so I knew a little bit about the finances, and he was trying to get a line of credit of $50 million, which seemed huge to me, I thought, oh my.

Well, I talked to him the other day, and he's found out he's done his planning, 50 isn't going to cover it, it's going to take $80 million. This is a 40 -- $50 million coop. We're at a real critical stage in agriculture. It effects our country elevators, it certainly effects us producers, because the same thing has happened to us, our inputs, fertilizer has gone up at least twice, phosphates selling for -- traded for $1,000 a ton, inputs of all kind have gone up, chemicals have gone up three times, so if you did lock in a revenue side, and it's more difficult to lock in the input side, you may be coming up on the short end of the stick and thinking you actually had, you know, made a reasonable, good deal.

So it's a problem, it's a credit issue, I think ag swaps would be helpful. There has to be some mechanism. I can't price '09 delivery right now because most of the elevators aren't willing to take that risk, they don't know what the market is.

And I say, what do you mean you don't know what the market is, you know, well, they really don't, and if they do price it, it is -- the basis is so wide, you just say, well, I can't do that, you know, that doesn't make sense.

So the banking industry, I've got to know my banker really, really well, and I hope they stick with me, we really like you, we have to, and we hope you like us. So it is extremely important to the banking industry, it is a part of this solution, it's extremely important that we understand each other. I'm also very concerned about the small community banks, which I think actually fund most of agriculture, most of operations my size; without them, we're dead meat, and regulations are getting tougher and tougher, and it's not necessarily the profit and loss, those kind of regulations are really important, it's the BSA and all the 911 regulations that, you know, are out there.

It's a big issue. We're in this together, we're going to have to really work hard to try to solve some of it.

I think we can do it. But I appreciate your willingness to hear some of our concerns.

MR. LUKKEN: Thank you, Jerry. We're going to do Chuck, and then Andy, and then I'm going to turn to my colleagues for questions on the dais. Chuck.

MR. COLEY: Thank you, Mr. Chairman. Chuck Coley, American Cotton Producers. I'm a cotton producer from Georgia, and not to reiterate a lot of things that's been said about the cotton market, just to give you a perspective from a grower down in south Georgia. I look to the futures market for two things, price discovery every day and also to transfer risk by forward contracting with some of these guys across the table. Our price discovery is there no more, and obviously we can't contract cotton anymore. So we have, like everybody else, have real high input cost, increased input cost, and no -- latest market off. You know, if the spike caused it, we need to determine what caused the spike, because we need a good, accurate market so we can know which way we're going to price these inputs, and we would urge that the CFTC do something rather quickly, the sooner, the better, maybe within 60 days with the cotton market will get us a more functional market. Thank you.

MR. LUKKEN: Thank you. Andy.

MR. WEIL: Thank you. Earlier in my initial statement, I had come up with some recommendations that we'd like for the CFTC to take action on. One of those was requiring the reporting of all swap and OTC contracts by market participants and to determine -- for you to determine the aggregation of those positions from all those various sources.

And aggregating those positions, especially as it relates to swaps, swaps have a hedge exemption. We would like to see that the funds are dealing these -- these and similar instruments to divulge who is the counter party. That's something we're required to do as traditional hedgers, and it's something we would like the CFTC to look into. And I agree, I think Woods and Chuck alluded to it, that we need to -- that we would like to see an investigation as to what happened in early March, just to determine what went on and how it can be corrected. Thank you.

MR. LUKKEN: Thank you. I'll turn to my colleagues, if there are any questions from the dais, anybody?

I actually have one, I'll take the Chairman's prerogative. This actually comes from somebody who wrote in from Underwood Cotton Company, Alan Underwood in Lubbock, Texas, but I think he raises a good point.

All of this was occurring at the same time, structurally in the futures markets, where we were going from open outcry trading to electronic. And I'm interested in the views, whether that had some mitigating or some problematic factors in that transition from open outcry to electronic; whether there were some dampening effects that open outcry provided that were not seen with the electronic trading that may cause additional volatility. I don't know if anybody has thoughts on that. I'll turn to the exchanges here; Charlie first.

MR. CAREY: Yeah, Charlie Carey from the CME Group. I do think that there's -- a lot of things have taken place this year. I think that electronic trading takes place so fast, it takes that market place from being a few hundred people in a room to suddenly the world has access to your markets virtually instantaneously. So somebody can be in Singapore, that's the good news and the bad news, it happens fast. It's like all the markets around the world, they all happen very fast, because activity, the way people want to trade today, the way people want access, clearly, it takes some adjustment.

And I think that electronic trading is definitely -- put it on the list, it's one of the many, many challenges that the traditional hedger, the traditional user is adapting to.

But most people wanted electronic trading. I was a pit trader, you know, and believe me, I preferred open outcry. But I also -- I'm sure there were people that preferred a horse and buggy to an automobile 100 years ago and they didn't do too good either, you know.

But the bottom line is, I think that -- I'd like to go in one different direction. We've all recognized the challenges, I think that the exchange is providing global benchmarks, I think that our over-the-counter offerings that we would like approval on will help mitigate risk, because the fact of the matter is, one size doesn't fit all, we know that from area to area, the basis, this convergence problem that we're trying to tackle, and I'm talking about corn, soybeans, and wheat, has been, from time to time, it's varied, but the fact of the matter is, I'd like to see anybody operate without some sort of a benchmark pricing, whether it's meeting your needs today or not.

The fact of the matter is, the world looks to the CME Group and the Chicago Board of Trade products for that pricing mechanism. Now it's up to us to fix the issues that are here with us domestically, plain and simple. And each market is different. Cotton is different from wheat, which is different from beans, which is different from corn, and I think it's only through a process like this that we can get there. But I had to take my opportunity to make that statement, Mr. Chairman.

MR. LUKKEN: Thank you. Tom.

MR. FARLEY: So on Friday, March -- on Friday, I think it was actually February 29th, we had our last day of pit traded futures in the 138 year history of the cotton market. On the following Monday, the price spiked 15 percent, and on the following Tuesday, we had four price swings, any of which would have been the most volatile in the history of the cotton market. I don't know if I'm courageous or stupid or a combination of the two, but I'm actually going to argue they had nothing to do with one another, despite what can only be described as a pretty amazing coincidence.

And the reason why we have considered this, the reason why is, on that Monday and Tuesday, we spent the whole day pretty much in what we call limit up situation; in other words, there were no futures trading. And so whether futures were trading on a floor or on a screen, I don't think really had any impact. All of the trading was done on the floor.

That said, I agree with what Charlie just said, we are in a new world, and I think electronic trading is different from pit trading, and perhaps we went limit up quicker than maybe we would have done in the floor environment, as people were getting used to this new trading situation.

MR. LUKKEN: Thank you. Lee, I know you had a question.

MR. STROM: Well, actually I -- Mr. Chairman, it's more of a comment I think, and it's been very informative to listen to all the discussion here today, and as I hear about some of the short term remedies, possibilities, long term remedy possibilities here, and the industry, the producer segments out there are talking about the challenges and issues, and again, being a producer, I guess the analogy that I would like to use, and Garry Niemeyer, you can probably relate to this being a corn producer also, but when you plant your corn crop, and then about the middle of June, when you get a two inch gentle rain that occurs over a two day period, that's what farmers refer to as the million dollar rain, because it treats the crop just right, gives it that drink of water.

But when you get that eight inch rain that occurs over a six hour period, you end up with a mess, you end up with a gully washer, the ground is hard, and it does not work well for the crop, because most of the water runs off anyway.

But using that analogy, I think what the producer segment here has been hinting to, is that there's been the issue in the cotton, there's been a discussion about the potential issue in the corn arena, and I would simply speak that, again, from a producer perspective and then transitioning into the -- a regulator in the financial industry, and I appreciate the comments about the responsive of the lending industry, because we've attempted to have the foresight to adapt to this flexible, very interesting and dynamic market place, but in that, also realizing that we want to ensure the safety and soundness of this whole industry and the lending industry going forward, too. So I just wanted to share that comment. I thank you for all of that input, it's been very helpful.

MR. LUKKEN: Lee is not only a Farm

Credit Forward Director, but also has taken the series three exam on futures trading, so he knows our industry.

MR. STROM: Yeah, many years ago.

MR. LUKKEN: Yeah, he knows our industry very well, so thank you, Lee. Mike, did you have a question, or Bart?

MR. DUNN: A couple of questions, and Layne, maybe I'd like to start with you, to talk a little bit about when you add all the volatility, where you kept going up I don't know how many days in a row, where you were lock limit up, and probably the same for the CME, because I've seen some charts that said what a tremendous increase you've had from this year to last year on lock limit ups, and what that causes, the problem it causes in the market place, and the inability to discover the price.

MR. CARLSON: Thank you. You're absolutely right. When price discovery halts, there's confusion in the market place. The grain exchange we saw back last fall, after September and December delivery months came through, we saw the volatility was increasing. We were trying to be proactive at that time, trying -- and we discussed with our members, and we actually had a proposal into the Commodity Futures Trading Commission here to raise the limits just a little bit because we anticipated that might happen.

Before the Commission was able to act on that even, the cash markets took off. At that point, with the locked limits on the futures side, we couldn't keep up. When cash markets would move up $1 in the pacific northwest, and our futures market could only move up 30 cents, we had people just trying to look at ways to find what the true market might be.

We pointed to the individuals and the market participants that they could trade synthetically. They took -- they learned very quickly what they could do on the opting side, and as the CFTC, Dave over here and John, pointed out quite clearly this morning, is that synthetically, they were able to find a cash -- they were able to come to where the cash market was. Only at the point in which the futures market was able to trade at -- widen the price limit were we able to kind of move in sync with the cash market. We'll see that despite all those things that happened, by the time -- in the March contract in particular, when it came to the first notice day, the day before delivery, we had almost the perfect convergence.

So what happened was that we had an artificial cap that interfered with the price discovery process until that price cap was removed, then the market took some time to adjust, but it came back very quickly where we were at on price convergence.

But again, this is -- I'll take another opportunity once more to point out that as an exchange, we've tried to develop some new contracts, and I'll mention it as I did earlier, before the break, that we have corn index contracts, and we have a soybean index contract that's financially settled, that doesn't involve delivery issues, that doesn't necessarily involve anything having to do with a single pricing point or a pricing directive.

We have -- it basically looks at the cash market on internal country wide basis. So we have an alternative risk management tool that is available out there for others to participate in. I've expanded beyond the question that you had asked, though.

MR. DUNN: The same for the CME Group. I see in all of 2007, you had nine limit locks in soybeans, and you've had 122 up through April the 4th, you had 33 corn contract settlement limits in 2007, you've had 64 so far through April 4th, you had 42 wheat contracts in all of 2007, and you've had 88 through this year. So give me a little bit of what went on. And, Tom, we heard from you on the same concern.

MR. LEHMAN: Well, Commissioner, as you point out, we've had a much higher incidence of prices reaching our daily price limit in the grains. And if you just stop and think about how the price limits are structured, they're fixed numbers.

In our contracts, they were 20 cents in wheat, 30 cents, I'm sorry, 20 cents in corn, 30 cents in wheat, and 50 cents in beans. And when we were at, you know, $5 wheat or 2.50 corn, those were pretty large moves. And, in fact, when we set those limits, it was in 2000, those limits were on average ten percent of the value of the commodity. As commodity prices moved sharply higher, those fixed numbers didn't adjust. So now we were at five percent of the value of the commodity, and the volatility in the markets really showed that we were, you know, we're bouncing between limits much more frequently than we would like. What happens when you move to a price limit, price discovery stops. That doesn't mean that somebody who's got price risk, you know, can't manage that risk, they'll go somewhere to manage the risk, and we do see an increased use of our option markets in that situation, but I think you probably also would see an increase in over-the-counter activity or activity going into the exchange traded commodities in London, where we really don't have the ability in the U.S. to see how that activity is impacting the market.

So we felt it was necessary to increase limits in light of the higher flat price levels. We implemented those on March 28th. And I don't have the numbers in front of me in terms of how many times we've touched the limit since then, but it's been reduced dramatically.

We also implemented at that time an expandable limit which allows that initial limit to increase by 50 percent if we do touch limit in the market. So we put a mechanism in place that we think allows the markets to better perform their role of price discovery and allow them to function.

MR. DUNN: I bring this up because some of the questions that we have been getting through emails and others, maybe somebody should do something about the price limits. But if you don't do that, you have a real problem with the clearinghouses; first of all, you have a real problem in price discovery, but then the clearinghouses have a problem because they're making those margin calls that we've heard so much about to ensure that they are financially sound.

We heard Tom say his concerns about what might happen not only to that clearinghouse, but the entire futures markets if that didn't take place. This then backs down to those local elevators, backs down to the farmers and ranchers out there, all of those folks that have to make those margin calls.

So all of these things are very, very much related. Everyone seems to say, well, here, if you just fix my one problem, then I would be in great shape, but it's a whole -- the totality of the thing is what I think we have to take a look at, and some of the suggestions, some of the things, Layne, that you said that the Minneapolis Grain Exchange has come up with, some of the swap clearing are some of the solutions that I think we'll begin to work towards that will really help us in the end. Let me start back down, and that's with the farm and ranch, because that's the one that I identify with the most. And, Sam, when you're making these loans, and you sit down with the producer at the beginning of the year, and I imagine a good example is -- what I used to do when I was a lending officer, and that was eons ago, but you'd try to do an enterprise analysis with that individual and see what they are making money on, what are they losing money on, what are their break evens, and if you come up with say, all right, here in the course grains, here's what their costs are, here are their break evens, let me go ahead and hedge a third of that crop, that will cover that expense, and this is something that's going up all the time, the input costs that we saw from the charts earlier on.

But you sit down and you do that, and when I was a loan officer, I'd say let's go ahead and hedge that, and I'd get on a third party hedge and I'd make those margin calls, and the producer would come in and say I'm really worried, I'm spending all this money on these margin calls, and I said that's not a third of your crop, the other two-thirds, we're making a lot of money on, and furthermore, I'm going to get paid back. And so I had no problem making those margin calls in those days. But it seems to me what is happening is, those margin calls got so high because of the problems that we had on going up the limits. I would have had a problem going back to my board and saying, hey, remember this guy that we're working with, and I said we'll do this hedge account with him, well, it's a little more than $100,000 I thought, it's now 500,000, and the board would look at me and say, I don't think so.

That seems to be a real problem, are there things that you're doing out there as a local bank on participation and putting together a consortium and upstream banks so that you will have that comfort level again, that you'll have that money to make those margin calls, and with the realization that you will get it paid back?

MR. MILLER: It's a very good question,

and I think there's a couple different answers. First off, at the producer level, those kinds of situations, we're doing that as a matter of course, and it's happening every day, and yes, the dollars are getting bigger. But, again, bankers understand that if you exit out of those positions, then you just totally negated the risk management plan that you put in place, we get that. We haven't talked at all today about the milk business. But the dairy markets had that last year. I mean I had dairy farmers, 600 cow dairy farmers that had million dollar hedge lines, that's a lot of money. And they paid it back when they got the milk check from the dairy, then they'd pay back that month's hedging activity. So, you know, it worked the way it was supposed to work. And the same thing is happening in the grains.

I would say, yes, farmers are borrowing more money because input costs have increased, land rents have gone up, fertilizer has gone up, seed has gone up, almost anything you can think of, it's gone up, so it takes more money to put a crop in.

And the banking sector handles that day in and day out with the farming sector. I don't think that's where the issue really lies. I think the issue is at the grain elevator sector. That's where the dollars get really big. And, yes, we are doing participations.

We're working with our fellow banks, we're working with the farm credit system, we're sharing across, you know, with other institutions that also understand these markets, because we don't want to partner on that side of the business that also is going to get nervous and say, hey, I want to get off the merry-go-round. So we have to all understand what's going on in that process. But there's one other issue here I think that maybe we're missing, and that is, yes, the banking sector is providing the capital, but the borrower has to provide some capital, as well. There aren't too many things you can borrow 100 percent on. You've got to put some money in, you've got to have some skin in the game yourself, so to speak. And it's those requirements that are really ramping up, as well.

If I lend you 80 cents on the dollar or 90 cents on the dollar, you've still got to come up with ten or 20, and ten or 20, when we're hearing about a coop that had a $3 million line that's going to 70 or 80, that's a significant increase in the amount of capital that they need at that level, as well. And that's important to take into consideration in this discussion.

MR. DUNN: Jim, I saw you nodding your head on elevator and on the elevator side. Would you amplify on that? Because we've heard both the fed and the farm credit system say that there is capital out there if there's an ability and willingness to make those loans, and I think that willingness maybe is something we really haven't touched on.

MR. BYRUM:: Well, thank you. I think there's three things I'd reference in that regard. First is the sheer volume of capital required versus, as Sam just said, the equity base is an issue in some situations, and I think that's where the real rub is in some matters. Second, overall, again, we're talking about the grain industry, but if one considers a diversified elevator that also handles agricultural inputs and put in their normal inventory fertilizer, pesticides, and seed this year, the value of that, the cash required, the credit required to fund that is roughly three times what it was a year ago.

So a normal agronomy operation, a good size agronomy operation, ten million historically, 30 million easily, in many of the large ones it's not uncommon for us to be at 50 to 75 million in inputs. Put that on top of the grain exposure, the overall credit requirement is absolutely astounding.

Third is, you know, going forward, I think we have to recognize that banks have been extraordinarily cooperative. We acknowledge that, I mentioned that before lunch. And we actually have good credit facilities out there. The challenge is, as I suggested, is not where we're at today, but where we could be if there's a hiccup. If Illinois doesn't plant in a timely fashion, if there's a weather upheaval somewhere, if there's a run in the weather market, that's the fundamental concern we have going forward.

We also should recognize and acknowledge, producers have a very, very good understanding of what elevators are going through. In fact, I'm actually amazed at elevators, the conversations I've been engaged in with growers and elevators, understanding the exposure that elevators have had because of the margin situation and the additional financing requirements of ag inputs, understand it, acknowledge it, and actually recognize that elevators have always handled that function for them in the market.

Going forward, that's one of the points I made earlier, that that fundamental, that risk that's been accepted by elevators and moving forward, probably is going to be passed off to the growers some way, unless there's some new instrument to pass that risk further along or move it up the chain, because it's extraordinary in the country side right now.

I'll just make one further point. Our winter conference started on January 12th, it was a Monday morning.

Our membership in Michigan we estimate ships somewhere between 100 and 125 million to Chicago for margin calls that morning. Just that analogy, that one little situation, it's absolutely astounding the kind of impact that we're seeing in the country side.

MR. LUKKEN: Well, given the lateness of the hour, I'll have Garry give some comments. But I did want to open it up to the audience present here. If there are any other members from the public or the Ag Advisory Committee that may have a comment or question, we may take one or two. And, Neal, we'll get to you as well, but first let's turn to Garry.

MR. NIEMEYER: Jim brought something up, and I'm astounded. I am pre-purchasing fertilizer for next year's crop, and my accountant told me to get, you know, go to the fertilizer dealer and make sure I had some kind of a financial agreement with him, and to prove that they were viable. It was almost an embarrassment for me. This thing is just getting totally out of hand. I mean the money is just unreal.

MR. LUKKEN: Neal.

MR. GILLEN: Observation question. Chicago manages to margin to the futures, future to future and option to option. ICE has reverted to that now, but says if we get another spike, you know, we're just going to have to go back.

How does Chicago survive doing the system that we recommend, and ICE can't figure out how to survive?

MR. FARLEY: Dave?

MR. LEHMAN: Well, margins are -- we set them based on volatility, our clearinghouse does, and I'm not involved in that function and that role, so I can't tell you specifically how they look at situation when we're at a price limit.

But they do margin based on settlement price. The objective of our clearinghouse is to cover one day's expected price move, and that's how margins are established. So if we have a price limit that won't allow prices to move beyond that level, then margins wouldn't be set higher than that level, as well. So that's sort of the outer bound, if you will, on margins.

And, of course, when we increase price limits, we're very sensitive to the industry that this would increase that outer bound of what margins could be if volatility, which is calculated statistically, and it's done in very excruciating detail. If you sat down with our risk committee, they look at 30 day, 60 day, 90 day, 180 day, out to two years worth of data, and looking at how the market has behaved in the past.

And, of course, that's the trick or where the judgement comes in, is that past history going to be an accurate predictor of the future. But in the case of a market that does have price limits, which all of our agricultural contracts do, that would be the maximum one day margin.

MR. GILLEN: So in summary, you're satisfied that the real price is the price of the future on the closed margin up?

MR. LEHMAN: Well, certainly we know that, at times, prices synthetically that are calculated from the option market are different than where our futures close. If we're closed because of price limits, and the cash market is well beyond that, then certainly, the cash price is, or the synthetic price, as determined by the options, would be a different price. But again, since our objective is to cover that one day price move, we feel we've accomplished that by using the settlement price in a lock limit situation.

MR. GILLEN: Tom, why can't you do that?

MR. FARLEY: We have -- the way our exchange is set up, we have an exchange board and we have a clearing board. Our clearing board is made up of, by and large, clearing members and risk experts and the guys whose, in addition to the people in this room, whose necks are on the line on a daily basis. And we went to them and posed that question, because as I said earlier, Neal, we don't really have a dog in this fight other than protecting the integrity of the clearinghouse. We make no money on collecting margin payments, and we're successful, and our customers are successful. So if the integrity of the clearinghouse weren't a concern, we would just do as our customers wish.

So we went to our clearing board, and they said, hey, notwithstanding what is done in Chicago, and we well know what is done in Chicago, we're not comfortable with that procedure.

I will note one thing about Chicago's procedures that I'm familiar with, they also reserve the right, similar to us, they reserve the right to use a different price other than the futures limit up or limit down price.

In practice, my understanding is they do not frequently, maybe even ever, but they reserve the right, similar to how we reserve the right. I just wanted to, kind of in an abundance of caution, be very explicit about situations when we would reserve the right, so that our customers can plan around it.

MR. LUKKEN: Any other questions from around the room? I see someone over here. If you could state your name and --

MR. SEEGERS: Yes, my name is Robert Seegers, Jr., and I'm from Crystal Lake, Illinois, and I'm with the -- the Grain and Feed Association of Illinois, and I have a -- would like to share a statement that was made to me by three very large banks that lend to the grain industry in Illinois at our annual convention in February, and then would like to ask Esther George a follow-up question regarding the statements.

The statements that were made to me by three of the banks, whether it's true or not, I'm hearing in other parts of the country may not be, was that the single greatest problem our industry has is the lack of convergence, because the banks, the lending institutions don't know what their collateral is worth.

And they are saying traditionally, when we had convergence, if they financed a grain elevator's inventory that was 20 cents away from a delivery point, they always knew their collateral was worth 20 cents under the Chicago Board of Trade futures.

As long as their lender, or borrower, excuse me, was adequate hedged, square in his position, they always knew their collateral was worth 20 cents under the Board of Trade.

Now they are financing purchases at 50 or 60 under the Board of Trade price, and those -- that collateral that they're holding may, in fact, end up being worth $1.50 or $2 under, as in the case of wheat, and that's what they were expressing as the risk of our industry is that they don't know what their collateral is worth.

I would -- believe they are also concerned about counter party risk, about the farmer producers actually delivering on their low price contracts. But I would -- my question then for the Federal Reserve, has any banks in your system, have they expressed those concerns, and is that just a way to say -- telling us we're just not very comfortable lending into your volatile environment right now?

MS. GEORGE: The issue you described is really an age old issue for banks in terms of how they value collateral. I would guess the greater issue that I hear from banks is not so much value in collateral, because they are largely also relying on cash flow, so they are looking at both of those things.

Certainly, the environment we've been in is a different environment. And just as we've heard from everyone, it's a different ballgame for them to look at how they're going to price that collateral. But my sense is, they have been very willing to work with that customer to come up with a reasonable value that meets the banks' standards for safety and soundness, and helps them extend the credit.

MR. LUKKEN: Well, thank you very much. Unfortunately, we're going to have to cut things off there. I know many people have planes to catch. But it's been a great discussion. And on behalf of my colleagues, I want to thank all the presenters and roundtable participants, as well as members of the public that tuned in here today; on the atrium, on the Internet, a variety of ways. I thought it was a great discussion.

In particular, I want to thank Lee Strom from the Farm Credit Administration, as well as Under Secretary Mark Keenum, for their participation. And last, but not least, the CFTC staff who worked tirelessly to organize this event, and in particular, Mike Otten from my staff, John Rogers, Tammy Semega from our Office of Management Operations, and her staff, as well.

We've had a big agenda here today, but now we have to close things up. And I would just note that we'll welcome additional comments for the next two weeks, with that period closing May 7th. So we appreciate everybody's participation, and thank you for coming.

(Whereupon, at 3:43 p.m., the

PROCEEDINGS were adjourned.)

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CERTIFICATE OF NOTARY PUBLIC

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

/s/Carleton J. Anderson, III
Notary Public # 351998
in and for the Commonwealth of Virginia

My Commission Expires:
November 30, 2008