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COMMODITY FUTURES TRADING COMMISSION

AGRICULTURAL ADVISORY COMMITTEE

PUBLIC HEARING COMMITMENTS OF TRADERS REPORTS, THINLY TRADED MARKETS, AND BASIS AND CONVERGENCE IN THE GRAIN MARKETS

Washington, D.C.

Tuesday, August 1, 2006

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Other Participants:

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DAN BROPHY

GREG ZERZAN

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FRED CLARK

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MICHAEL HAIGH

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PARTICIPANTS (CONT'D):

JACK GAINE

NEAL GILLEN

ELDON GOULD

TONY JACKSON

JULA KINNAIRD

RICK KIRCHHOFF

GARY MARTIN

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BEVERLY PAUL

JOHN RUTHERFORD

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PARTICIPANTS (CONT'D):

TOM ERICKSON

TOM COYLE

SUSAN KEITH

ANDY MORTON

DALLAS TONSAGER

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P R O C E E D I N G S

(9:37 a.m.)

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

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

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

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

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

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

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

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

(Laughter)

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

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

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

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

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

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

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

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

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

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

(Laughter)

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

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

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

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

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

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

Regional Offices in a listen mode only.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

MR. WESTON: Ryan Weston, American Sugar Alliance.

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

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

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

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

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

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

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

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

MR. SHAEFFER: Larry Shaeffer, Renewable Fuels Association.

COMMISSIONER DUNN: Are there any other members?

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

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

We have from the Hill representing the

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

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

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

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

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

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

CFTC's Large Trader Reporting Level.

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

(Laughter)

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

We will begin the discussion with a

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

MR. HEITMAN: What I am going to do is

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

COMMISSIONER DUNN: Thank you very much. Dan?

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

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

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

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

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

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

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

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

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

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

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

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

We are asking the CFTC to create either

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

COMMISSIONER DUNN: Thank you very much. Greg?

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

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

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

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

There is no reason to single out this

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

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

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

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

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

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

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

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

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

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

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

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

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

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

COMMISSIONER DUNN: Thank you, Tom. Fred?

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

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

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

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

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

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

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

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

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

Having said that, we think one critical

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

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

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

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

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

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

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

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

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

COMMISSIONER DUNN: Would you amplify, Dan?

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

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

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

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

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

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

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

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

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

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

(Laughter)

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

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

COMMISSIONER JEFFERY: We are open to all suggestions.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

COMMISSIONER DUNN: Sure.

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

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

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

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

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

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

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

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

COMMISSIONER LUKKEN: Over-the-counter position.

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

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

MR. FENTON: Right.

COMMISSIONER LUKKEN: Thank you.

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

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

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

MR. FENTON: In my opinion it does.

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

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

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

MR. STEVENSON: Randy Stevenson with R-

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

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

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

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

COMMISSIONER DUNN: Jack, please identify yourself.

MR. GAINE: I am Jack Gaines, President

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

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

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

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

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

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