SUBMISSION COVER SHEET

Exchange Identifier Code **(optional)** #07-39 **Date** May 17, 2007

ORGANIZATION	Chicago Mercantile Exchange Inc.

FILING AS A: ☒ **DCM** ☐ **DCO** ☐ **DTEF**

TYPE OF FILING

- **Rule Amendments**

  ☐ Self-Certification Under Reg. 40.6(a) or 41.24

  ☒ Commission Approval Requested Under Reg. 40.5 or 40.4 (a)

  ☐ Notification of Rule Amendment Under Reg. 40.6(c)

  ☐ Non-Material Agricultural Rule Change Determination Under Reg. 40.4(b)

- **New Products**

  ☐ Self-Certification Under Reg. 40.2 or 41.23

  ☐ Commission Approval Requested Under Reg. 40.3

RULE NUMBERS

CME Live Cattle Futures Rule 10103.B.4. – Par Delivery and Substitutions.

DESCRIPTION (Rule Amendments Only)

Permit the par delivery of heavier cattle in live-graded deliveries on already-listed contract months

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May 17, 2007

Ms. Eileen Donovan
Office of the Secretariat
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, NW
Washington, DC 20581

RE: Regulation 40.4(a) Submission. Amendments to Terms or Conditions of Enumerated Agricultural Contracts. Amendments to CME Live Cattle Futures Rule 10103.B.4. – Par Delivery and Substitutions. CME Submission #07-39.

Dear Ms. Donovan:

I. SUBMISSION

In accordance with Regulation 40.4(a), Chicago Mercantile Exchange Inc. ("CME" or "Exchange") hereby requests review and approval, under the provisions of Regulation 40.5, of amendments to CME Live Cattle Futures Rule 10103.B.4. – Par Delivery and Substitutions.

II. TEXT OF PROPOSED RULE CHANGES

The text of the proposed rule amendments is presented below, with additions underlined and deletions bracketed and overstruck:

CHAPTER 101
LIVE CATTLE FUTURES

10103. SETTLEMENT PROCEDURES

10103.B. Live Graded Deliveries

4. Par Delivery and Substitutions.

   a. Par Delivery Unit. A par delivery unit is 40,000 pounds of USDA estimated Yield Grade 3, 55% Choice, 45% Select quality grade live steers, averaging between 1,100 pounds and [~~1,350~~] 1,425 pounds with no individual steer weighing more than 100 pounds above or below the average weight for the unit. No individual animal weighing less than 1,050 pounds or more than [~~1,400~~] 1,475 pounds shall be deliverable.

      Par delivery units shall have an estimated average hot yield of 63%.

      All cattle contained in a delivery unit shall be healthy. Cattle which are unmerchantable, such as crippled, sick, obviously damaged or bruised, or which for any reason do not appear to be in satisfactory condition to withstand shipment by rail or truck shall be excluded. No cattle showing a predominance of dairy breeding or showing a prominent hump on the forepart of the body shall be deliverable. Such determination shall be made by the grader and shall be binding on all parties.

   b. Weight Deviations. Steers weighing from 100 to 200 pounds over or under the average weight of the steers in the delivery unit shall be deliverable at a discount of 3¢ per pound provided that no individual animal weighing less than 1,050 pounds or more than [~~1,400~~] 1,475 pounds shall be deliverable. For purposes of computing such discount, the weight of the over or under weight animals shall be considered the same as the average weight per head of the delivered unit. Steers weighing more than 200 pounds over or under the average weight of the load are not acceptable. The judgment of the grader as to the number of such overweight or underweight cattle in the delivery unit shall be final and shall be so certified on the grading certificate.

(Remainder of Rule 10103.B.4. unchanged)

III. EFFECTIVE DATE AND RULE PROMULGATING AUTHORITY

The Exchange, pursuant to CME Rule 230.j., approved these proposed amendments on May 17, 2007. The amendments will become effective for the December 2007 and subsequent contract months following Commission approval.

IV. OPERATION, PURPOSE AND EFFECT OF THE PROPOSED AMENDMENTS

CME is proposing changes to the Live Cattle futures contract to permit the par delivery of heavier cattle in live-graded deliveries, and to eliminate a long-standing inconsistency in the maximum allowable weights for live-graded and carcass-graded deliveries. These changes will be applied to already-listed contracts following Commission approval, beginning with the December 2007 contract month, to alleviate the potential for market distortions like those experienced during the February 2007 delivery period.

Maximum Weights

Slaughter weights for cattle in general, and steers in particular, have been increasing steadily for several decades due to such factors as better genetics and improved feeding practices (Exhibit 1). Slaughter weights also vary seasonally due to normal production cycles, with peak weights typically occurring during the fall and winter months. The combined effects of the long-term upward trend plus the seasonal upturn caused a large percentage of the steer population to exceed CME's maximum allowable weights during the February 2007 delivery period. As a result, delivering shorts found it difficult to make delivery and force convergence, and Live Cattle futures traded at a substantial premium to the cash market (Exhibit 2).

When similar conditions occurred in 2001-02 and again in 2002-03, the Exchange responded each time by increasing both the maximum average live weight and maximum individual live weight in the live-graded delivery provisions by 25 pounds. Today, the Exchange is proposing an increase of 75 pounds in both the maximum average and maximum individual live weights, beginning with the December 2007 delivery period. This action will correct the immediate problem for the 2007-08 deliveries, and provide time for the Exchange to develop and implement longer-term solutions.

For a number of years the Exchange has attempted to anticipate the increase in cattle weights and the industry's response to those higher weights in the form of discounts or other price adjustments. At the same time, many industry observers have predicted that weights would eventually plateau. Reasons cited for this expected flattening-out include 1) larger cattle produce larger cuts of beef that may be unacceptable to the consumer, 2) higher corn prices make it uneconomical to feed cattle to higher weights, and 3) a trend away from "extreme" breeds that mature at higher weights, and toward more traditional breeds (or crossbreds involving traditional breeds) that reach desired quality grades at more moderate slaughter weights.

Despite these predictions, there has been no perceptible slowdown in the rate of increase in weights, and the Exchange's efforts to anticipate industry trends and address those expectations with small, periodic increases have been largely unsuccessful. At the present time, the Exchange once again finds that actual weights far outstrip anything that was predicted just a few years ago. In addition, maximum weight specifications that appear reasonable for most of the year can become unnecessarily restrictive in the fall and winter months when weights reach their seasonal maximum.

To illustrate, average steer weights reached a record high, equivalent to 1,351 pounds on a live-weight basis (789 pounds carcass weight divided by 63% hot yield), for the week ending September 23, 2006, and again for the week ending October 7, 2006 (Exhibit 3). If we assume that steer weights are normally distributed, then half of the steers weigh more than the average and half weigh less. Therefore, given the current maximum allowable average weight of 1,350 pounds, slightly more than 50% of the U.S. steer population was undeliverable in the week ending October 7 because it exceeded the maximum CME allowable weights. Notice that this 50% figure does not include steers that would have been undeliverable for failure to meet other, non-weight-related specifications, so the actual percentage of undeliverable steers would have been substantially greater than 50% of the U.S. steer population.

The average remained above 1,340 pounds for nearly three months, and as a result nearly half of the U.S. steer population failed to meet the CME weight requirements and remained undeliverable through the week ending December 30, 2006. Unfortunately, the necessary data are not available to calculate the standard deviations around these weekly averages, which then could be used to quantify the exact percentage of the steer population that would meet the current CME weight specifications in any particular week. However, from the data presented here, it should be obvious that a substantial percentage of the steer population is undeliverable at any time because it exceeds the current weight limitations.

Steer weights then declined gradually, dropping below 1,290 pounds in the week ending March 3, 2007. While this might suggest that the deliverable supply situation had improved somewhat for the February 2007 delivery period, a series of winter storms made it difficult to transport cattle and offset any benefit from the modest improvement in average weights. Some might argue that the extreme weather conditions in February 2007 were the reason for the congestion in the delivery process, since average weights actually peaked in early October and were more than 50 pounds below that peak during the February delivery period. CME would agree that weather conditions did play a role, by revealing how little excess capacity actually exists in the deliverable supply when the system is not running at peak efficiency. In CME's view, the real surprise may be not that there was so much congestion in February 2007, but that there was so little congestion in October 2006 and December 2006 given the deliverable supply situation in those two delivery periods.

Linear regression can be used to analyze long-term trends and project those trends into the future. Using USDA data from the past 30 years, average weights have been increasing at a rate of .0216 pounds per day, or nearly 8 pounds per year (see regression results in Exhibit 1). The R^2 value of .8811 indicates that 88.11% percent of the variation in weights is explained by this equation. This is a surprisingly high value, considering that the only independent variable in this equation is a simple time trend. Also worth noting is the fact that within the seasonal cycles the maximum and minimum values exhibit steady increases – e.g., both higher highs and higher lows – providing additional evidence that weights are experiencing a steady upward shift over time.

The results from this regression also can be used to project when cattle weights might be expected to once again exceed the proposed increase in maximum deliverable weights. Dividing the proposed increase in the maximum average weight (75 pounds) by the rate of change (8 pounds per year) equals approximately 9 years, assuming there are no structural shifts in the intervening period that change the underlying relationships. While this may appear to be a long-term solution, the Exchange is actively pursuing other contract changes, which will be applied to newly listed contract months, to further increase deliverable supplies and prevent a recurrence of these problems.

Live-Carcass Weight Inconsistencies

The proposed 75-pound increase also will eliminate the inconsistency in allowable weights between live-graded and carcass-graded deliveries. The Live Cattle contract allows two methods of delivery: to a stockyards delivery point where live animals are graded ("live-graded"), or to an approved packing plant where the animals are slaughtered and the resulting carcasses are graded ("carcass-graded"). The maximum weights for live-graded deliveries have been substantially lower than for carcass-graded deliveries since carcass-graded deliveries were first allowed in 1995.

At the time, it was believed that the maximum allowable live-graded weights needed to be lower because of the way that cattle received in CME deliveries are merchandised. It is generally impossible for a receiving long to take delivery and immediately sell those cattle to a packer, due to scheduling lead-times and other logistical issues. Instead, the receiving long typically places the cattle back on feed until they can be sold to a packer, and the weight gain during that time could result in discounts if the cattle become too heavy.

Currently, the maximum allowable average weight of the delivery unit at par is the equivalent of 1,429 pounds (900 pound carcass divided by 63% hot yield) for carcass-graded deliveries, but only 1,350 pounds for live-graded deliveries. In addition, the receiving long selects the delivery method (live or carcass), so cattle that meet the weight specifications for carcass-graded deliveries may be ineligible for live-graded deliveries. Increasing the maximum average weight for live-graded deliveries to 1,425 pounds – essentially the same as for carcass-graded deliveries – will eliminate this discrepancy, make more cattle available for delivery, and increase the ability to force convergence when futures are at a premium to cash.

Similarly, the maximum allowable weight for an individual animal at par in a carcass-graded delivery currently is the equivalent of 1,429 pounds (900 pound carcass divided by 63% hot yield). Deliveries are permitted for cattle weighing the equivalent of between 1,429 and 1,508 pounds (950 pound carcass divided by 63% hot yield) at one schedule of USDA-published market-based discounts, and for cattle weighing the equivalent of between 1,508 pounds and 1,587 pounds (1,000 pound carcass divided by 63% hot yield) at another, more stringent, set of USDA-published market-based discounts. Animals weighing in excess of 1,587 pounds also are permitted in carcass-graded deliveries, although at a substantial penalty.

In contrast, in a live-graded delivery, no individual animal weighing more than 1,400 pounds can be delivered under any circumstances. Increasing the maximum individual weight for live-graded deliveries to 1,475 pounds – well within the 1,429 to 1,508 pound range of allowable individual weights in carcass-graded deliveries – would make more cattle available for delivery and increase the ability to force convergence when futures are at a premium to cash.

USDA data show that packer discounts on cattle weighing the equivalent of between 1,429 and 1,508 pounds are much less severe than had been believed when the contract was designed in the early- to mid-1990s. No published data were available at that time, so the Exchange had to rely largely on anecdotal information. However, USDA reporting of these discounts began on a voluntary basis with the "National Carcass Premiums and Discounts for Slaughter Steers and Heifers" report (NW_LS195) in late September 1996 and continued until mandatory reporting began and this particular report was eliminated in mid-April 2001. During this period the reported discount for cattle weighing the equivalent of between 1,429 and 1,508 pounds was zero ($0.00 per pound).

With the start of mandatory reporting in mid-April 2001, USDA began publishing the "National Weekly Direct Slaughter Cattle – Premiums and Discounts" report (LM_CT155). From April 2001 through mid-May 2007, the average discount nationwide for cattle weighing the equivalent of between 1,429 and 1,508 pounds, was $0.70 per hundredweight ($.0070 per pound) on a live-weight basis. However, these national figures may be distorted by packers located outside the major cattle feeding areas and/or involved in specialized activities.

A much more relevant publication is the "5-Area Weekly Weighted Average Direct Slaughter Cattle – Premiums and Discounts" report (LM_CT169), which also uses mandatory reporting but includes only packers in the 5 major cattle feeding areas. In addition, this report is the source of premium/discount values for the CME Live Cattle contract. The average 5-area discount for cattle weighing the equivalent of between 1,429 and 1,508 pounds was just $0.02 per hundredweight ($.0002 per pound) on a live-weight basis from the first publication of this report in October 2003 through mid-May 2007.

It should be clear from this discussion that in the region where CME live-graded deliveries occur, the cash market imposes negligible – if any – discounts on cattle in the 1,429 to 1,508 pound weight bracket. Therefore, applying the proposed weight changes to existing contracts should have no material impact on a receiving long that places cattle from a live-graded delivery back on feed until they can be merchandised to a packer.

Implementation Schedule

The seasonal nature of cattle weights, discussed elsewhere in this Submission, makes it essential that the Exchange implement these changes to existing contracts beginning with the December 2007 contract month. Otherwise, the Exchange believes there is good reason to expect delivery problems in the December 2007 and subsequent contract months due to a shortage of cattle that meet current CME weight specifications.

We believe the proposed implementation schedule allows market participants ample time to respond to the proposed changes. First, open interest in the December 2007 and subsequent contracts is still relatively low, which minimizes the number of entities that might claim to be affected by these changes. As of the close of business on May 16, open interest in the December 2007 futures contract was 15,913, and open interest in the December 2007 options was 5,126 (3,040 calls, 2,086 puts).

Second, market participants will be notified of these changes tomorrow, Friday, May 18 via Special Executive Report S-4575 (copy attached). First Notice Day for December 2007 Live Cattle futures does not occur until Monday, December 3, 2007. As a result, there is more than 6 months between notification of market participants and proposed implementation, which far exceeds the typical 140-160-day feeding period. It would be extremely difficult for any market participant, on either side of the market, to make a credible argument that they anticipate making or taking delivery of cattle in December 2007, and somehow have been disadvantaged by these changes, when none of the cattle that would be involved in the delivery have been placed on feed yet.

Third, the Exchange has demonstrated here that allowing the delivery of heavier animals as proposed will have a neutral impact on prices, because the heavier animals that would be allowed in deliveries trade in the cash market at effectively no discounts. Because these cattle are indistinguishable in the cash market, any price reaction of the December 2007 and subsequent contract months relative to the prices of other contract months following the announcement of these proposed changes may actually represent a "congestion premium" in the futures price due to the anticipated lack of adequate deliverable supplies, rather than anything involving anticipated cash price. If this indeed is the case, then any change in these spreads following the public announcement simply confirms the regulatory necessity and economic soundness of these proposed contract changes.

Regulatory Considerations

The Exchange's request to apply these changes to contract months of an enumerated commodity with open interest underscores the urgency of this matter, and demonstrates its commitment to protecting the integrity of its contracts and meeting its obligations under the Core Principles.

Core Principle #3 requires Designated Contract Markets to list "only contract that are not readily susceptible to manipulation" and Guideline #1 requires, for contracts involving physical delivery, that "the terms and conditions, as a whole, result in a deliverable supply such that the contract will not be conducive to price manipulation or distortion and that the deliverable supply reasonably can be expected to be available to short traders and salable by long traders at its market value in normal cash marketing channels."

Core Principle #4 requires exchanges to "monitor trading to prevent manipulation, price distortion, and disruptions of the delivery or cash-settlement process." The analysis of market data presented above is one way that the Exchange is making an appropriate response to potential market disruptions.

The Exchange believes this proposal is an appropriate self-regulatory action to address bona fide concerns about manipulation and congestion.

In conclusion, no entity has a greater stake in the performance and continued success of its markets than CME. The Exchange believes it should be given the latitude to take appropriate actions to protect its own markets from disruption, and in complying with the Core Principles. These changes are being submitted in the best interests of the broad spectrum of market participants, and in keeping with CME's responsibilities as a Designated Contract Market to maintain fair, efficient, and orderly markets, so that the Live Cattle contract continues to perform its vital price discovery and risk management functions.

V. OPPOSING VIEWS

CME developed this proposal in response to the congestion experienced during the February 2007 delivery period. Separately, CME hosted a meeting of cattle industry representatives, including leaders of the National Cattlemen's Beef Association (NCBA) and individuals representing both hedgers and speculators, at the Exchange on April 12. Although this proposal was not presented at that meeting, these weight changes are consistent with the ideas discussed at that meeting and supported by nearly all of the attendees. In addition, these weight changes are consistent with the relevant sections of NCBA Policy M-1.9.

We are confident that the industry will support these changes once they are published by the Commission for public comment. Although a few longstanding market participants can be expected to raise objections to these changes, the Exchange is not aware of any substantive opposing views to the proposed amendments.

VI. APPLICATION OF THE ACT AND REGULATIONS

There does not appear to be any need for amendment or interpretation of the Act and Regulations in order to approve the proposed amendments.

VII. CONFIDENTIAL TREATMENT

Confidential treatment is not requested for this submission.

If you have any questions regarding this submission, please contact Paul Peterson at (312) 930-4587 or via e-mail at ppeterso@cme.com . Please refer to CME Submission #07-39 in all correspondence regarding this matter.

Sincerely,

John W. Labuszewski, Managing Director
Research & Product Development

EXHIBIT 1
AVERAGE LIVE WEIGHTS (STEERS ONLY)

CALCULATED FROM STEER CARCASS WEIGHTS USING 63% HOT YIELD

SOURCE: USDA, Actual Slaughter Under Federal Inspection, SJ_LS711

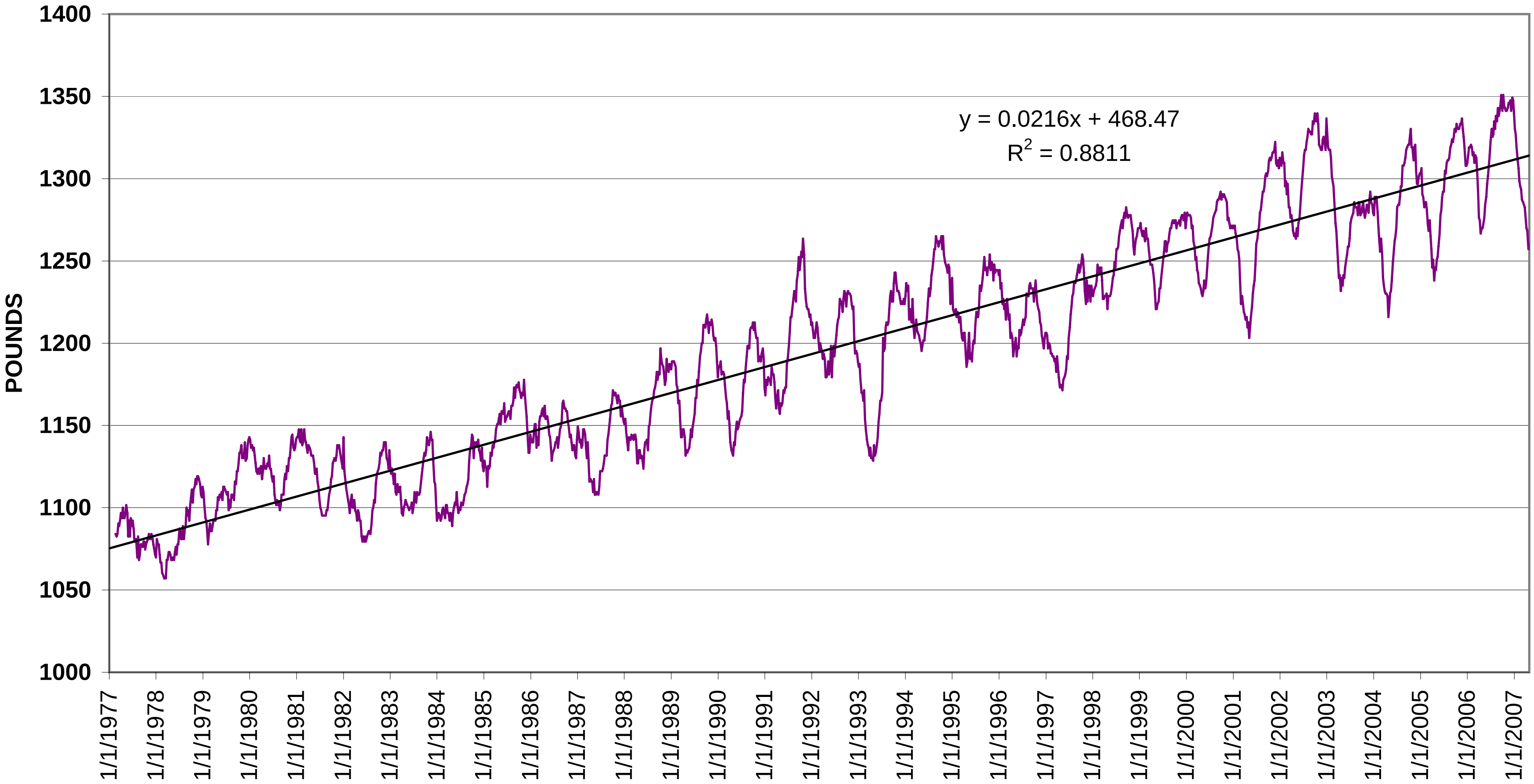


EXHIBIT 2
LIVE CATTLE PRICES

5-Area Live Steer Price (35-65% Choice) vs. Feb '07 Futures
First Notice Day through Last Trading Day

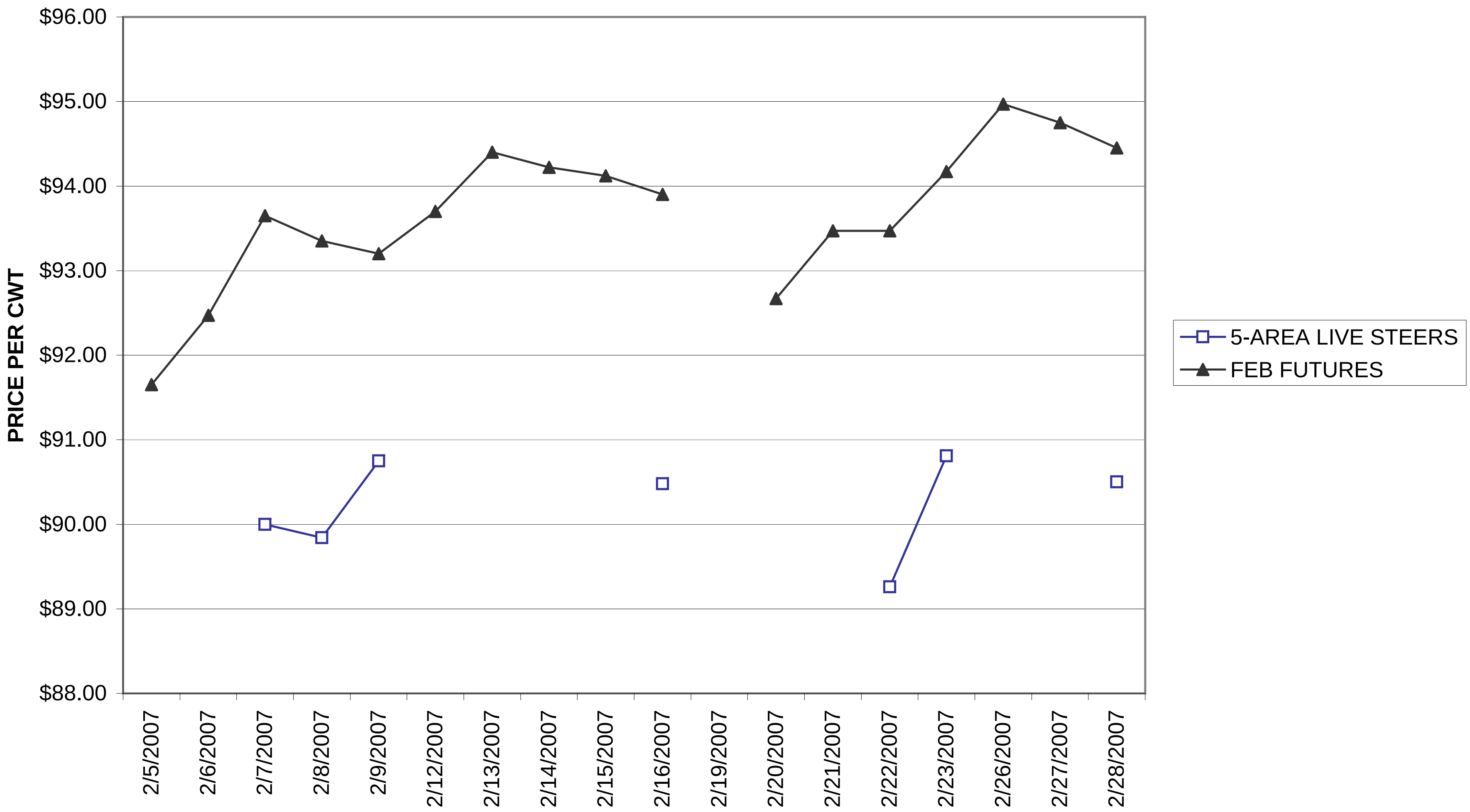
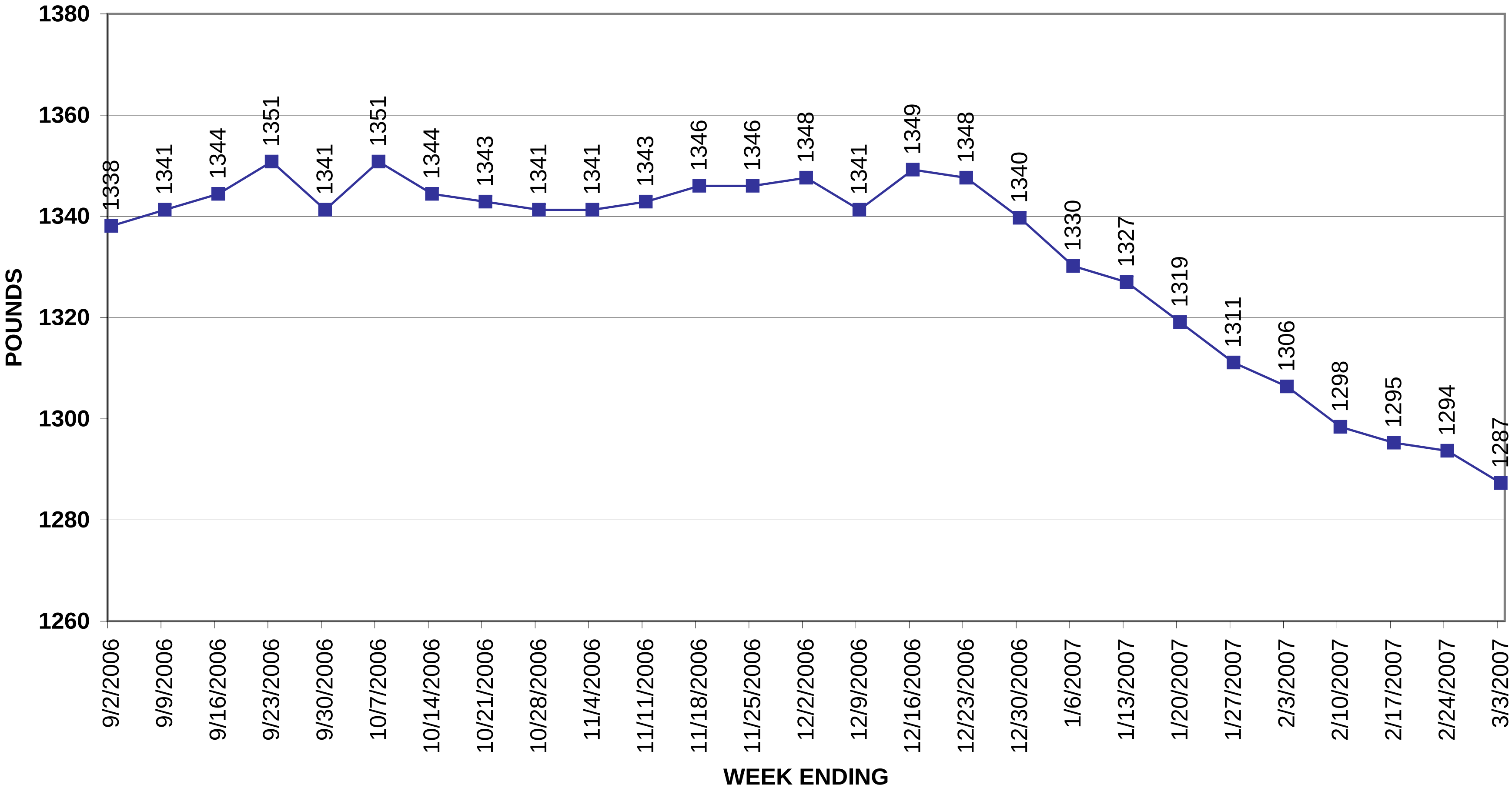


EXHIBIT 3
AVERAGE LIVE WEIGHTS (STEERS ONLY)

CALCULATED FROM STEER CARCASS WEIGHTS USING 63% HOT YIELD

SOURCE: USDA, Actual Slaughter Under Federal Inspection, SJ_LS711



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Special Executive Report

S-4575 **May 18, 2007**

EXCHANGE APPROVES CHANGES TO LIVE CATTLE DELIVERABLE WEIGHTS BEGINNING WITH DECEMBER 2007 CONTRACT MONTH

The Exchange has approved changes to the Live Cattle futures contract to permit the par delivery of heavier cattle in live-graded deliveries. <u>These changes will be applied to already-listed contracts, beginning with the December 2007 contract month, following CFTC approval.</u>

The text of the proposed rule amendments is presented below, with additions underlined and deletions bracketed and overstruck:

CHAPTER 101
LIVE CATTLE FUTURES

10103. SETTLEMENT PROCEDURES

10103.B. Live Graded Deliveries

4. Par Delivery and Substitutions.

a. Par Delivery Unit. A par delivery unit is 40,000 pounds of USDA estimated Yield Grade 3, 55% Choice, 45% Select quality grade live steers, averaging between 1,100 pounds and [~~1,350~~] <u>1,425</u> pounds with no individual steer weighing more than 100 pounds above or below the average weight for the unit. No individual animal weighing less than 1,050 pounds or more than [~~1,400~~] <u>1,475</u> pounds shall be deliverable.

Par delivery units shall have an estimated average hot yield of 63%.

All cattle contained in a delivery unit shall be healthy. Cattle which are unmerchantable, such as crippled, sick, obviously damaged or bruised, or which for any reason do not appear to be in satisfactory condition to withstand shipment by rail or truck shall be excluded. No cattle showing a predominance of dairy breeding or showing a prominent hump on the forepart of the body shall be deliverable. Such determination shall be made by the grader and shall be binding on all parties.

b. Weight Deviations. Steers weighing from 100 to 200 pounds over or under the average weight of the steers in the delivery unit shall be deliverable at a discount of 3¢ per pound provided that no individual animal weighing less than 1,050 pounds or more than [~~1,400~~] <u>1,475</u> pounds shall be deliverable. For purposes of computing such discount, the weight of the over or under weight animals shall be considered the same as the average weight per head of the delivered unit. Steers weighing more than 200 pounds over or under the average weight of the load are not acceptable. The judgment of the grader as to the number of such overweight or underweight cattle in the delivery unit shall be final and shall be so certified on the grading certificate.

(Remainder of Rule 10103.B.4. unchanged)

If you have any questions regarding this matter, please contact Paul Peterson, Commodity Research & Product Development at (312) 930-4587; John Harangody, Commodity Products at (312) 466-4437; or Ken Lovett, Market Regulation at (312) 930-3257.