secretary

From: Ken Stein [Kenneth.Stein@gte.net]
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To: secretary
Subject: Comment on CBT Wheat Futures Contract Amendments

To: Commodity Futures Trading Commission
Re: Comment on Chicago Board of Trade Wheat Futures Contract Amendments

Chairman Lukken and Commissioners:

Two events in the last several months seemingly should have narrowed the enormous $2/bu gulf between CBT wheat futures and Toledo cash prices, which by design are supposed to maintain such a tight relationship that they are identical when every contract expires:

1. An unusually large harvest of soft red winter wheat, much of which was purchased by commercial elevators and short-hedged in Chicago futures.

2. Recent substantial liquidation of positions by both index and discretionary funds.

Despite these actions the spread between cash and futures, which must converge to be viable, did not narrow in the expirations of either July or September. To place their difference in perspective, $2 per bushel is more than 20% of the futures price, *equal to ten of what not long ago were rarely-seen limit moves in futures* – a difference so great, and maintained for so long, that this contract cannot be said to represent the price of the underlying wheat market. It is a "wheat" contract in name only, has no utility for the farmers, elevators, or end users that are the reason it exists, and is in fact no longer in any commercial use except by elevators *gambling* that at some future point it will return to functionality and generate enormous (and legitimate) profits for them. It cannot be represented by anyone as performing the function for which CFTC grants it the right to operate for *the last few years.*

The volume delivered against both July and September was large. During September just expired, they averaged over 1,000 each day in just a small geographic area. "Delivery" is not a market for wheat. There is no consumption involved; it is meant only to make certain that the contract actually represents the underlying physical. Larger volumes of delivery are not what makes the contract work, since even a small amount delivered at higher than its actual cash value should converge the two. There is more than enough delivery capacity in existence to accomplish this, and it is being exercised.

The CME proposal to greatly expand the volume and geographic area of delivery will not converge cash with futures. If taking ownership of wheat via the futures market at drastically over the actually traded price in the cash market were sufficient to compel convergence, that would have already occurred. And, pointless expansion would generate its own negative consequences. If, say, a truly huge volume were delivered and the cash basis thereafter rose to above futures price (quite plausible), the weight on the spread would be so great as to prevent narrowing to reflect the above-delivery basis. That would in another way diminish the efficacy of futures, whose spreads must widen to manage an excess of supply over demand, but also narrow and even invert to provide a tool to manage the excess of demand over supply. If simply burying the contract would suffice to converge it, that would have already occurred in *many* previous expirations. The CME suggestion is at theoretical and practical odds with how a functioning grain-futures contract should be designed.

Also, expanding the physical delivery territory to encompass disparate locations, whose values can be interrelated only by those with the personnel to track and value shifting national production and usage patterns, and overlay onto those changing transportation relationships, adds impossible complexity for nearly all customers and grants a greater advantage to the largest commercials. Not knowing whether delivery will occur in Toledo or Tennessee makes it difficult and nebulous to value a local price relative to futures. A functioning futures contract acts as an "equalizer" between the largest and smallest entities, all of whom can have accurate knowledge of their local price relative to a widely-quoted big-volume point like Toledo. If the location of delivery becomes unclear over that wide an wide area, hedging in futures becomes an exercise in correctly forecasting the entire U.S. grain system in order to approximate one's own "delivery-equivalent" basis.

Thus, much larger delivery volume over a much broader area - particularly on the heels of a failed expiration period in which as much as 2,000 contracts was delivered in a single session - clearly does not address current problems, and will create further diseconomies pointlessly detracting from commercial function.

If there is no utility to Chicago "wheat" futures, then why is open interest so high? The answer is simple: Because of CFTC and CME rules, there are several classes of traders who are able to participate in large volume despite their obliviousness to the risk of owning a derivative so wildly overpriced.

Index funds, whose size has grown enormously since a unique CFTC grant of exemption from speculative limits, have in the past year frequently comprised *the majority of long open interest* in the nearby contract. As such, the Chicago wheat contract represents for CFTC analysts the "poster child" for the most damaging example that its exemption has produced. These funds are not the lone cause of the convergence problem, but the illiquidity they create greatly exacerbate it.

Index funds have become an enormous, homogenous bloc of open interest which is "rolled" to a further-out contract on well-advertised dates prior to the delivery period, supposedly so as not to create delivery distortion. But the roll itself distorts: Giant volume rolled at a well-advertised time widens spreads artificially, usually to the maximum "full carry" calculation, temporarily distorting the cash grain market. (i.e., as rolling activity overwhelms the spread relationships which were previously reflective of cash markets, it perforce artificially distorts cash-basis levels.)

As the huge index-fund bearspreading volume forces spreads out to near full carry "maximum," that attracts into the market an offsetting set of large-volume bullspread participants equally oblivious to the relationship of paper futures to actual grain price. These participants then can take delivery and earn low-risk returns comparable to T-bills, plus a chance at larger profits should the spread narrow. The volume of non-grain-price- related traders eager to earn that type of safe return will easily swell to absorb any increase in the volume delivered, no matter how large. That's the main reason why expanding delivery volume will do nothing to converge cash and futures: As long as those taking delivery are able to buy their futures spread wide enough, they have essentially sold the further-out contract at the same premium to cash as the nearby they're taking delivery of.

The leaden *modus operandi* of index funds is to buy and thereafter do nothing regardless of price fluctuation, oblivious to whether what they own even remotely resembles what they have represented it as to their customers. Other traders, who get short to profit by what is supposed to be the proper narrowing of futures with cash, thereafter encounter great difficulty covering their positions regardless of price behavior, because so much of the offsetting long open interest will not sell anything at any price. And that sends the futures price still higher relative to cash.

CFTC, by authorizing formation of huge blocs of capital permitted to exceed position limits enforced on everyone else – limits which exist in order to avoid any potential for uneconomic influence - has inadvertently created a major, and in the case of wheat, dominant, class of trader whose pre-announced "rolling," in a small market, forces an artificially wide spread relationship. The spreads can then be bought on a cash-management, rather than cash grain, basis, in a volume far larger and at a difference greater due to large index volume and industry foreknowledge of what the trade will be and when it will occur.

CME's proposal reveals it to have been co-opted by the present size of wheat open interest originating from other than the wheat business, which also offers it potential for expansion via traditional marketing techniques to other purely "financial" participants. That's why CME's proposal is to manufacture more deliveries, so more is available for more "financial" stoppers to offset larger index trading. But its proposals would still leave wheat futures as the same virtual gambling joint it is today, unrelated to wheat prices and having nothing to do with the *raison d'etre* for which CFTC authorizes the contract.

This situation is illustrative of:

--What happens when a regulatory body naively sanctions discrimination in favor of one specific type of trade;
--How that spawns a new sort of market distortion;
--How the free market adapts to accomodate a new equilibrium of buyers and sellers created by the distortion.

But it's no longer wheat-trading.

CFTC should reject CME's application to enlarge delivery volume and area, which does not reflect a basic understanding of the problem and will introduce new sorts of problems without offering any chance of improving convergence.

There are numerous external diseconomies created by a $2 separation between cash and futures:

--It artificially hastens consolidation of domestic industry. In normal markets, when a regional flour miller bids for wheat from a multinational, each has equal knowledge of what the futures price is and how his local basis relates to Toledo, which each knows will be at par during the delivery period. That is what keeps the transaction "honest." When nothing remotely close to convergence can be anticipated, the buyer doesn't know what his basis is vs futures, which are by then entirely out of the commercial picture. Nearly all pricing power passes to the larger company. This increases wheat costs to the smaller miller relative to the largest.

--Similarly, for a foreign trader the pricing reference can no longer be the futures market, which he can enter and exit easily and inexpensively as price projection or needs change. Without a relevant futures market, the only way to accurately hedge costs is by flat-price cash purchase contract, which is relatively illiquid.

--The commercial elevator's wheat bid to farmers will be reduced sharply, as the crude but only way he can manage his risk when futures that relate to it no longer exist. This year, the bid for wheat is based on the price of corn, which provides a liquid futures and flat-price backstop.

--USDA has inaccurately calculated its subsidized crop-insurance rates for soft red winter wheat, basing them on Chicago futures despite the $2/bu premium to actual cash wheat. The result is an unrealistically large farm subsidy and misspent taxpayer funds. This will encourage unneeded wheat area at the expense of corn and soybeans desperately needed to meet ever-larger "biofuels" mandates.

To function without undue distortion as they had for decades, CME grain contracts must accomplish two things: They must be an accurate quality proxy for the most commonly-traded contract grade, and an accurate price proxy for the physical product at the delivery point - with the Exchange empowered to monitor and make certain that that price-equivalency actually occurs during delivery. Anomalies will occur, but cannot be more than small and infrequent without calling into question contract design or rules. The nearby wheat contract has not converged for so long, is today not converging by such huge dollar amounts, and allows delivery of a grade which few can accept, at a price far above the actual one, that its continued existence in this form must be called into question. But is basic contract design faulty, or just the rules under which the contract operates?

CME has responded to delivery-quality problems by holding meetings but has been slothful in taking corrective action. The vomitoxin tolerance commonly traded in the industry is 2 ppm, 3 at a discount. The 4 ppm option permitted by CME at a 12c/bu discount to 3ppm, which would remain in effect until 2011, actually trades at something like 80c discount in the commercial market. CME, dismissive of the deleterious effect on its contract, has been irresponsible in responding since the problem arose about six years ago, bowing to pressure of some large commercials in whose hands, again, this placed far greater control over cash values. This is "rules"– that the delivery grade must always be readily merchandisable - so can be changed rapidly to preserve contract validity. How can the contract be valid and transparent if it represents delivery of a grade which cannot produce flour that can meet FDA standards?

If the entire commercial trade must base its business on 2 ppm with 3 ppm permissible, then it's blatantly distortive for CME to not reflect this universal standard. If a high-vomitoxin crop means that few deliveries can occur, *then futures will invert, perhaps sharply, as the trade scrambles to attract the quality it must have, or substitute another class. That's not an undesirable distortion or evidence of a "squeeze," rather it's what the market is supposed to do.* To not even address that until 2011 is simply feckless, and illustrative of the lack of interest by CME due to satisfactory volume in wheat futures, even though today's trading volume is based on an entirely different function than cash wheat.

There's little need to treat the application for variable carrying charges at length. A necessary attribute of futures is simplicity and transparence to customers, including those far removed from U.S. cash markets, and this is a needless complication as well as a fruitless contract change. *Adding a few cents per month to a few months can hardly make a dent in a $2/bu gap.* Cash carrying charges are usually, but not always, widest at harvesttime, and oddly, that seems to have struck CME as something which might have major bearing on the contract's separation from cash reality. Yet if current carrying charges were insufficient to reimburse deliverors at harvesttime, then why have deliveries been so heavy in the expiration of July and September this year? It's a worthless complication which should be rejected, in particular because it is to take effect in less than a year, in contracts already actively traded on a substantially different arithmetic basis. Futures spreads govern the natural storage function of a product for which the entire supply is produced once a year. So for the CME to sharply alter spread allowances in contracts already having substantial open interest entered into on a different cost schedule is unjust. CFTC should frown on such changes to standing contracts This is again illustrative of the lack of concern and expertise CME has applied to this problem, as its income is not being much affected and anyway this is a small contract in the context of its business.

Why would CFTC allow CME to widen carrying charges by 60% on standing contracts already having large open interest based on previous rules, but delay exclusion of 4 ppm vomitoxin until introduction of entirely new contracts in 2011? The effective dates should be precisely the opposite from the aspects of urgency, ability to solve the problem, and in what situations material change to active open contracts is allowed.

CFTC should reject CME's application wholesale and order it to formulate a better plan to return the contract to at least crude workability, or risk greater CFTC oversight of product design.

A practical solution which would rapidly return Chicago wheat futures to viability can easily be implemented with tools at hand, avoiding ineffective, harmful, or unjust changes to contracts already actively traded:

--Short of withdrawing its blanket hedge exemption for agricultural products, CFTC can find that index funds comprise an excessive percentage of open interest in the Chicago wheat contract, and withdraw it for wheat only. CFTC experts must surely recognize that an overwhelming bloc of unidirectional trade which does not economically respond to any futures, spread, or cash grain eventuality - precisely how futures stays related to cash - reduces liquidity enormously and certainly should not be specifically enabled by CFTC exemption from rules which apply to everyone else.

--I have attended or followed nearly all of the industry wheat-contract meetings for years, which were unsuccessful early on in coming to grips with the vomitoxin problem, and since biofuels legislation, unsuccessful in or dealing with the gross lack of contract relevance to the cash market. The point is that there is simply no prospect for industry or academic consensus of any sort of why it is happening much less how to correct it. *But that does not mean there exists no practical corrective action which will return this badly-needed contract to commercial viability. The bottom line is that by allowing participants to take delivery when the cash with which it is supposed to converge is vastly below, we are allowing a gaming of the system in which the "T-bill" aspect of the market entirely trumps its actual function.*

I believe that CME possesses the authority to return the contract *in its present form* to at least rough efficacy *without* damaging function when it returns to normalcy. Clearly if a delivery-taker were required to load out all or a portion (i.e., to sell it at the actual, much lower cash bid), that would converge the contract with cash. But occasionally, such as when crop size overwhelms storage availability, convergence does not occur. At those and other times of transportation dislocation, "forced loadout" would be draconian in its bearish effect on price. The legitimate taker of delivery must have a viable 100% storage option. No futures contract is ever purchased with the expectation that the Toledo basis will be above futures and loadout will be ordered. Chicago wheat futures functioned adequately for decades while rarely resulting in loadout, as convergence makes that needless.

But forced loadout would, indeed, converge cash with futures, and within this concept lies the essential key to rapidly returning the contract to workability*: The taker of a delivered wheat contract must be compelled to do so with at least some reference to its actual value.* The recent $2/bu gap makes painfully clear that there is today no connection between the two, despite heavy deliveries.

In expiration of contracts which are at inverse to their successors, CME scrutinizes the basis at delivery points to determine the economics of the longs. It intensifies its scrutiny of individual positions if it seems plain that cash can be bought below convergence so that the long is uneconomic, i.e., there is no conceivable economic grain function to staying long other than accomplishing a too-high distortion of the futures contract. It can then take action to make sure that uneconomic nearby long positions do not squeeze into distortion the value of futures relative to cash.

Why can CME not exercise the same discretion that it uses to prevent a "squeeze" in an expiring inverted market to discourage uneconomic longs in a carrying-charge market? *The aim in both cases is to preserve contract integrity by prohibiting distortion by those wishing to profit by staying long futures above the actual cash value.* In an inverse, CME will split hairs of 1c per bu if a stubborn long refuses to liquidate or bid for the cash, because it represents an uneconomic squeeze. Why, in a distortion as gross as the current one, can CME not devise a lighter-handed manner of discouraging long positions during delivery if it appears uneconomic within, say, 25c/bu? That generous standard would not dissuade anyone from taking delivery if he foresaw a cash-market eventuality different from present, but would make all potential stoppers unwilling to risk staying long spreads during delivery if the contract price isn't at least in the ballpark of what the grain and food industries are using it as a hedge against. The present situation makes it possible for a small number of individuals to *profitably* own wheat which is in reality enormously unprofitable wheat, and in the process ruin the contract for the entire world market. Futures' intended function is being "held up" by a comparatively tiny group, at a ridiculously large cost to everyone else.

If CFTC first withdraws the hedge exemption of index funds (non-commercial derivatives might also be addressed) for wheat and allows 90@120 days for compliance, and that is followed by a CME announcement that it reserves the right to require some loadout of deliveries if widely-disseminated cash offers make it plain that cash wheat can be procured at the delivery point 25c below convergence, it would rapidly return the contract to at least crude workability, and probably better than that. (The second step is the more important, and would be largely successful without CFTC withdrawal of hedge exemption.) Because 25c is such a lax standard by which to judge distortion, it could not be said to inhibit any legitimate trading. With the index funds' volume thus reduced beforehand, the volume of spreads rolled at an artificial price into the hands of "financial stoppers" would be reduced. The number of "financial stoppers" would be further reduced to those cognizant of whether the nearby futures price was highly distorted, not difficult to determine. And because 25c is so loose, CME discretion would not be a consideration as the market returns to the accuracy of convergence experienced for decades.

Correcting these distortions so counterproductive to normal market function means that futures price will decline to the actual price of soft red winter wheat at Toledo. Any protest by "longs" of Commission or Exchange actions would lack economic merit, since each trader is responsible for the consequences of his decisions, which is in this case is to be long a futures contract which he knows, or should very well know, is wildly above the actual price of soft wheat at the Toledo delivery point, not to mention everywhere else in the world. There would be no grounds for any protest, rather it would be CFTC doing its job by stepping in in the public interest with commonsense correctives to restore an important financial instrument after the Commssion's charge, the CME, had failed to rein in truly wild distortion by itself.

Respectfully,

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