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COMMENT

November 12, 2002

Ms. Jean A. Webb
Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, D.C. 20581

Dear Ms. Webb:

The Chicago Mercantile Exchange (CME) has recently proposed to change spot month position limits for their Live Cattle futures contract. I understand that from time-to-time changes are required in a futures contract, but rarely are terms of an actively traded contract changed just weeks before it enters its delivery period. Surely the Commission recognizes that changes to a contract with large pre-existing open interest holds much more damage potential than changes to contracts that have not yet been listed.

In their submission dated Oct. 18, 2002 (CME# 01-101), the Exchange states that the supply of deliverable cattle has been "reduced" because live weights in the cattle population have increased. This, they claim, warrants the reduction in spot month position limits. I am concerned that the Exchange is not being completely candid in its portrayal of the situation. The only justification the CME offers to support this request—dramatic reductions in deliverable supply due to heavier cattle weights — does not hold up under close scrutiny.

A Closer Look at Deliverable Supplies:

In their submission to the CFTC dated Jan 6, 1997 (CME #97-03), the CME described the Live Cattle delivery system as similar to "pouring a bucket of water through a funnel". The bucket of water represents the supply of deliverable cattle and the funnel is the physical delivery system comprised of stockyards, graders and packing plants (page 33). In 1997, the CME was arguing that the real limiting factor in deliveries was the ability to process live-graded deliveries at the stockyard (the "neck" of the funnel). Nothing has really changed with respect to the physical delivery system. Some delivery points have been deleted, but others have been added. There were 10 delivery point stockyards in 1997 and there are ten today. Thus, the overall capacity to process deliveries should be very close to what it was in 1997 when the CME estimated that a minimum of 5,630 contracts could be delivered through the stockyard delivery system in any one month (Exhibit 66, CME submission #97-03). At the same time, the CME argued that there were enough deliverable cattle to fill 17,741 contracts per month (Exhibit 66, CME submission #97-03). Clearly, the limiting factor was the ability of stockyards to process deliveries.

With its current action, the CME is now arguing that contract specifications must be changed mid-stream because there is a serious lack of deliverable cattle. Suddenly, now the "bucket" rather than the "funnel" is the problem.

It should be noted that the Commission approved the CME's submission in 1997 and that submission expanded spot month position limits from 300 contracts to 600 contracts. Obviously, the CME (because it submitted the request) and the Commission (which approved the request) both believed that the ability to deliver 5,630 contracts in any month was adequate to permit a 600 contract spot month position limit. So, surely the CME wouldn't request, and the CFTC wouldn't approve, a spot month position limit reduction unless deliverable supply is now less than 5,630 contracts? This would seem logical.

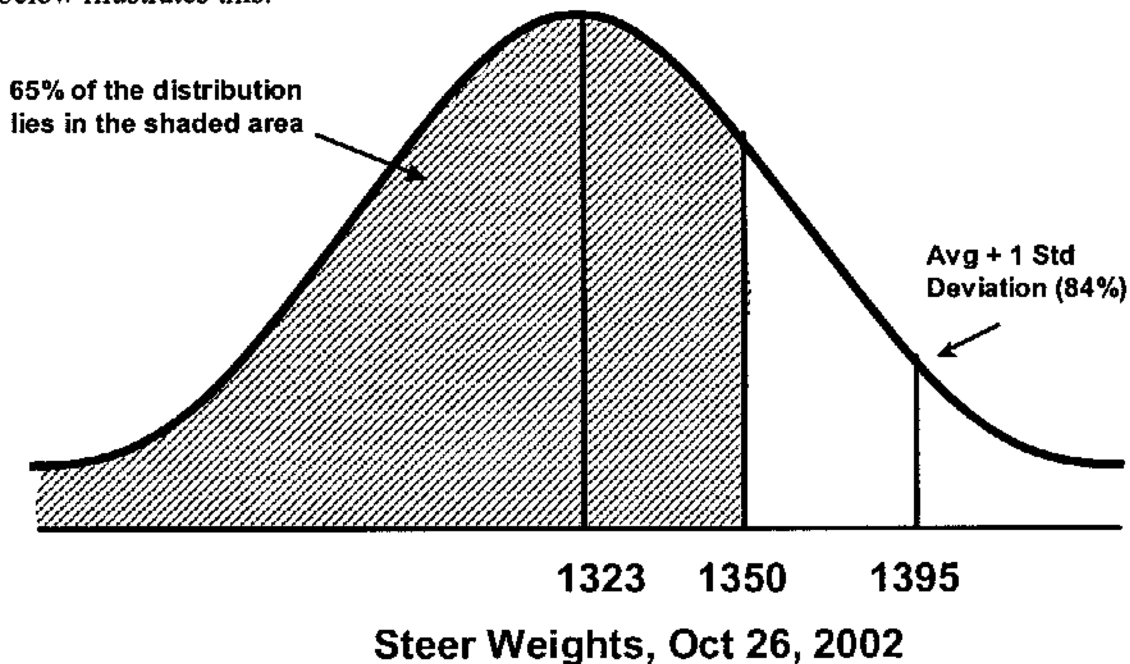
Further, as recently as January 2000, the CME requested an increase in spot month position limits from 600 contracts to 900 contracts. In that submission, the Exchange calculated that the smallest number of contracts that could move through the live-graded stockyard delivery system in one month was 5,480 (page 5, CME Submission #00-03). Thus, the Exchange felt that the ability to deliver 5,480 contracts was adequate to permit a 900-contract spot month position limit. Further evidence that there is no problem with the "funnel".

What about the "bucket"? It would seem that as long as there are enough deliverable cattle to make 5,630 loads in any month, then the bucket is not a problem since the funnel becomes the constraint at that point. The contract specification that makes a steer un-deliverable in a live-graded delivery is the maximum allowable weight of 1350 pounds. The 1997 submission requested the 1350-pound maximum beginning with the June 1998 contract and that limit is still in effect today. One logical starting point is to answer the question, "What percentage of the U.S. fed steer population weighs less than 1,350 pounds right now?"

USDA data for the week ending October 26, 2002 lists average steer carcass weights at 840 pounds (AMS report, "Actual Slaughter Under Federal Inspection", WA_LS711). Steers will yield between 63 and 64 percent. Applying a conservative 63.5% yield, an 840-pound carcass would have come from an animal with a live weight of 1323 pounds. In other words, actual data complied from all the cattle slaughtered under federal inspection indicates that the average steer live weight is currently 1323 pounds. Right away it is apparent that more than half of the slaughter-ready cattle in the U.S. steer population would qualify for the delivery (1323 < 1350).

I did some additional research. Average live weights were compiled for nearly a million head of cattle slaughtered in 2002 that originated from a large cattle feeding operation with locations in several states. The standard deviation of live weight for slaughter steers in any week was consistently in the 70-75 lb. range. If it is assumed live weights are normally distributed around the average, and we use 72 lbs. as the standard deviation of that normal curve, it means that 65%

of the current slaughter-ready steer population weighs less than 1,350 pounds. The diagram below illustrates this.



Now, recall that in 1997 the CME's own calculations showed a minimum of 17,741 contracts of deliverable supply would be available in any month (under the proposed specifications that included a maximum allowable weight of 1,350 pounds). Currently, 65% of steers would be deliverable. If 100% were deliverable in 1997 (conservative) and only 65% would be deliverable now, then there has been a 35% reduction in deliverable supply due to the increase in steer live weights. If we reduce the 1997 deliverable supply by 35%, the result is 11,531 contracts (17,741 x 0.65). This calculation uses very conservative estimates and the CME's own deliverable supply calculations that were in a submission approved by the Commission. Clearly, even with the rise in live weights that has occurred over the intervening years since spot month limits were raised to 600 contracts, ***the bucket is still far larger than the funnel.***

There are some additional points that make me question the sincerity of the CME in their assertion that heavy live weights necessitate a reduction in spot month position limits:

(1) In early 2000, the CME estimated that the minimum number of steers that were deliverable under live-graded contract specifications was 6,020,055 head per year (CME submission #00-03, page 7). To arrive at this number, the Exchange took into account location, live weight, quality grade, yield grade and "captive supplies". The CME found that even after excluding cattle that would not be deliverable for any of the above

reasons, there was still a deliverable supply of 14,435 contracts per month. This was down slightly from the 17,741 contracts estimated to be available for delivery in 1997, but still a very large number. In that submission the Exchange was arguing that a deliverable supply of 14,435 contracts/month was adequate to support a 900-contract spot month position limit. Does it make sense that now, when deliverable supplies are only slightly lower, (11,531 contracts/month) that spot month position limits greater than 300 contracts pose a threat to the contract? That logic is difficult to follow.

(2) Cattle weights decline seasonally from mid October into late spring. The negative influence of heavy weights on deliverable supplies will decrease from this point forward. It would seem unjustified to request this type of change just as the "problem" is fading.

(3) The Exchange increased the maximum allowable live-graded delivery weight in May of this year effective with the June 2003 contract. Surely, they studied the issue carefully when they determined that a 25-pound increase was sufficient to keep the contract functioning properly. No mention was made at that time of a need to reduce spot month position limits. Cattle weights have been trending higher for decades, were the increases this Fall a surprise?

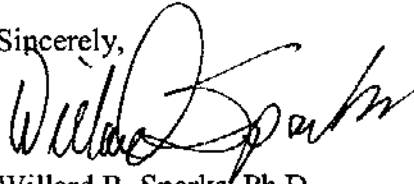
(4) This type of change is not price-neutral as the CME stated in their submission. Data from the *Commitments of Traders* report released on Nov. 8, 2002 show that large speculators in the CME's Live Cattle market are about 35,000 contracts net long. These are the individuals that will have to shed positions as result of this rule change, bringing extra selling pressure that wouldn't exist without the position limit reduction. Prices will be lower as a result.

In all, it seems rather apparent that the CME doesn't really believe that heavy live weights will reduce deliverable supplies to a level that threatens the industry's ability to make physical delivery on the contract. Granted, when the average live weight of the cattle population increases, it becomes more difficult (and costly) to build a deliverable load of steers. However, we need to recognize that in those situations a deliverable load of cattle is worth more than it would have been when the cattle population live weight was lower. If futures-deliverable cattle are worth more, the futures price goes up. That is a normal economic function. *Is that what the Exchange is reacting to with this request?* Do they see futures prices rise to larger-than-normal levels over the average cash market and assume that there is a problem with deliverable supply? It is unfortunate that the CME doesn't recognize this as normal economic response that should be expected when cattle weights increase. The same thing would happen if quality grades (% Choice) were low in the average cattle population. In that situation (which does occur from time to time), a load of par futures cattle has more value than the average pen of cash cattle and thus the futures price rises to a "larger-than-normal" premium over the average cash market. Again, there is no deliverable supply problem, just the proper economic result. Given the Exchange's

current action, market participants must be left to wonder if in the future, the CME will move to change contract rules mid-stream whenever an atypical, but perfectly normal, economic price response occurs.

In closing, I thank the Commission for the opportunity to express my views on this proposed rule change. I think that a rule change of this magnitude, imposed upon such a large number of outstanding contracts, should be looked at very carefully. I have done just that and can find no support for the argument presented by the Exchange to justify this change. Either they just don't get it or they intend to mislead the Commission. I hope it is the former rather than the latter. Regardless, it is bad policy and I recommend that the Commission ask the CME to withdraw this submission and reserve future submissions of this nature for contracts that have no open interest.

Sincerely,



Willard R. Sparks, Ph.D.
Member, Chicago Mercantile Exchange

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