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10 AGRICULTURAL ADVISORY COMMITTEE MEETING

11 Sheraton Overland Park Convention Center

6100 College Boulevard

12 Overland Park, Kansas 66211

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Thursday, April 5, 2018

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1           MR. THORNTON: Good morning. Welcome  
2 to Kansas. My name's Charlie Thornton. I'm  
3 the designated federal officer for the Ag  
4 Advisory Committee. As the agricultural advisory  
5 Committee designated federal officer and acting chair  
6 of this committee, it's my pleasure to call  
7 this meeting to order.

8           First I would like to go around the  
9 table and ask the committee members to  
10 introduce themselves. We have several new  
11 members, four temporary members and 10 people  
12 participating remotely by phone. That's the  
13 sound you'll hear above beeping in and out.

14           So we'll start with Lynn. If you  
15 could state your name and your organization,  
16 I'd appreciate it.

17           MR. CHRISP: I'm Lynn Chrisp.  
18 All right. Thank you. I'm Lynn Chrisp  
19 serving as first vice president for the  
20 National Corn Growers Association. My farming  
21 operation is in South Central Nebraska.

22           MR. KOVANDA: I'm Joe Kovanda, member  
23 of National Cattleman's Beef Association and  
24 representing them today. I work for a company  
25 called Bartlett Cattle Company.

1                   MR. HAWKINS:   Garrett Hawkins.  
2   Deputy director of the Missouri Department of  
3   Agriculture representing the National  
4   Association of State Departments of  
5   Agriculture.

6                   MR. HANDKE:   Hello.   Good morning.  
7   I'm Steve Handke.   I'm the president and CEO  
8   of the Union State Bank in Everest, Kansas.  
9   We're a community bank in Northeast Kansas,  
10   Northwest Missouri.   I'm honored to serve as  
11   the chairman of the ICBA's ag committee and  
12   representing ICBA today.

13                  MS. MESA:   I'm Jackie Mesa  
14   representing the Futures Industry Association.  
15   Tom Kadlec is our current representative on  
16   the Ag Advisory Committee.   I'm honored to  
17   represent FIA today.

18                  MR. KOTSCHWAR:   Good morning.   I'm  
19   Lance Kotschwar.   I'm here representing  
20   Commodity Markets Council.

21                  MR. HINES:   I'm Matt Hines.   I'm a  
22   licensed broker with Loewen & Associates,  
23   Manhattan, Kansas and Chairman of the Market  
24   Structures Committee for American Farm Bureau  
25   Federation.   That's who I'm representing here

1 today.

2 MR. PETERSON: Good morning. I'm  
3 Monte Peterson. I'm a farmer from Southeast  
4 North Dakota and director with the American  
5 Soybean Association and representing them here  
6 today.

7 MR. WILSON: TJ Wilson here  
8 representing Morrill & Janes Bank on behalf of  
9 the American Bankers Association.

10 MR. WANDS: My name is Hayden Wands.  
11 I'm representing the American Bakers  
12 Association (inaudible). I chair the  
13 commodity and agricultural policy committee  
14 for them and my company is Grupo Bimbo.

15 MS. GUETTERMAN: Jodi Guetterman and  
16 (inaudible). I'm here representing Guetterman  
17 Brothers Farms.

18 MR. ZACHARIAS: I'm Tom Zacharias,  
19 National Crop Insurance Services, Overland  
20 Park, Kansas.

21 MR. LANCLOS: Ken Lanclos, USDA Risk  
22 Management Agency, Washington D.C.

23 MR. BARKER: Joe Barker. I work for  
24 CHS and I'm here representing the National  
25 Council of Farmer Cooperatives.

1           MR. RINIKER: Paul Riniker, National  
2 Farmers Organization, farmer in Northeast  
3 Iowa. I raise about 500 acres of corn and  
4 feed about 1500 Holstein and feeder cattle.

5           MR. COYLE: I'm Patrick Coyle. I'm  
6 here representing the National Grain and Feed  
7 Association. I work with COFCO International.

8           MR. GALLAGHER: Good Morning. My name's  
9 Ed Gallagher. I'm representing the National  
10 National Milk Producers Federation, and I work  
11 with Dairy Farmers of America.

12          MR. BAKER: Good morning. I'm  
13 Dustin Baker with the National Pork Producers  
14 Council.

15          MR. STRONG: Morning. I'm Steve  
16 Strong. I work for Bunge North America and St.  
17 Louis, and I'm working with the North American  
18 Export Grain Association.

19          MR. ULLMER: Kim Ullmer here on  
20 Continental Marketing here representing R-CALF  
21 and United Stockgrowers of America.

22          MR. OWEN: I'm John Owen. I'm here  
23 representing USARice Federation. I'm a rice  
24 producer in Northeast Louisiana. I also  
25 produce corn and soybeans.

1           MR. THORNTON: Thank you. Also,  
2 before we get started, there are a few  
3 logistical items that I've been asked to  
4 mention to committee members and invited  
5 speakers.

6           First of all, if everyone here could  
7 put their phones on silent or turn them off,  
8 that would be greatly appreciated.

9           Also would you please ensure that your  
10 microphone is on when you speak? And I've  
11 just noticed that these microphones -- you have  
12 to turn yours off, so the next person can be  
13 able to speak. So make sure after you speak,  
14 turn it off, so we can proceed.

15           And please speak clearly because  
16 there's a webinar audience. They will -- for  
17 them to be able to hear you, you have to speak  
18 into your mic.

19           Also, please state your name and  
20 organization. We have a court reporter here  
21 and they need that for the record.

22           If you would like to be recognized  
23 during this discussion, please position your  
24 placard so that it sits vertically on the  
25 table or raise your hand. When you are

1 finished speaking, please turn off the  
2 microphones. And then, as I explained, only one  
3 mic can work at one time.

4 For AAC members participating by  
5 webinar, please keep your phone on mute until  
6 you are ready to speak and identify yourself  
7 beforehand.

8 After each panel presentation, I will  
9 ask the moderator to unmute the speaking lines  
10 and you'll have the opportunity to ask  
11 questions.

12 Finally, please refrain from using  
13 any electronic devices during the meeting. We  
14 have a full agenda today, and we would like to  
15 ensure full participation by all members of  
16 the AAC.

17 I would now like to turn to  
18 Commissioner Behnam, the AAC sponsor, for  
19 opening remarks.

20 COMMISSIONER BEHNAM: Thanks,  
21 Charlie.

22 Good morning and welcome to the first  
23 CFTC Agriculture Advisory Committee Meeting of  
24 2018. I am pleased to sponsor this meeting  
25 and thrilled to be able to host this meeting

1 in Kansas. In addition to being home to a  
2 CFTC regional office, Kansas is home to  
3 America's heartland, where many of our  
4 nation's farmers and ranchers proudly produce  
5 the food and fiber that feeds our world's  
6 growing population.

7 Before we move into the substance of  
8 today's meeting, I want to thank Commissioner  
9 Quintenz and the soon-to-arrive Chairman  
10 Giancarlo for being here this morning and  
11 for their contributions to today's discussion.

12 I want to thank each of the  
13 panelists. We have gathered a distinguished  
14 group of speakers, and their willingness to  
15 participate is greatly appreciated and  
16 critical to today's discussion.

17 I would also like to thank Christa  
18 Lachenmayr. As a member of the CFTC's  
19 Division of Market Oversight, Christa's hard  
20 work, dedication, and knowledge of  
21 agricultural markets have proven, for many  
22 years, to be an invaluable resource to the  
23 CFTC, market participants, and stakeholders.  
24 Christa played an integral role in setting  
25 today's advisory agenda, and her skills will



1 certainly be on display throughout the  
2 morning.

3           Finally, I want to thank Charlie  
4 Thornton, CFTC's Director of Legislative  
5 Affairs and this Committee's Designated  
6 Federal Officer. Charlie and I have worked  
7 together as staff on the Senate Agriculture  
8 Committee for several years. In selecting  
9 Charlie as the Committee's DFO, I considered  
10 his knowledge of agricultural policy and our  
11 strong working relationship. As sponsor of  
12 the AAC, it's important that I engage  
13 thoughtfully with the Committee's members and  
14 outside stakeholders. My goal is to lead  
15 discussions that will drive better policy and  
16 ultimately strong, transparent, safe  
17 derivatives markets. Charlie certainly will  
18 play a leading role in helping me -- and all  
19 of us -- to reach that goal.

20           In November 2017, shortly after being  
21 sworn in as Commissioner, I announced a  
22 listening tour for the first year of my term.  
23 Since then, I have been fortunate to visit  
24 many businesses across the country, including  
25 several here in Kansas City. Throughout my

1 visits, I have been able to hear directly from  
2 members of the industry, market participants,  
3 end users, and the public. And, I've shared  
4 some of my own views. The meetings and  
5 conversations have allowed me to inform and  
6 formulate goals and ideas for my term that are  
7 grounded in real-world concerns and  
8 challenges. Today's panels reflect some of  
9 the more pressing concerns brought to my  
10 attention.

11 Today we will dive into two timely  
12 topic areas; crop insurance and agricultural  
13 block trading. First, crop insurance is a  
14 critical risk management tool for growers; its  
15 importance cannot be understated.

16 Having worked on the 2014 Farm Bill,  
17 I intimately understand the important role  
18 crop insurance plays in a producer's risk  
19 management and tool box. However, the  
20 fundamental role futures markets play to crop  
21 insurance is often overlooked. I am hopeful  
22 this morning's discussion will educate and  
23 inform the Commission regarding the  
24 intersection of the two and further the CFTC's  
25 active engagement with registrants, market

1 participants, USDA, and agricultural  
2 stakeholders to ensure confidence in the crop  
3 insurance program.

4 Later this morning, we will discuss  
5 price discovery and the recent implementation  
6 of block trading in agricultural futures  
7 contracts. I am looking forward to hearing  
8 from both the panelists and the Committee  
9 membership on this important issue. Price  
10 discovery and liquidity are integrals to  
11 well-functioning futures markets, and the CFTC  
12 must ensure that market structure does not  
13 adversely affect either.

14 Finally, we are very fortunate to  
15 have staff from the Farm Credit Administration  
16 in attendance to share their insights on the  
17 state of the farm credit and the role risk  
18 management plays in a producer's ability to  
19 borrow capital. Farmers and ranchers place  
20 everything on the line at the beginning of the  
21 season, often needing to borrow significant  
22 capital to purchase machinery, seed,  
23 fertilizer, crop protection materials, and  
24 feed. That said, the well-hedged producer is  
25 a stronger borrower, and hopefully this will

1 be the first of many discussions between the  
2 CFTC, FCA, and stakeholders to better educate  
3 borrowers and creditors about the futures  
4 market and the role it plays in risk  
5 management.

6           The agricultural economy has faced  
7 stiff headwinds for many years. Persistently  
8 low commodity prices, extreme weather events  
9 resulting from climate change, and trade  
10 policy are a few of the significant hurdles  
11 that made production agriculture more  
12 challenging every year. The CFTC has  
13 historically played a key role in helping  
14 producers discover prices and manage risk.  
15 As the Congress considers the 2018 Farm Bill,  
16 I am committed to ensuring that the CFTC plays  
17 a leading role in ensuring that the  
18 derivatives markets remain a desirable,  
19 cost-effective, and transparent risk  
20 management tool for all agricultural  
21 producers, including our new and beginning  
22 farmers. A healthy farm economy is a big part  
23 of a strong and vibrant rural economy, which  
24 is integral to our nation's prosperity.

25           This morning's AAC meeting, and the

1 first of its kind Ag Conference hosted by  
2 Kansas State University, are steps to fulfill  
3 that commitment and I look forward to the  
4 many important discussions today and tomorrow.

5 Thank you.

6 MR. THORNTON: Thank you,  
7 Commissioner Behnam.

8 Commissioner Quintenz.

9 COMMISSIONER QUINTENZ: Thanks,  
10 Charlie. Thank you for your work. Thank you,  
11 Christa, for your great work. Thank you to  
12 our Kansas City office and all of the CFTC  
13 staff for coming out, for the great work in  
14 putting on what I think is a fantastic event  
15 and which I'm very excited to participate in.

16 And thank you, Commissioner Behnam, for your  
17 leadership in hosting today's meeting. This  
18 is the second advisory committee meeting  
19 you've sponsored in the last two months and  
20 it's the second advisory committee you've  
21 sponsored in the last two months. So good  
22 work and thank you for your effort.

23 Today's meeting of the Ag Advisory  
24 Committee is actually only the second meeting  
25 that has occurred since 2015, which in my

1 opinion is much too long of a time to have  
2 gone by without taking advantage of your input,  
3 quality, or expertise. While practice of the  
4 prior leadership of this committee was to hold  
5 one meeting a year, I'm hopeful that either  
6 with your leadership, Commissioner Behnam, or  
7 new leadership, once additional commissioners  
8 get confirmed, we can take much more frequent  
9 advantage of this important panel's  
10 significant expertise.

11 So I'm delighted to join all of you  
12 and the distinguished members of the  
13 committee, some of whom I've had the privilege  
14 of meeting in D.C. over the last year or so.  
15 Some of them I've actually had the privilege  
16 of meeting in your places of business around  
17 the country, talking with you directly about  
18 your concerns with our markets. For  
19 decades, this advisory committee has provided  
20 the CFTC with invaluable insights into the  
21 pressing issues of the day: agricultural  
22 trade options in the 1990s, the transition  
23 from pit to electronic trading in the 2000s,  
24 and current challenges involving the deliverable  
25 supply and convergence. I look forward to a

1 robust discussion today about the state of our  
2 futures markets and their ability to serve as  
3 an effective price discovery and risk  
4 management tool for the ag community.  
5 It is fitting that the AAC Committee is  
6 meeting today in Overland Park because the  
7 town was founded by William Strang in 1905.  
8 William Strang left home at the age of 15 and  
9 became an American railroad magnet, building  
10 railroads all over the country, including the  
11 Missouri and Kansas Interurban Railroad that  
12 ran through Overland Park and that was built  
13 along the historic Santa Fe Trail. And he was  
14 an avid believer in innovation and built the  
15 first self-propelled railroad motorcar in the  
16 world.

17 He was fascinated by progress. He  
18 also built the first -- or constructed an  
19 airfield here in Overland Park in 1909 -- only  
20 six years after the Wright brothers conducted  
21 their first flight -- so that locals could  
22 witness the novelty of so-called "flying  
23 machines."

24 I highlight those accomplishments  
25 because I believe that they were a reminder of

1 what's possible if we follow our aspirations  
2 and how a pound of vision of one person can  
3 have a generational economic impact on a  
4 region. The railroads that Mr. Strang built,  
5 in conjunction with America's natural inland  
6 waterways, enabled cities like Chicago and  
7 Kansas City to become hubs of commerce and  
8 market for America's grain, produce, and  
9 cattle.

10 Today, of course, there are different  
11 challenges that must be overcome by modern  
12 vision, leadership and ingenuity. And as I'm  
13 going to discuss in more detail tomorrow, the  
14 challenges facing the agricultural industry  
15 today -- historically low commodity prices,  
16 intense international competition, and slimmer  
17 profit margins -- make it more important now  
18 than ever that the futures markets remain a  
19 trusted and effective tool for price discovery  
20 and risk management for America's farmers and  
21 ranchers.

22 Indeed, the need for futures prices  
23 to reflect supply and demand fundamentals  
24 impact even those who choose not to directly  
25 participate in futures markets. Crop



1 insurance, an essential risk management tool  
2 for many farmers, relies upon futures prices  
3 to determine the expected income of farmers in  
4 the event a payout is made. Today, over 300  
5 million acres of farmland is covered by crop  
6 insurance, with an insured value of over \$100  
7 billion. I am interested to learn more about  
8 how the crop insurance program is working  
9 today from our first panel and make sure that  
10 we all understand that any lack of convergence  
11 impacts not only risk management hedging, but  
12 also the effectiveness of the crop insurance  
13 safety net.

14 In addition, given the past several  
15 years of depressed commodity prices, many  
16 farmers are struggling with access to credit.  
17 According to the USDA's Economic Research  
18 Service in 2017, the farm sector's  
19 debt-to-income ratio, which measures a  
20 farmer's ability to pay down liabilities, rose  
21 above six to one. The last time we saw such a  
22 high debt-to-income ratio for farmers was the  
23 1980s. I look forward to hearing from the  
24 FCA today about the various ways that they and  
25 the private sector can continue to meet the

1 financing needs of farmers and ranchers.

2 From our final panel, we will hear  
3 from the CME about recent implementation of  
4 block trading in certain agricultural  
5 products. I'm interested to hear that panel's  
6 observations about how the expanded use of  
7 block trade in this space is impacting  
8 liquidity and price discovery.

9 Together, the futures markets and  
10 crop insurance are the cornerstones of the  
11 farm safety net. They work together to ensure  
12 that farmers don't lose access to credit in a  
13 very volatile industry so that they can  
14 continue to providing America and the world  
15 with high-quality, low-cost food.

16 Again, I commend Commissioner Behnam for  
17 hosting this meeting today, thank the staff  
18 for their hard work, and look forward to  
19 exploring with you how all of these issues are  
20 impacting the vitality of the ag community.

21 MR. THORNTON: Thank you,  
22 Commissioner Behnam and Commissioner Quintenz  
23 for your opening remarks.

24 As noted in today's agenda, our first  
25 discussion will cover risk management with

1 regard to crop insurance. Our panelists are  
2 Kent Lanclos, director of Business Analytics  
3 at USDA's Risk Management Agency, Tom  
4 Zacharias, president of the National Crop  
5 Insurance Services, and Jodi Guetterman, a  
6 producer of corn, soybeans, and wheat from  
7 Guetterman Brothers Family Farm. Please  
8 begin.

9 MR. LANCLOS: Thank you and good  
10 morning. Let me begin with a little bit of  
11 information about the history of the Federal  
12 Crop Insurance Program. Federal Crop  
13 Insurance established in 1930s in the depth of  
14 the Great Depression and the Dust Bowl.  
15 However, it is only during the past 20 years  
16 or so that it has become the primary core  
17 safety net. It helps farmers recover from  
18 disasters and severe weather events, sustains  
19 local infrastructure to agriculture such as  
20 (inaudible), suppliers, community growers, and  
21 grain handlers and reduces the impact --  
22 financial impact -- of disasters on rural  
23 communities supporting local businesses and  
24 jobs.

25 Crop insurance operates as a

1 public/private partnership. The program  
2 partners the federal government's financial  
3 capacity with effective private sector  
4 delivery. RMA develops and approves  
5 policies and procedures, provides regulatory  
6 oversights and is the primary reinsurer for  
7 the companies and the program. There are  
8 currently 15 private insurance companies that  
9 sell and service crop insurance. Mr. Zacharias  
10 can provide a bit more information and background  
11 on these companies and who they are.

12 Federal crop insurance has seen immense growth  
13 in the past 20-plus years. In 2017, we  
14 insured about 310 million acres of farmland  
15 in the U.S. as compared to only 100 million  
16 acres in 1994. Linkage to other farm programs  
17 in 1995 led to significant increase in insured  
18 acreage. Mandatory crop insurance participation  
19 was repealed in 1996, but most of the  
20 insured acres stayed in the program and  
21 since that point, insured acres has continued  
22 to grow.

23 In recent years, a big driver of the  
24 program has been insurance for Pasture  
25 Rangeland and Forage (PRF) introduced in

1 2007. Over 75 million acres of pasture has  
2 been insured by 2017. Insurance coverage is  
3 available for over 130 crops. Aside from  
4 PRF, we otherwise have limited product for  
5 livestock, however, and those products that we  
6 do have provide basically marketplace  
7 coverage. In 2017, these livestock market  
8 products accounted for about \$550 million  
9 dollar in liability and about 18 million in  
10 (inaudible). They're not a large part of crop  
11 insurance portfolios. Truly crops are what we  
12 actually do with our program.

13 In terms of market penetration, about  
14 9 percent of the (inaudible) major crops,  
15 primarily corn, soybeans, wheat, grains,  
16 et cetera is now insured by our program and  
17 the average coverage level is over 70 percent.  
18 The expected crop is insured by our program.

19 As mentioned, in 2017, federal crop  
20 insurance will cover about 106 billion dollars  
21 in crop value entering a total premium of  
22 about \$10 billion. Of the 106 billion for  
23 crops, corn, soybeans, wheat, and cotton  
24 accounted for about 75 percent of that total.  
25 Pretty consistent with what we see year in,

1 year out.

2           As you can see, however, the amount  
3 of insurance is quite variable reflecting the  
4 inherent variability of commodity prices. For  
5 example, in 2010, we insured about \$78 billion  
6 in crop value. By 2013, the amount of  
7 insurance had increased to over \$123 billion,  
8 so a rather large increase in just a very  
9 short period. Annually there are about 1.2  
10 million policies earning the premium in our  
11 program purchased by some 550,000  
12 policyholders.

13           Now, turning to the pricing aspects.  
14 For non-exchange traded commodities, the  
15 insurance prices generally reflect an estimate  
16 expected season average price for that  
17 commodity. For the most part, these estimates  
18 are developed by U.S.D.A. analysts based on  
19 consideration, supply and demand factors such  
20 as stock-to-use ratios, planting intentions,  
21 et cetera.

22           With few exceptions, revenue  
23 insurance is not available to producers with  
24 non-exchange traded commodities, though I can  
25 attest they would really like to have regular

1 insurance for corn and soybean growers. But  
2 simply put, it is difficult to provide  
3 insurance in a sound manner absent [a price  
4 reference]. The advantages of a futures  
5 exchange [price] are not easily replicated by other  
6 methods of price discovery such as some type  
7 of a (inaudible) model or some other type of  
8 simulation approach. An exchange is an  
9 efficient aggregator of [supply and demand]  
10 information. An exchange provides an  
11 objective, unbiased, and transparent  
12 third-party source of prices.

13 Exchange values are forward looking,  
14 not backward looking, and they readily  
15 incorporate information as it becomes  
16 available. For crop insurance, the result is  
17 that insurance based on exchange values is  
18 much less susceptible to adverse selection. That  
19 is, people only buying insurance for (inaudible)  
20 also will buy exchange base revenue insurance, so  
21 there is much less risk of a pricing mistake  
22 inadvertently distorting the market. For  
23 example, inducing a large increase of acreage  
24 because the projected price is too high  
25 (inaudible) actual expectations.

1 Farmers have eagerly embraced revenue  
2 insurance where it is available. The first  
3 revenue insurance policies were offered in  
4 1996. By 2007, revenue insurance accounted  
5 for about 80 percent of total program premiums  
6 and has remained at that level since this  
7 time. As noted before, revenue insurance is  
8 generally only available for those crops where  
9 there is a futures exchange for price discovery  
10 or in some cases where there is a derivative for an  
11 exchange-based commodity, so it primarily  
12 means corn, soybeans, wheat, cotton and rice,  
13 again with extension to other commodities.

14 For the crops with revenue insurance,  
15 the exchange values are used to project both  
16 the projected price, the volatility, and  
17 harvest prices. That way, we assure pricing  
18 consistency and minimize the potential for  
19 adverse selection amongst the insurance  
20 products.

21 How you use the exchange value on the  
22 projected and harvest prices is contained in  
23 the commodity exchange price provisions. The  
24 general process is as follows: For corn, the  
25 applicable exchange is Chicago Board of Trade.



1 In the Midwest the sales closing date for  
2 spring crops is March 15th. That is the date  
3 by which you must make a crop insurance  
4 purchase decision. For these states, the  
5 December CBT contract is the referenced  
6 contract. Our (inaudible) projected price 15  
7 days in advance of the sales closing date, so  
8 about March 1. The intent with this date is  
9 to provide farmers with an opportunity to make  
10 an informed decision, but not so far in  
11 advance of sales closing that the price has  
12 become stale or been outweighed by subsequent  
13 events, so it's striking a balance between  
14 (inaudible) and currency.

15 The projected price itself is  
16 determined as the average of the daily values  
17 of the December contract for the month of  
18 February. For most states in the Midwest, the  
19 harvest price is determined as the average of  
20 the daily values of the December contract  
21 during the month of October. In the interest  
22 of transparency, [USDA/RMA] publishes most of  
23 this information - from deriving the projected  
24 harvest prices to the volatility factors - on our  
25 public website.

1           As shown here, this is Section 1 of  
2 the commodity exchange provisions. It  
3 provides definitions of terms applicable to  
4 all of these revenue -- exchange-based revenue  
5 products. The method for calculating the  
6 volatility is also available on the website.

7           Section 2 of the price provision  
8 provides the reference exchange, contract month,  
9 and projected and harvest price discovery period  
10 for each state and sales closing date. It's a  
11 little bit small here, but trust me. For  
12 example, for counties with January 31st sales  
13 closing date in Texas, the referenced contract  
14 corn is September CBT contract. The projected  
15 price discovery period, as stated in this  
16 document, is December 15th through January  
17 14th, and the harvest price discovery period  
18 is August 1st through October 31st.

19           Also shown here is counties of Texas  
20 with a February 15th sales closing date, which  
21 would have its own set of terms as listed here  
22 as well as counties (inaudible). So for every  
23 state and every closing date for every  
24 commodity, you can find on our website all the  
25 materials about which contract, which pricing

1 period is used for price discovery.

2           So how is the record contract  
3 determined? In brief, the record contract is  
4 the new crop futures contract at the end of  
5 the harvest period for the post-harvest  
6 contract for the crop in the area. As we've  
7 kind of seen already, the projected price  
8 discovery period dropping to a 30-day period,  
9 ending 15 days prior to sales closing. The  
10 harvest price discovery period is  
11 approximately a 30-day period that corresponds  
12 to when most farmers are actively harvesting  
13 the crop in the area.

14           We do impose certain threshold  
15 requirements to use the exchange values as  
16 described in the commodity exchange price  
17 provisions. In particular, there must be  
18 at least one full active trading day during  
19 the price discovery period for a full active  
20 trading date defined as any trading date with  
21 at least one open-interest contract available  
22 at the close of trading. The contract itself  
23 when traded at least once during the discovery  
24 period, that is at least one trading date  
25 equal to one. These threshold requirements

1 are not fairly stringent, but still we must  
2 address the question: If the threshold  
3 requirements are not met, what then? That  
4 answer is also spelled out in the commodity  
5 exchange price provisions. Specifically, on  
6 the rare occasion that the threshold  
7 requirements are not met, you first look to a  
8 futures contract.

9           So if the threshold requirements are  
10 not met for December contract, for example,  
11 just average to projected price, we would then  
12 look to the September contract. However, that  
13 futures contract is also subject to the same  
14 threshold requirements. If the threshold  
15 requirements are still not met for the  
16 projected price, then revenue coverage will  
17 not be offered. Only real coverage will be  
18 available at a price determined by RMA. If  
19 the threshold requirements are still not met  
20 for the harvest price, that is a bit trickier  
21 because farmers have already purchased the  
22 revenue insurance coverage, so we can't simply  
23 say that once the revenue coverage is gone or  
24 not available. In that situation RMA will  
25 determine a harvest price to allow the

1 companies to sell contracts, insurance  
2 contracts.

3           Thankfully we have only a few  
4 instances, primarily for rice, where we have  
5 to use a substitute futures contract to  
6 establish the price. It's a very rare  
7 situation. And as far as you can recall, we  
8 have not had a situation in which RMA has had  
9 to itself determine either the  
10 projected price or the harvest price, so the  
11 instances we've had have all been based on  
12 projected price and (inaudible) data, if you  
13 will, for publishing that.

14           With regard to volatility, the rating  
15 method for revenue insurance assumes that the price  
16 distribution is normal and that the [value] can  
17 be computed from an option-based volatility  
18 measure. The parameters in price  
19 distributions together with the assumed price  
20 correlation are used in a simulation procedure  
21 to calculate the revenue load, which are then  
22 charged to the farmer which is the revenue  
23 coverage.

24           RMA derives a measure of price  
25 volatility based on observed option contract

1 prices for the underlying futures contract  
2 using the actual framework. However, we do  
3 not calculate the value ourselves;  
4 rather, we obtain those values. So go to a  
5 public source for those volatilities. We do  
6 apply a time adjustment to take (inaudible)  
7 into account the time difference between  
8 the expiration of the options contract and the  
9 time period the farmer uses to establish the  
10 harvest price.

11 Finally, volatility is the simply  
12 average of the time-adjusted volatilities for  
13 the last five days of the projected price  
14 discovery period.

15 As a quick example of how revenue  
16 insurance works and how it differs from  
17 straight yield insurance, consider the  
18 following illustration: In all these  
19 examples, the average yield is assumed to be  
20 100 bushels, projected price is \$4 per bushel  
21 and the coverage is 75 percent. So for  
22 revenue insurance to guarantee 75% of \$400  
23 dollars is equal to \$300, the [product of] one  
24 hundred bushel average yield, \$4 dollar projected  
25 price and the 75 percent coverage level.

1           For yield insurance, the guarantee is  
2    stated in bushels, so that is setting by  
3    bushels. (Inaudible) the actual yield is 65  
4    bushels and the harvest price is \$3 a bushel.  
5    So for yield insurance indemnities, simply  
6    calculate a product of the 10 bushel shortfall  
7    and \$4 projected price, that's \$40. For  
8    revenue insurance HPE, the indemnity's \$105  
9    obtained is the difference between the  
10   \$300 dollar guarantee and calculate the  
11   harvest revenue of \$195.       That is the  
12   product of the 65 bushel actual yield and the  
13   \$3 harvest price.

14           Now, in this illustration you see two  
15   revenue insurance products listed. Revenue  
16   insurance and revenue insurance HPE are  
17   harvest price exclusions. What is the  
18   difference? Standard insurance includes  
19   replacement cost coverage for lost production.  
20   That is, if the market price has increased at  
21   harvest, it pays off any lost production at  
22   that prior price. The basic idea is that if a  
23   farmer has already contracted to a grain  
24   manager to deliver a certain amount of  
25   production and subsequently sustained a

1 significant production loss, the farmer still  
2 has to fulfill that contract and those bushels  
3 to that grain handler. So the farmer has to  
4 go to the market -- cash market -- and buy the  
5 replacement bushels.

6 In case of, like, some type of  
7 significant loss like in 2012, the market  
8 price will be a lot higher than what would  
9 have otherwise occurred. So he would pay  
10 a lot more above the price to purchase those  
11 replacement bushels. This feature of this  
12 revenue insurance provides coverage for that  
13 occurrence and helps compensate them for that  
14 type of situation. Now, revenue insurance HP  
15 simply excludes that replacement cost for the  
16 future.

17 Now, even though revenue insurance  
18 HP is offered, excuse me, to most farmers, 95  
19 plus percent choose the standard revenue  
20 insurance policy that provides the replacement  
21 cost coverage. So the same illustration as  
22 before, only the harvest price is now  
23 increased to \$5 a bushel. The yield coverage  
24 is unaffected by the price change. The  
25 indemnity is still \$40 as before. The



1 indemnity for revenue production HP is also  
2 \$40. The indemnity for the standard revenue  
3 insurance, however, has increased to \$50,  
4 reflecting the \$10, 10 bushel yield loss and  
5 now a higher \$5 price.

6 As mentioned before, revenue  
7 insurance is available for select crops and priced  
8 as a derivative [of another futures price]. For  
9 example, revenue insurance for barley and  
10 grain is based off of projected harvest prices  
11 for corn. For sunflowers, prices are derived  
12 from soybean. All futures and organic pricing  
13 is derived from the exchange values for the  
14 traditional crop.

15 The way we approach that is that we  
16 derive a factor that reflects some historical  
17 relationship between the price of the  
18 reference crop and the price for the product  
19 or type of interest. How that factor is  
20 derived is specific for each crop. Organic  
21 corn and soybean compare prices of USDA,  
22 (inaudible), the CBT contract to drive that  
23 historical relationship. Organic cotton is  
24 obtained from proprietary data on organic cotton  
25 prices compared to futures prices for

1 conventional cotton.

2 So basically, there is no standard  
3 approach or data to be used to develop these  
4 factors. We fill out and look at what's out  
5 there. And it's always been a hurdle that our  
6 pricing on organic commodities (inaudible), so  
7 we make do with what we have.

8 Now, as I stated before, (inaudible)  
9 transparent with our pricing methodology. And  
10 so on our public website you have a link shown  
11 there. We provide documentation how we  
12 establish these prices for these other crops  
13 and types.

14 That concludes my presentation.  
15 I thank you for your time. I am happy to  
16 answer any questions you might have.

17 MR. THORNTON: Thank you. Tom.

18 MR. ZACHARIAS: Thank you,  
19 Commissioners and the Committee Members here.  
20 It's a privilege and opportunity to be here  
21 today. I apologize in advance. I've got  
22 a little bit of a cold and a little bit of a  
23 cough, so I'll try to muddle through this.

24 That said, first I emailed yesterday  
25 for slides and I knew they weren't going to

1 get in, so you're going to have to go  
2 unplugged here with me, but I think we'll be  
3 fine. Kent's slides provide an excellent  
4 overview, so I'm going to just basically peel  
5 off of that for my remarks.

6 This is the first time I have been  
7 here with this group, so we'll do a little  
8 introduction. Our organization, National Crop  
9 Insurance Services, is actually about four  
10 blocks down the street from here. We are the  
11 service organization for all the insurance  
12 providers that hold a standard reinsurance  
13 agreement with USDA's Risk Management Agency.

14 We also serve as the company's liaison  
15 for their state-regulated business, which is  
16 primarily hail coverage. In general, our  
17 organization provides industry training on the  
18 development of loss-adjustment procedures. We  
19 also administer a national agronomic research  
20 program that is used to develop the  
21 loss-adjustment procedures for farmers in the  
22 field with the adjusters. We are also  
23 responsible for industry outreach and industry  
24 communication activities.

25 A little bit about our membership.

1 As I said, we are comprised of those companies  
2 holding the standard reinsurance agreement  
3 that write both state and federally-regulated  
4 crop insurance. Our focus here today will  
5 primarily be on the federally-regulated  
6 segment of the business.

7 As Kent mentioned, there are  
8 currently 15 holders of the standard  
9 reinsurance agreement and that defines the  
10 rules of the road, the rules of engagement,  
11 the contractual obligations between the  
12 companies and USDA. Their top six riders hold  
13 about 75 percent market share, and this has  
14 been fairly stable over about the last ten  
15 years. Currently there are 15 carriers, and  
16 between 15 and 16 carriers have been a fairly  
17 stable -- I'm hesitant to use the term  
18 equilibrium, but that's where it's played out  
19 over about the last ten years or so.

20 These writers of insurance are in the  
21 U.S., both domestic and international capital.  
22 We have writers such as QBE out of Australia, Zurich,  
23 Great American Financial out of Cincinnati,  
24 Des Moines is The Chubb Company. Rain and  
25 Hail is a Des Moines company in Chubb.

1           And then most notably, one of our  
2 members is a family-owned operation,  
3 Farmers Mutual out of Des Moines, which just  
4 celebrated its 125th anniversary of writing  
5 crop insurance business. These guys used to  
6 ride around in bicycles, and their promotional  
7 activity was giving pink pencils to their  
8 insureds. So the crop insurance industry has  
9 a long history dating back to the early 1900s,  
10 late 1800s as well.

11           But the history has pretty much been  
12 hail. And as Kent mentioned, in the early  
13 '90s with the Reform Act of 1994, then that's  
14 really when the game started changing for  
15 federally-regulated crop insurance.

16           What are some of the attributes of  
17 crop insurance that has brought us to where we  
18 are today that has led to its farmer  
19 popularity and its political support? This  
20 isn't necessarily in order of importance, but  
21 these are some of the key things that have  
22 gotten us to where we are.

23           Crop insurance is contractually  
24 based. There's a policy between the insured  
25 farmer and the insurance company. The rules

1 of the game are written down. There's the  
2 standard reinsurance agreement that defines  
3 the rules of the road between the companies  
4 writing the business and USDA. In addition,  
5 companies have contractual relationships with  
6 the agents writing this business as well, and  
7 then there's a portion of this business that  
8 is laid off in the private reinsurance market  
9 and that stuff is written down.

10 Okay. There are multiple levels of  
11 cost sharing in the crop insurance industry.  
12 The farmer pays about 40 percent of the risk  
13 premium. They also shoulder a deductible.  
14 The average deductible is probably about, oh,  
15 20 to 25 percent nationwide. As you get to  
16 the corn belt, farmers are probably holding 80  
17 to 85 percent coverage. So farmers are  
18 sharing not only in the cost of the premium,  
19 but they are also absorbing the first loss  
20 with their policies.

21 The taxpayers share in supporting  
22 delivery expense and risk sharing with the  
23 crop insurance companies. The companies bear  
24 a portion of the delivery expense as well as  
25 risk sharing with USDA. Another advantage of

1 crop insurance is that it can be individually  
2 tailored to meet the farmers risk management needs.  
3 As Kent mentioned, there's about 130 crops with  
4 alternative coverage levels. If you expand  
5 that to the number of counties that are  
6 included in the U.S., you can find about, oh,  
7 probably, at this stage, maybe 70,000  
8 different crop combination ways to manage risk  
9 through the Federal Crop Insurance program  
10 today.

11 In practice, the changes to the  
12 policy can be managed by the agency. Crop  
13 insurance does not require direct legislative  
14 action to change and update the features of  
15 the program. Sometimes this is done, as was  
16 done in the 2014 Farm Bill, but crop insurance  
17 can, in some sense, run along by itself. It  
18 has its own enacting legislation, so things  
19 can keep running.

20 If you notice during the government  
21 shutdowns that we've had a couple of times,  
22 crop insurance companies are still required to  
23 pay and manage claims with their insureds  
24 during these down times.

25 So the efficiency of the private

1 sector and the private sector's ability to  
2 interface with USDA and interface with the  
3 farmer to deliver this program is one of the  
4 features that has led to its popularity. If  
5 you look at the efficiency of delivery in  
6 2012, Under Secretary Scuse was quoted as  
7 saying, when we went out to the field --

8 (Interruption in proceedings.)

9 I used to teach at LSU and people  
10 would leave the class, so... Kent knows about  
11 this.

12 Anyway, back to 2012. Under  
13 Secretary Scuse went through the country and  
14 he handed out his card and he said, "if you've got  
15 a complaint about crop insurance, give me a  
16 call." His staff was not crazy about that, but  
17 I don't think anybody ever called him.

18 Also, in terms of regional disasters,  
19 if you look at the situation in 2011 where you  
20 had a regional drought in Kansas, Texas and  
21 Oklahoma, those claims were handled by the  
22 private sector as well, in addition to the  
23 flooding in the Midwest along the Missouri and  
24 Mississippi rivers. So efficiency of private  
25 sector delivery complements this.



1           And lastly, crop insurance is  
2 bankable at the individual level. Both the  
3 lenders and the farmers know what their risk  
4 is ex ante, before, prior to, planting the  
5 crop and they know what crop insurance will  
6 indemnify the farmer for in the case of a  
7 loss.

8           All right. So as Kent has  
9 demonstrated, revenue exchange-traded  
10 products, primarily RP, revenue protection  
11 with corn and soybeans is very popular, has  
12 broad participation. So from the insurers'  
13 perspective, what makes this desire, what  
14 makes a risk insurable? So I'm going to go at  
15 sort of a high level here.

16           Okay. It's easy in these  
17 conversations to talk about what can be  
18 covered. From an insurer's perspective, it's  
19 just as important to talk about -- can the claim  
20 be adjusted? Can the claim be adjusted  
21 fairly? Can it be adjusted accurately? In  
22 the case of revenue products, can the pair be  
23 defined clearly? And I believe the answer is  
24 in the affirmative with respect to this. We  
25 know what the spring prices are; we know what

1 the harvest prices are; farmers know what  
2 these prices are. And so the claims  
3 adjustment process becomes very  
4 straightforward.

5 On the production side, Kent  
6 mentioned the yield coverage part of it.  
7 Yield coverage has been around since about  
8 1980 with federal crop insurance services.  
9 Those procedures are well understood. There  
10 are individual situations where people -- I'll  
11 use the vernacular sometimes the adjuster has  
12 to hold the farmer down to what he wants.  
13 A farmer may not always feel that way, but it's  
14 a little bit of a joke.

15 Moving on. All right. But  
16 basically, we can understand the loss and how  
17 it works. The coverage is clearly defined  
18 both in production risk and price risk. In  
19 terms of actuarial targets, crop  
20 insurance -- a broad metric is that crop  
21 insurance has come under and met its actuarial  
22 targets in terms of losses relative to  
23 premium. If you look at this over the long  
24 run, the long-run loss ratio is in the range  
25 of about 1/100th, okay, premiums equaling

1 losses. And crop insurance has met that  
2 actuarial target, so we're collecting the  
3 right amount of money; we're rating it  
4 correctly.

5 So let me turn to that from the  
6 insurer's perspective and ask a couple of  
7 questions there. Is the rating process  
8 transparent? If you go out to RMA's website,  
9 you can find documentation with respect to how  
10 it's rated? I don't think anyone can actually  
11 take that document and go get a bunch of data  
12 and duplicate their stuff exactly, but I don't  
13 think that's a necessary condition. The  
14 companies writing this business have  
15 confidence in the rating methodology. There  
16 is a process. If we believe our academics as  
17 well, if there are concerns with the rating  
18 methodology, that those can be addressed and  
19 as he demonstrated those are publicly  
20 available. You can have a conversation about  
21 those.

22 Is the data public or private? In  
23 the case of the exchange-traded markets, the  
24 price data is publicly provided, publicly  
25 available through the exchange. I think this

1 is a big attribute for a major feature that  
2 shouldn't be or should be emphasized and  
3 credit should be given for that.

4           There are technical issues from time  
5 to time that show up. Kent mentioned the  
6 volatility factors. There's been a discussion  
7 on that. And I would say, in general, in  
8 terms of a rating methodology, which if we're  
9 going to have private sector capital in this  
10 market, they have to have confidence in the  
11 rating structure; they have to have confidence  
12 in the underwriting.

13           And so in terms of a methodology, I  
14 would say a couple of things. If the farmers  
15 believe the rates are affordable and they have  
16 confidence in them, they're purchasing the  
17 product and the methodology produces a rate  
18 that also generates an adequate return for the  
19 insurers. I think that's about as good as  
20 you're going to get and we should accept that.

21           Now, does everything work like we  
22 expect or want? Obviously not. I have the  
23 privilege of sitting on an international board  
24 and primarily folks from the European  
25 community and they have an insatiable desire

1 to have a revenue program in Europe. There is  
2 a demand for revenue coverage and it meets the  
3 farmers' needs. Farmers tend to like it.  
4 All right.

5 Revenue coverage works best when  
6 there's lots of data and lots of trading.  
7 Now, when those conditions don't hold, then we  
8 do have problems. The example Kent mentioned  
9 is probably the one in terms of rice where  
10 there has been limited data. It is a thin  
11 market. I would say to that that RMA has done  
12 a good job about getting out in front of that  
13 and defining what to do in the case when  
14 that's not met. Now, has that met everybody's  
15 satisfaction in every case? Probably not.  
16 But in general, there are procedures in place  
17 to deal with the problems of thin markets, and  
18 so I think that's an important aspect of this.

19 There are also situations -- Kent  
20 mentioned the extension of revenue coverage  
21 beyond futures-traded commodities -- and there  
22 have been some attempts to offer coverage  
23 there and there have been some breakdowns.  
24 But these can be worked through with the  
25 agency, with the private sector and the

1 farmers, and I think this can be resolved.

2 And I will have to be quite honest:  
3 if people don't understand these rules or  
4 don't agree with these rules, then we go to  
5 legal and then we go to the Secretary of  
6 Agriculture for some formal resolution on  
7 this. But there is a vehicle to fix these  
8 problems as they come up.

9 So in closing -- in general, I would  
10 say the experience from the industry's  
11 perspective with the exchange-traded crops,  
12 the revenue protection has been quite  
13 favorable. Farmer participation has been  
14 high. It's met its actuarial target, can be  
15 underwritten and clearly adjusted.

16 With that, I will conclude my remarks  
17 and appreciate the opportunity to have been  
18 here today.

19 MR. THORNTON: Thank you.

20 Ms. Guetterman.

21 MS. GUETTERMAN: Okay. I was asked  
22 to come and talk about how we, on our  
23 operation, have used crop insurance in the  
24 past. I'll just give you a quick overview of  
25 our operation. We're a 100 percent no-till

1 farm and we are located just south of Overland  
2 Park here about 15 miles in Bucyrus, Kansas.  
3 Our operation supports five families and three  
4 full-time employees. Here's my husband, his  
5 dad, and his three brothers that the operation  
6 supports. We are primarily dry land and our  
7 crops are waxy corn, Amos corn, soybeans, and  
8 winter wheat.

9           And so how do Guetterman Brothers  
10 utilize the futures in our operation? First  
11 I had forward contracting, but as of yesterday  
12 that changed. We use it as an element of  
13 surprise and excitement in our household. As  
14 I was in the shower yesterday morning, my  
15 husband yells, something must have happened  
16 overnight. Well, soybeans were down 50  
17 cents. So we use it as an element of surprise  
18 in our operation, too.

19           But the first is forward contracting.  
20 Another way we utilize the market is through  
21 options and the third way is -- and this is a  
22 way that you don't think of in most times -- but  
23 it's also through crop insurance.

24           So just briefly on forward  
25 contracting. Usually our operation

1 forward-contracts about 30 percent of our  
2 anticipated crop prior to harvest. Usually  
3 during the spring and summer months we try to  
4 take advantage of any planting scares and/or  
5 any, you know, midsummer scares.

6 We sell another 20 percent usually by  
7 January just for cash flow purposes, and then  
8 the remaining 50 percent is sold in the spring  
9 and summer months following harvest after  
10 January, hoping to take advantage of any  
11 rallies that we may have. We do have on-farm  
12 storage so this allows us to go ahead and  
13 store.

14 Another way we utilize the markets in  
15 our operation is through options. Most of the  
16 time ours are primarily through utilizing  
17 puts. Since we do have the on-farm storage,  
18 we usually put some puts on and hope for the  
19 best, but make sure we have that floor in, if the  
20 prices go down.

21 And the third way is crop insurance.  
22 And why do we have crop insurance on our  
23 operation? The first and foremost is risk  
24 management and the safety net that it provides  
25 for us. Our fixed and variable costs are



1 high -- they're not going down -- and it gives  
2 us a baseline to budget our year off of and  
3 manage those costs from.

4 And as a disclaimer, in the 20 years  
5 that I've been involved in the operation, I  
6 looked back and there are very few years that  
7 we actually get back our premium. But the one  
8 or two years that we have, it was essential to  
9 keeping our operation functioning and we don't  
10 buy it with the intention to actually use it.  
11 You don't buy your car insurance with the  
12 intention of wrecking your car.

13 It's required by our lender. Our  
14 working capital we do have to get from a  
15 lender the funding for that. And our crop  
16 insurance is the collateral for our lender.  
17 And it also allows us marketing flexibility.  
18 We know that we can safely market up to a  
19 percentage of our APH and be covered.

20 So how do the markets affect our crop  
21 insurance coverage? Crop insurance revenue  
22 products are essential, and to not just  
23 covering the loss of the bushels, but to cover  
24 the revenue also. And 2012 was a -- on our  
25 operation was a -- huge year that really made you

1 a believer in the crop insurance system. And  
2 the markets, when they truly reflect the  
3 supply and demand, it's crucial for our  
4 survival.

5 Here's what we look like coming in  
6 the spring. We're not in Iowa. Our average  
7 APH, our average yield, is about 120 bushel  
8 an acre. The spring price for crop insurance  
9 in 2012 was \$5.68. So that's a gross that we're  
10 expecting to bring in on an average year of  
11 \$6.81 and then \$3.53 worth of just input  
12 expenses. That's just seed, chemical,  
13 fertilizer, cash, rent. That doesn't include  
14 paying our employees, paying for equipment,  
15 paying our liability insurance, regulatory  
16 expenses or living expenses.

17 So then the reality of 2012 hit and  
18 our corn averaged 44 bushel an acre. At that  
19 point, the fall price did go up, but our gross  
20 income was significantly reduced. If you can  
21 see, it's not even covering our inputs. It  
22 wasn't covering the seed, chemicals,  
23 fertilizer -- what our crop actually yielded --  
24 let alone paying our employees, let alone  
25 paying for the equipment, let alone paying for

1 our own living expenses.

2 So when crop insurance kicked in in  
3 2012 -- and it's hard to see -- but the spring  
4 price was \$5.68. That was the price determined  
5 in the spring. But by the fall, in the  
6 October discovery period, it increased by \$7.50.  
7 The market did its job. Supply was low  
8 throughout the United States and the market  
9 went up.

10 So if we would have just had the  
11 spring price, our operation -- as you see at  
12 the bottom on the gross profit, our operation  
13 probably would have been okay; we might have  
14 had to restructure some things. But with the  
15 option of having that harvest price and the  
16 market going up because supply was down, we  
17 were able to operate, not restructure, and  
18 continue going. Yes, it ended up being an  
19 average year. It wasn't a bumper year, but we  
20 were able to sustain and keep going.

21 So the bottom line for us is the  
22 markets do affect our operation when we have  
23 grain to sell, but they also affect our  
24 operation when we don't have the grain to  
25 sell.

1 MR. THORNTON: Thank you. And thank  
2 you all for your presentations. I now open  
3 the floor for questions or discussion.

4 Mr. Gallagher.

5 MR. GALLAGHER: Question for Jodi.  
6 I'm in the dairy industry. So the revenue insurance  
7 programs are relatively new for us. Trying to figure  
8 them out to help our members. So in 2012, where you  
9 had your revenue insurance policy-- did you also manage  
10 your risk using forward contracts and futures and  
11 options as well? Tell us a little bit about that.

12 MS. GUETTERMAN: (Inaudible). Well,  
13 we usually do forward -- like I said, we  
14 usually do forward contracts. In any given  
15 year, it's a difference between 30 to 50  
16 percent of our crops. We had  
17 forward-contracted some prior to the market  
18 going up. So in that sense, not only did we  
19 not have the bushels, but didn't get to take  
20 advantage of it when the market did go up.

21 So with the revenue coverage, that  
22 helped offset some of that loss on the bushels  
23 that we didn't produce. On the bushels that  
24 we did produce, the 44 bushels that we did  
25 produce, we had to fulfill those contracts at

1 the lower price.

2 MR. THORNTON: Mr. Owen.

3 MR. OWEN: Thanks. I'd just like to make  
4 a couple comments. You know, crop insurance works  
5 really well when prices are high because you  
6 can utilize it as a subsidized put option, and  
7 when prices are low it is not as effective.  
8 And also, it's really important that the  
9 futures markets are converging properly for  
10 crop insurance to work properly because -- and  
11 particularly during a harvest price discovery  
12 period that's generally when the bins are full  
13 and full, you know -- in times of abundance basis  
14 generally will widen, and so the contracts  
15 need to be structured in the delivery  
16 territory to promote convergence. Because  
17 with a lack of convergence, it's very easy,  
18 particularly in rice, for the futures price to  
19 be above the indemnity trigger, but the cash  
20 price the farmers receive is below the indemnity  
21 trigger. So you should be receiving an  
22 indemnity, because business is bad, but you're  
23 not getting it because of a lack of convergence  
24 between cash and futures.

25 MR. THORNTON: Thank you.

26 Mr. Ullmer.

1           MR. ULLMER: One of the major problems in  
2 South Dakota is we have a problem with the  
3 packer concentration on the livestock  
4 side, but it's much worse on the elevator  
5 side. They just united two more elevators.  
6 When I bought the farm, there was five choices  
7 for elevators; now there's one. They are  
8 taking 25 percent out of your check. You  
9 aren't calculating that in when you go in there. If  
10 [If] you look on the regions where there's still  
11 competitive elevators, you're dealing with 4, 6 or 8  
12 percent. They're taking 20 to 25 percent out  
13 of our checks. It's not worth even trying to  
14 put a cash crop in because they take 25  
15 percent (inaudible).

16           Now that there's only one elevator  
17 left for the entire northern region of  
18 South Dakota, now they've got heavy discounts;  
19 now they've got whatever price they want to  
20 price for the fertilizer. We've got to go just  
21 pay it. We've got no competition. We can't  
22 call anybody. They raise their prices up, so  
23 the elevators are raising their prices and they're  
24 building million-dollar elevators and taking 30  
25 percent away from us and that's before we even

1 start and so we have to go to a feed crop.

2 Then you go to a feed crop and you go  
3 to your insurance agent and say, we want to  
4 put in a feed crop and make an attempt with  
5 cattle because we can't make money with cash  
6 grain, then they won't insure the feed crop.  
7 So there should be a way to insure feed crops,  
8 because they're afraid of feed crops because  
9 they can't find a valuation of it turning into  
10 cash because you're going to feed it through  
11 the system.

12 Well, if you're going to let them  
13 take 20 to 25 percent out of our checks on the  
14 cash side and that doesn't even come close to  
15 working, at least try to help us insure our  
16 feed crops, because we're sitting there  
17 setting up 1,800 acres trying to set it up so  
18 100 percent is fed, because you can't -- if  
19 somebody's going to take 20, 25 percent out of  
20 your check when you are making a cash crop,  
21 you aren't even remotely calculating that into  
22 your crop insurance prices. They're taking  
23 it.

24 They just join together. It doesn't  
25 matter what they set their prices at; we have

1 no choice. They're the only company out there. So  
2 it's a major problem.

3 MR. THORNTON: Paul.

4 MR. RINIKER: I've had Federal Crop  
5 Insurance since about prior to '93 for sure,  
6 maybe after the '88 dry weather in Iowa, they call  
7 it. The government was pushing us farmers  
8 to go in the federal crop and over all of  
9 those years, like Jodi, I probably collected  
10 maybe two years. Not the 2012 because we had  
11 rain and our disaster was 180 bushels of corn;  
12 last year was 245.

13 So talking about this low revenue  
14 Coverage, since corn was so low, I've got a  
15 real high APA, it's over 200. I'm not sure exactly,  
16 but I think I'm covered at about \$7.50. Again,  
17 my expenses, just under rent, are more than  
18 what you guys are paying for everything, Jodi.

19 I look at crop insurance. Like my  
20 dad said, it was just something to have, to  
21 hold the operation together. It isn't  
22 something to make money on, and the guys are  
23 making money on it are the guys that are  
24 wrecking their cars and it isn't long before  
25 the insurance company gets involved and



1 there's fraud and all those kind of things  
2 involved.

3 But I think it's really well regulated  
4 the way it's done. It's not perfect by no  
5 means, but it's like all insurances: It is  
6 something as kind of keep you from going broke  
7 in one year's time. If you lose a crop and  
8 there's a lot of dollars invested, it doesn't  
9 matter if you have 500 acres of corn like myself or  
10 whatever you guys are raising for crops. It will  
11 literally devastate you, set you back 10, 15 years and  
12 in default with your lender if you're not carrying  
13 crop insurance.

14 And I carried it long before it was  
15 popular simply because at the time USDA or FSA  
16 was pushing that even with their -- when we did have  
17 a hail claim one year and our accounting was over 20  
18 percent and they went ahead and made an extra -- it  
19 was not a loan, it was kind of free money for the  
20 folks that had federal crop -- and that was in '09.  
21 So my situation, those premiums are not too  
22 bad in our area, but boy, it can be hell if you don't  
23 have coverage and something happens.  
24 Thank you.

25 MR. THORNTON: Mr. Gallagher.

1 MR. GALLAGHER: Kent, I think you said 90  
2 percent of the major crop acreage was insured.

3 MR. LANCLOS: Yes, that's correct.

4 MR. GALLAGHER: How much of that is  
5 on a revenue insurance program?

6 MR. LANCLOS: In terms of premium,  
7 about 80 percent of the premium in the program  
8 is revenue insurance product. In terms of liability,  
9 it's about 75 percent or so, so... I did put  
10 a number -- I don't have it right here for all  
11 of the programs, but you kind of extrapolate that.  
12 It's going to be very high up there for these  
13 crops.

14 MR. GALLAGHER: So to compartmentalize  
15 this -- there's traditional crop insurance,  
16 which is just insuring against loss versus  
17 revenue insurance. So has the market, then,  
18 kind of shifted kind of away from that to the  
19 revenue insurance products?

20 MR. LANCLOS: Yeah, it definitely has  
21 in terms of the farmers' purchase decisions, yes.  
22 I mean, in 1995 there was no revenue insurance  
23 coverage, so the market share was zero. And basically,  
24 a decade later it's, basically, 80 percent of the  
25 business for the major crops, if you will, is revenue

1 insurance.

2 So definitely it has embraced by the farming  
3 population and we constantly -- for the non-major  
4 crops, crops that don't have a type of futures  
5 exchange or easy extension, if you will, non-GMO  
6 corn or something like that -- we're constantly being  
7 approached by farmers to develop a revenue insurance  
8 product for them. So the farmers of these non-  
9 exchange traded commodities, many of them feel  
10 they're at a competitive disadvantage because they  
11 don't have that revenue insurance option. So we're  
12 constantly getting approached. But as I described,  
13 it's very difficult to develop revenue insurance. So  
14 how do you? The market does that. The exchange is  
15 that good at extracting that information for price  
16 discovery. After that we're kind of at a standstill.

17 MR. THORNTON: Mr. Barker.

18 MR. BARKER: Gentlemen, and lady, I  
19 think you did a great job explaining the key  
20 points of crop insurance. I would say, from  
21 my perspective, and as a committee, could you  
22 give us some explanation as to the  
23 prevented planting components that are built in  
24 the crop insurance? That gets very confusing  
25 from a price discovery perspective as to how  
26 the different regions have prevented planting and  
27 sometimes

1 they can take a plan on this commodity and  
2 plant another, and that gets very confusing to  
3 market participant.

4 MR. LANCLOS: Let me first say they  
5 are very confusing. I do apologize. I didn't  
6 (inaudible). Prevented planting is a situation  
7 where, let's say, the river overflows its banks and so  
8 that the land --

9 MR. THORNTON: Can you speak up just  
10 a little bit? Thank you.

11 MR. LANCLOS: I'm sorry.  
12 Prevented planting is a situation where, for  
13 example, the river or the stream, whatever, overflows  
14 its banks and the ground becomes flooded and therefore  
15 the farmer can't get in there, in that ground, in  
16 a timely manner and plant the crop. And we do  
17 have dates set in the policies that say that  
18 the crop must be planted by a date certain in  
19 order to receive the full guarantee. Most  
20 crops have a late planting period.

21 For each day beyond this we would  
22 reduce your guarantee by X amount, just  
23 recognizing that, if you will, the optimal  
24 planting window is passed. You're more likely  
25 to have an early freeze, something like that,

1 whatever the conditions are.

2 So you do have that option there, but  
3 if you still are unable to plant, you are  
4 eligible for most crops to get a prevented planting  
5 payment that is basically -- I want to say  
6 it's 50-55 percent of the guarantee. Our  
7 senior actuary is back there, he's not in sight, so I  
8 know I'm in good shape.  
9 But basically, 55 percent of the guarantee  
10 that we will pay the farmer in order to  
11 prevented planting situation.

12 So basically, if your guarantee would have  
13 otherwise been \$300, you would get paid \$150, \$165.  
14 Something like that would be what your payment  
15 would be. Just because you incurred expenses, to get  
16 the ground ready for plant if you can plant, so  
17 therefore it's compensation for those expenses.  
18 There is a -- again I'm forgetting -- there's a 1st  
19 crop/2nd crop option where you can -- you can forgo  
20 --you can forgo the prevented planting payment  
21 on the 1st crop, plant the 2nd crop and then -- I will  
22 admit I'm a little bit fuzzy right now, but...75  
23 percent at that point for you to do the 1st crop/2nd  
24 crop option. But it is complex.

25 MR. ZACHARIAS: I would say, with  
26 respect to preventative planning, replant --

1 these types of features in the crop insurance  
2 policy, the benefit of the private sector  
3 delivery in terms of a good relationship  
4 with the crop insurance agent. Because these  
5 are you -- as you stated, these are region  
6 specific and crop specific. And so for the  
7 farmer to have a working relationship with the  
8 agent and to know the terms and conditions of  
9 the policy are what's essential. We have  
10 people in our office that spend a lot of time --  
11 quote, unquote -- on prevented planting coverage  
12 refining it and improving it.

13 But it's not -- as you saw with Kent  
14 and I, you've got to go back and read the book  
15 to get it right, and so that becomes the value  
16 of the agent and the adjuster and the farmer  
17 having confidence in them to help manage his  
18 policy and manage his risk.

19 MR. BARKER: If I may  
20 follow up. I guess my point in asking the  
21 question [is that] it is confusing for me. When we  
22 talk about the impact on price discovery, the  
23 data flow of what the prevented planting acres  
24 are and you get a report at 7:31 Monday  
25 morning, and then on Wednesday you get a

1 report from a different agency that has  
2 different numbers. It can be quite confusing  
3 to the price discovery mechanism of the future  
4 market.

5 And so as a committee member, I guess  
6 my point in asking the question or to raise  
7 the issue was to say if we want to think about  
8 the impact of crop insurance on price  
9 discovery, it would be nice to have improvement in  
10 that data flow.

11 MR. THORNTON: Thank you. Take two  
12 more questions here and then we'll go to the  
13 participants remotely and see if they have any  
14 questions.

15 MR. KOVANDA: Jodi, thank you for  
16 your presentation. You mentioned that crop  
17 insurance allows for marketing flexibility. I  
18 wondered if you might expound on that a little  
19 bit further. In particular, how much of your  
20 cash transactions are negotiated transactions  
21 that you do the day that you ship the product  
22 or within seven days? And how do you think  
23 that your propensity to when you transact the  
24 cash commodity influences the issue that was  
25 raised about cash and futures convergence?

26 MS. GUETTERMAN: I guess I'm not

1 understanding the question on within seven  
2 days pricing.

3 MR. KOVANDA: I guess, a simple  
4 example of it would be how many of your  
5 bushels that you sell to an elevator, you  
6 bring them to the elevator and you price them  
7 as (inaudible). Or you sell them seven days  
8 and then ship them?

9 MS. GUETTERMAN: At harvest?

10 MR. KOVANDA: Not necessarily at  
11 harvest, but perhaps in April -- on April 1st  
12 you transact 5,000 bushels and by April 3rd  
13 you ship the product. What percentage of your  
14 production would be transacted in that way?

15 MS. GUETTERMAN: So you're saying  
16 we'd sell within -- okay. The 50 percent that  
17 we sell after harvest, probably 40 -- well, 40  
18 to 50 percent of that would be selling it to  
19 deliver within 30 days. And the remainder  
20 would be to deliver within two to three months  
21 on our operation. We do have the capability  
22 to store, so we don't have to usually sell for  
23 storage issues because we do have the  
24 capability to hold it.

25 MR. KOVANDA: So does that impact





1 your experience in convergence (inaudible)?

2 MS. GUETTERMAN: We are very close to  
3 the Kansas City market, so that supply and  
4 demand that you may have out in Western Kansas  
5 where you're dumping wheat at harvest, we  
6 don't experience wide swings in basis in  
7 our area.

8 MR. THORNTON: Thank you. I'll remind  
9 folks here today, if you can state your name,  
10 your organization for the folks remotely  
11 participating, you can speak.

12 MR. HANDKE: Thank you. This is Steve  
13 Handke, Independent Community Bankers. We're a large  
14 agriculture lender in Northeast Kansas and on  
15 the Missouri side, so I guess I have two  
16 points to make, anecdotally. First an amazing  
17 success of crop insurance, though an amazing success,  
18 but also in a small way an amazing failure in  
19 prevented planting. Let me talk about the amazing  
20 success. So I'm a third generation farmer. I've  
21 never seen any cases where your crop insurance, your  
22 production cost -- our farmers are generally  
23 about 3,000 acres in Missouri bottoms and we  
24 generally count crop insurance loans in 500,000  
25 Units (inaudible). More importantly a lot of a  
26 million-five (inaudible)  
27 in crop earnings. So I'm going to guess

1 Jodi -- I'm going to guess she probably is  
2 rolling one-million, one-million five  
3 of operating inset settlement for her farm.

4 Every year exposed to weather and  
5 you're dead on. That gives assets a lender  
6 the collateral to finance those and to have a  
7 reset with them if there is a crop failure.  
8 An amazing success through the 2000s.

9 Also, and it's really, really  
10 odd year, so in my whole farming career history,  
11 I never saw a year like 2015. Northeast  
12 Kansas could not get planted; Northwest  
13 Missouri could not get planted. About 60  
14 percent of the acres got planted, so then  
15 you're trying to figure out the prevented  
16 planting rules. From a banker's position, it  
17 was an absolute disaster.

18 And the part of -- and luckily it's  
19 not a big part of your program. Maybe it  
20 happened one in 30 years, but it was  
21 regionally significant. And what our  
22 operators were faced with is trying to figure  
23 out if the time had melted away in July, do I plant  
24 or do I not, the crop insurance prevented  
25 planting keeps rolling away from them. The ones that  
26 decided to plant beans on the 25th

1 of July did much better than those  
2 that took prevented planting and the  
3 main reason for that is the tremendous cost  
4 in maintaining idle acres. So there wasn't any  
5 really discount. They actually had to keep the --

6 MR. THORNTON: Can you please speak  
7 into the microphone?

8 MR. HANDKE: I guess if there's only  
9 a small retooling it would be of prevented  
10 planting. That for 90 percent of what you do, I  
11 think is basically successful.

12 MR. THORNTON: Thank you. I'll ask  
13 the operator to unmute the lines to see if we  
14 have anybody on remote, participants who would  
15 like to ask some questions.

16 Okay. Thank you. I'll turn to the  
17 Commissioners and Chairman. Start with  
18 Commissioner Behnam, if you have questions.

19 COMMISSIONER BEHNAM: No questions.  
20 But thank you for your participation. Thank  
21 you.

22 COMMISSIONER QUINTENZ: Yeah, no questions  
23 for me either but I found it very informative.  
24 Thank you very much for your presentations.

25 CHAIRMAN GIANCARLO: I want to

1 apologize for arriving late. I was able to  
2 inform the Federal Reserve District President that the  
3 CFTC actually exists here in Kansas and we're doing  
4 some unique things here. The first Ag Advisory  
5 Committee meeting in some time, the first one  
6 outside of the beltway in some time. And the  
7 first ever ag commodity futures conference  
8 will start later on today.

9           And I don't say that really to pat us  
10 and all of you on the back as much as to say the CFTC  
11 is very, very focused on our ag commodity  
12 futures markets, making sure these markets  
13 serve all the people that you serve and  
14 farmers like yourself so the message is that  
15 we are very, very focused on making sure these  
16 markets continue to serve all of our nation's  
17 producers and the world as well as they  
18 possibly can, because these markets are vital  
19 national and international interests and that  
20 is what we hope comes out of the next 48  
21 hours of meetings just like this one. Thank  
22 you all for your participation and involvement  
23 (inaudible).

24           MR. THORNTON: I would like to thank  
25 the panel and open for any closing remarks

1 that you may have.

2 With that, I thank you. We will now  
3 be taking a five-minute break and we will  
4 resume at promptly 10:35 for our second panel.  
5 Thank you.

6 (Recess taken.)

7 MR. THORNTON: Everyone please take their  
8 Seats. I would like to call the AAC meeting back to  
9 order and begin our next panel in which staff from  
10 Farm Credit Administration will discuss risk  
11 management. Our panelists are Mike Duffy, Credit  
12 Specialist Program Manager in the Office of  
13 Examinations, and Steve Koenig, an economist  
14 in the Office of Regulatory Policy. Please  
15 begin.

16 MR. DUFFY: Thank you and thanks for  
17 the opportunity to speak to the Committee this  
18 morning. My name is Mike Duffy. As Charles said,  
19 I'm the Credit Specialist Program Manager in  
20 our Office of Examinations. We're the  
21 federal regulator, regulatory agency for the  
22 farm --

23 MR. THORNTON: Could you speak up just a  
24 little bit into the mic?

25 MR. DUFFY: Sure. Just a little bit

1 about myself. I'm based in Bloomington, Minnesota in  
2 our Office of Examinations. Grew up on a grain  
3 and livestock farm in Northeast Iowa in Paul's part  
4 of the world. I have been lucky enough to  
5 remain involved in our farming operation, so I  
6 have some perspective from that side of the  
7 business as well.

8 But we're here to talk about risk  
9 management and financing and risk management  
10 in the Farm Credit System. Steve will give an  
11 overview of current conditions in the Farm  
12 Credit System, and then I'll talk a little  
13 more specifically about what lenders look for  
14 when they're financing risk management and  
15 some of the things they expect from borrowers  
16 in that area. So with that, I will turn it  
17 over to Steve.

18 MR. KOENIG: Thank you, Mike. And  
19 welcome everybody, this morning. Again, my  
20 name is Steve Koenig. I'm with the Office of  
21 Regulatory Policy in our McLean, Virginia  
22 headquarters. A little bit about my background. I have  
23 been in the farm credit industry since 1981, but  
24 through the 1980s as a credit system lender and later  
25 on at USDA and then more recently with the Farm

1 Credit Administration.

2 I want to start out this morning with  
3 a little introduction of the cooperative Farm  
4 Credit System for those who are not familiar  
5 with it. The system is currently comprised  
6 of -- the system is currently  
7 comprised of six direct lending associations  
8 and they are served by four regional banks,  
9 funding banks. Those 69 associations have  
10 over a half-a-million borrowers, about 1.5  
11 million in loans. Those loans total about \$259  
12 billion at the end of the year. To give you some idea  
13 of the size of the Farm Credit System, it's assets,  
14 total assets are about \$330 billion, nearly a third of  
15 a trillion. If it was a single entity in the  
16 commercial banking system, it would be about the  
17 seventh or eighth largest bank in the United States.

18 This next slide is a little bit confusing,  
19 but it shows a system of the territories. Those 69  
20 associations, and the point I want to direct you  
21 here is that there's some very large associations  
22 and there's some very small associations. We  
23 have some associations with portfolios with  
24 just 100 million and we have some with  
25 portfolios over 20 billion. So we have a  
26 range of credit policies, a range of



1     sophistication, a range of geographic  
2     location, and so that can be sometimes a  
3     little difficult to characterize activities in  
4     the Farm Credit System and those in respect to credit  
5     underwriting procedures and the price and risk  
6     management tools that our borrowers use.

7             This next slide shows a little  
8     discussion about the system's financials.  
9     They're very strong right now. Loan  
10    performance is historically very good. Under  
11    one percent of loans are not performing. The  
12    system has had very good earnings in recent  
13    years. It had 5 billion -- over 5 billion  
14    in earnings in 2017, that enabled it to grow  
15    its capital again. You can see on that chart  
16    that capital is at the highest level since  
17    the great recession. So asset quality is good;  
18    earnings are good. Overall, things are  
19    performing quite well.

20            Who supplies farm debt? Who's the  
21    suppliers? Well, system provides about 40  
22    percent, commercial banks provide about 40  
23    percent, and then there's a selection of other  
24    lenders. I was at a conference just last week.  
25    Most -- actually all of the lenders are reporting

1 actually very good performance in their loan  
2 portfolios. Loan indemnities are down. Losses are low.  
3 USDA's direct farm loan program are performing better  
4 than they had expected, given the difficulties some  
5 farmers have had in the last few years.

6 This next chart shows the system's  
7 portfolio. It's broken down by commodity.  
8 It's a very diverse portfolio. But if you  
9 look up there, you will see the cash grains and  
10 cattle constitute a little over a quarter of  
11 the portfolio. I think that is important to  
12 this group in that those are two of the  
13 enterprises where risk management tools can be  
14 often more critical than some of the other  
15 commodities that are under contractual arrangements.

16 This next slide shows some price  
17 trends. This group is very expert on that. But  
18 from a lending perspective, I wanted to include  
19 this to show if you look at the figure, the  
20 green particularly in the last decade, we've  
21 had a rising price situation and more volatility  
22 particularly on the grain side. But recent  
23 years we're kind of trending back to the  
24 previous decade where we had more -- less  
25 volatility, more consistency --. And so

1 my point is, I'm not sure where we're going,  
2 but those marketing tools, those risk  
3 management tools, perhaps might be even more  
4 important.

5           It's easy to make money when prices  
6 are good. It's not as easy when prices are  
7 not. And we're potentially in a situation  
8 where we are right now where profit windows  
9 are relatively short, not deep. And so  
10 decisions need to be made at a much finer  
11 level.

12           In the grain sector side, farmers continue to  
13 struggle with that cost price squeeze we've see  
14 in recent years. It just shows the red line  
15 is prices paid. It is sticky, land prices,  
16 land rents. Seed costs are very fixed as  
17 opposed to commodity prices which are more  
18 volatile. And so we have a lot of our  
19 producers that are facing this and have been  
20 for several years. How do you close that gap?  
21 And that appears to be a continuing problem.

22           This next slide shows business income  
23 from the USDA, the latest forecast in  
24 February. I included it to show that the  
25 pricing situation, at least from the USDA's

1 perspective, is likely to continue. The red  
2 numbers there are the major commodity groups  
3 that lenders finance and USDA's calling for declines  
4 in that cash farm income across the board.

5           Some few observations on borrowers'  
6 financial positions. Farmers balance sheets have been  
7 held up pretty well-- with resilient farmland prices.  
That's enabled a lot of producers to restructure,  
8 rebalance their balance sheets, right-size them  
9 whatever terminology you want to use, work with  
10 their lenders in that respect. A lot of farmers  
11 came into this downturn, particularly on the grain  
12 side, some very strong balance sheets and they've been  
13 able to weather the tighter margins I just showed in  
14 the previous slide.

15           Again, working capital is declining,  
16 though, and that is a concern. USDA is  
17 forecasting another double-digit decline in  
18 working capital for 2018, again on its February  
19 forecast. So with less cash, there's more  
20 need for borrowing. You see the operating  
21 credit demand go up in recent years, and  
22 that's going to be the case this year as well.

23

24 So, credit use is rising, interest rates are rising,  
25 too, as we all know.

26           That is going to be a stress

1 going forward, I believe. There's roughly 375  
2 billion dollars in farm debt outstanding. In  
3 the system, about half of the system's farm  
4 debt reprices at least on an annual basis.  
5 So those costs, interest costs will translate  
6 into borrowers' financial statements  
7 relatively quick, and we're talking big  
8 numbers here. We're talking probably billions  
9 of dollars in interest cost over the next coming year.

10 Farmers continue to work through cost  
11 adjustments and that will be ongoing theme, I think,  
12 unless commodity prices turn around soon.

13 And I want to close by pointing out  
14 the farm safety net has helped in this  
15 whole process for sure. When I talk farm  
16 safety net, I talk about crop insurance and the  
17 farm programs, ARC and PLC. I think was mentioned by  
18 someone earlier. Those tools are probably  
19 going to be less important going into 2018,  
20 just the way the formulas work on them in terms of  
21 price and so on.

22 So with that, I'll turn it over to you Mike.

23 MR. DUFFY: Thanks, Steve. With

1 that, I'll touch base on a few of the specific  
2 areas that lenders look for in financing risk  
3 management activities. And first, I would  
4 say, as a regulator and certainly the lenders  
5 and as a credit program manager, I would say  
6 everyone is in agreement that financing --  
7 borrowers, farmers should have reasonable risk  
8 management practices and lenders should  
9 finance them. It's the sound business  
10 practice to do that. And I would only  
11 emphasize the reasonable risk management. Once  
12 it goes beyond that, lenders become much less  
13 comfortable. As you move into margin  
14 enhancement and maybe on the speculative side,  
15 lenders become much less interested in  
16 financing that type of activity. But risk  
17 management itself, lenders can and should be  
18 involved in financing that.

19 As Steve already mentioned, volatility  
20 and shorter profit windows really create the  
21 need for better risk management. I don't  
22 think the last week -- you probably couldn't have  
23 a better example than, I think, markets were almost  
24 limit up Thursday with a surprise on the planet  
25 acreage intentions, and then yesterday morning with

1 some of the trade discussion going on, 40 cent  
2 or 50 cent move down in soybeans. The  
3 volatility and the need to move quickly on  
4 markets is increasing, if anything.

5 I'd say, as a personal aside, we  
6 finished up our old crop soybean sales Monday,  
7 felt pretty good about it yesterday morning  
8 and then I think they got about half that back  
9 since yesterday morning, so by next week we  
10 might wish we wouldn't have sold it all, but  
11 that's just the nature of the markets here  
12 lately.

13 One other comment on -- just on  
14 financing side -- . There are a number of basic  
15 tools that are very common, particularly on  
16 the grain side, with forward pricing,  
17 hedge to arrive contracts, that don't require cash  
18 outlays, don't need borrowing to do those.  
19 Typically done through local elevators or  
20 ethanol plants in my part of the world. So  
21 there's a fair amount of risk management that  
22 can be done without financing. As you move  
23 into more sophisticated activities in hedging,  
24 obviously financing is required.

25 Just a few of the basic things that

1 our lenders would say is, they need to  
2 understand the risk management strategy to  
3 finance it. If a borrower wants to come in  
4 and get financing, they need to be able to  
5 explain their plan in terms that the lender  
6 can understand and get comfortable with.

7 Another thing, without exception, the  
8 system lenders would say they need to be the  
9 primary operating lender to also finance risk  
10 management strategies. Split-financing in that  
11 situation is just too difficult to track, and  
12 so if they're not the primary operating  
13 lender, they would not finance some other risk  
14 management strategies separately.

15 And then the final bullet:  
16 Exceptions exist, but the ideal scenario is a  
17 customer that knows the cost of production,  
18 has a written and executable marketing risk  
19 management plan. And, like I said, there is  
20 going to be exceptions. Strong borrowers,  
21 smaller loans and certainly competitive  
22 pressures will result in some loans when they  
23 don't have that,

24 but I think the lenders that we  
25 talked to, more than anything else, they



1 emphasize producers need to know their cost of  
2 production to have a good risk management  
3 plan. If you don't know the cost of  
4 production, it's very hard to lock in a  
5 profit.

6 And, I would say, five years ago, a  
7 lot of grain farmers probably didn't know  
8 their cost of production, but a lot more of  
9 them know it today. I think they've gotten  
10 that message a lot over the last few years, as  
11 margins have been squeezed and much more  
12 conscious of that in the current environment.

13 A couple of things. When a lender  
14 gets a request to finance risk management,  
15 they need to decide on a couple of things. Will  
16 they do it as part of the operating loan or  
17 will they set up a standalone hedge account or  
18 a standalone hedging loan? And then also how  
19 much they'll provide. And typically, if it's  
20 a fairly small portion of the total operating  
21 needs, they'll keep it within the operating  
22 loan, particularly on smaller  
23 borrowers and with fairly basic hedging or  
24 risk management strategies. As the dollar  
25 amounts go up and the hedging activities get

1 more complex, then typically it will be in a  
2 standalone loan.

3 And, I would say, in particular on the  
4 livestock side, when operations are hedging  
5 both their input cost and the production,  
6 those would more typically be in a standalone  
7 hedging account rather than combining with the  
8 operating loan, just for tracking purposes and  
9 to keep things clear of what's going on in the  
10 accounts.

11 I wanted to mention just one thing,  
12 and getting a little bit more technical here,  
13 but if it is a standalone, hedge loan,  
14 three-way brokerage agreements are now very  
15 common with the system and this would be  
16 probably an outcome from the MF global  
17 situation a few years ago. Now the lender,  
18 borrower and broker would sign an agreement  
19 where funds would flow automatically between  
20 the hedge loan and the brokerage account and  
21 back. There would be cash sweeps on a daily  
22 basis on larger accounts to avoid situations  
23 where there's a lot of margin money sitting in  
24 that brokerage account.

25 And as some of you I'm sure would

1 recall, in an MF global situation, when they  
2 filed bankruptcy there was a lot of customer  
3 money in those accounts that was tied up.  
4 I think eventually all of the money did go  
5 back to the borrowers, but -- or the farmers  
6 that were hedging, but it took a long time.  
7 And so one of the things that has come out of  
8 that is three-way brokerage agreements to  
9 avoid that situation. And as part of that,  
10 the lenders can get, you know, in some cases, real  
11 time brokerage position reports, they can go in at  
12 anytime to see what the hedge account looks  
13 like, and so that's definitely an advantage  
14 for lenders and something they look for as  
15 risk management strategies get more  
16 sophisticated.

17 A few things that we would consider  
18 red flags for lenders in brokerage reports.  
19 Three-way option trades. And again, getting a  
20 little technical, but probably I'm way down the  
21 curve from some of the folks in this room, so  
22 I'll throw it out. In this case, it's fairly  
23 common to, for instance, buy a put and sell a  
24 call to cheapen it up, get part of that  
25 premium back.

1           If you get into situations -- and  
2       certainly some brokers will encourage it: Buy  
3       one put -- sell two calls, get even more of  
4       the premium back. When you start to do that,  
5       you're taking some risk on the other side and  
6       lenders get more uncomfortable as you get  
7       into those more complicated options or any  
8       other trades that would result in some risk to  
9       the borrower versus risk management.

10           Another sign is frequent placement  
11       and lifting up positions. Again, fairly common  
12       on the brokerage side to encourage customers  
13       to take some profits, maybe get back later.  
14       From a lender perspective, they'd rather see  
15       the borrower lock in a price, hopefully a  
16       profit, and stay with that hedge until the  
17       production is sold. So frequent in-and-out  
18       transactions are a flag for lenders.

19           And then also, activity that differs  
20       from historical norms or the size of the  
21       operation. If they're buying more futures  
22       contracts than they have production, that  
23       obviously is a flag that they move beyond risk  
24       management into the speculation side, so that  
25       would also be a flag for the lenders.

1           As I said earlier, lenders are  
2           committed to financing risk management and  
3           valid hedging, but they want to stay away from  
4           speculation. And obviously, there's not  
5           always bright lines between hedging and margin  
6           management and margin enhancement, which is a  
7           common term, and speculation. So I think  
8           that's something that they continue to monitor  
9           transaction reports for and ensure they  
10          understand the borrower's plan to make sure  
11          that is not going on or at least they're not  
12          financing it.

13                 And as I think most would agree in  
14          any industry, lenders don't like surprises  
15          any more than anybody else, and so  
16          transparency on what -- and communication on  
17          what's going on in the hedging activity is  
18          very critical to the financing piece.

19                 Just a few things I wanted to  
20          mention. Strength, challenges, and  
21          opportunities, I guess, in this area. Some  
22          livestock producers are very active margin  
23          managers, and from our perspective and what  
24          the system lends to with the swine industry is  
25          probably a great example of that. There's

1     been a lot of consolidation in that industry,  
2     obviously, but with some very tough years in swine  
3     a few years back, a lot of the larger  
4     producers have really focused on locking in  
5     both the input and the production side and  
6     managing the margin, and they have been very  
7     successful at it in the swine industry.

8             It's been more difficult in the  
9     cattle industry, locking in fears that at  
10    profitable levels with what prices were  
11    particularly a few years after the drought  
12    conditions.

13            And it's been very difficult in  
14    dairy. I don't think I need to tell anybody in this  
15    group that. You probably know it better than us.  
16    You know, I think there's various discussions  
17    about why the basis is much more volatile and  
18    tougher to track on the dairy side. Not  
19    as actively traded, obviously, is one of the  
20    things that has been brought up. It's much  
21    more difficult, for system borrowers at least,  
22    to do as much margin management on the dairy  
23    side.

24            Another strength, I guess, in this  
25    case, would be a challenge. Particularly in

1 the grain industry, producers are reluctant to  
2 go beyond cash sales and forward contracts.  
3 Basically, what they can do through their  
4 local elevator or maybe, like I said, local  
5 ethanol plants in some areas...

6 We talked to some of our lenders in  
7 the last few days. They indicated probably  
8 10 to 20 percent of their grain borrowers  
9 actually have hedging accounts. Otherwise,  
10 most go through their local elevator  
11 cooperative. And that would be by number, not  
12 necessarily by volume. Because some of the  
13 larger borrowers certainly are more active  
14 hedgers, but most farmers are not as  
15 comfortable in the grain side in actually  
16 having the hedging accounts themselves,  
17 concerned about margin calls, things like that.

18 And so, you know, I think we would  
19 say continued education, information about  
20 what's available and what they can do is  
21 important. I think the lenders in the system  
22 have tried to do that with some of their  
23 borrowers -- get them more familiar with the  
24 tools that are available, but there's probably  
25 still a ways to go there.

1           The final bullet on this slide that  
2   lenders need to understand the impact of  
3   hedging on financial statements. As you get  
4   into larger accounts, certainly comprehensive  
5   income, unrealized gains and losses have a  
6   huge impact on the financial statements of the  
7   borrowers and a big impact on whether or not  
8   they're meeting their covenants. So  
9   understanding how those hedging gains and  
10  losses are being accounted for is also very  
11  important and sometimes difficult to sort out.

12           And again, a challenge, and  
13  I mentioned it earlier, knowing a cost of  
14  production from a lender's perspective is key  
15  to having a good risk management strategy and  
16  good financial records or high quality  
17  financial records are very important. And I  
18  think most lenders, and at least the system  
19  lenders we talked to, would say a lot of  
20  borrowers are still probably don't  
21  have their financial records where they need  
22  to be to truly know their cost of production  
23  and do risk management.

24           So again, a case where the system  
25  institutions encourage borrowers to improve



1 their financial records, some have offered  
2 accounting systems. I think there's a new one  
3 that's kind of a QuickBooks-type product that  
4 one of the institutions is offering now to try  
5 to get the records up to a higher level,  
6 particularly on smaller customers again, so  
7 they can more effectively manage risk.

8           And I think I comment -- a question that  
9 maybe was brought up before we came in today  
10 was in a more stressed environment when  
11 borrowers probably need risk management the  
12 most, what can lenders do? And, you know,  
13 what we would say in that case is they  
14 probably need to focus on less cash-intensive  
15 strategies. Lenders are not going to be as  
16 comfortable extending a lot of new money for  
17 hedging accounts to a borrower that's  
18 struggling. But options, contracts with  
19 buyers, hedge to arrive, forward contracts, still  
20 all very available options and those borrowers  
21 would need to do more of it, so lenders would  
22 continue to encourage risk management. They  
23 just probably wouldn't be as willing to extend  
24 as much cash to a distressed borrower in that  
25 situation.

1           One other challenge, again getting a  
2     little bit technical, on contracts that may  
3     not require delivery do create challenges for  
4     lenders. One example I throw out, that I'm  
5     familiar with, is a cash plus contract that  
6     some elevators would offer where they're  
7     buying the old crop at a certain price and  
8     then also throwing in a premium based on  
9     selling a call option, and if, you know, if  
10    that option expires worthless, the seller,  
11    the farmer, keeps that premium. If not, then  
12    it would convert to a hedge to arrive contract  
13    in the fall. In a situation like that, the  
14    farmer doesn't know for sure if he's got crops  
15    sold for the fall. So, you know, that  
16    uncertainty, I think optionality is a term  
17    that gets thrown into it sometimes. That  
18    creates some discomfort for the lenders  
19    because then the farmer may or may not have crops  
20    sold, won't know until later, and if they  
21    don't then price may change in that time  
22    frame. So those types of contracts, where  
23    delivery is not certain, is a challenge and  
24    makes lenders uncomfortable.

25           One last comment. I know we're about

1 up on our time. I want to leave some time for  
2 questions.

3           You know, lenders and borrowers need  
4 to stay committed to using the risk management  
5 strategies that are in place. Once  
6 everybody's agreed this is a strategy we're  
7 going to finance, they need to stay with it.  
8 And we have, you know, a couple examples I'll  
9 throw out from the system in recent years  
10 where that was effective. We talked with one  
11 lender; the hog prices spiked in 2014. A lot  
12 of their borrowers had production contracted or  
13 locked in at around \$100 per cwt, went up to about  
14 \$132 in a very short time frame. They stayed  
15 with those borrowers. In about a three-month  
16 period that particular larger hog lender  
17 increased their financing about \$500 million.  
18 In another three months the market stabilized,  
19 the production started to go to market and  
20 they got that \$500 million back. But they  
21 have to be in a position and willing to ride  
22 those markets up once the production is hedged  
23 and it is a true hedging strategy.

24           Another example, going back a little  
25 bit further, was in 2008. I'm sure most can

1 recall as ethanol started to enter the picture,  
2 grain prices spiked dramatically in that  
3 summer. In some of the agribusinesses with  
4 production locked in, had huge margin calls as  
5 grain went up dramatically and a few of the  
6 big lenders, they needed to get participations  
7 both from other system lenders and commercial  
8 banks to continue to fund it. It went into the  
9 billings in that situation and they were able  
10 to stay with those customers and finance the  
11 hedging activity through that sharp run up.  
12 It's not the high prices as much as the change  
13 in prices that really increase the need for  
14 financing, and having lenders that are willing  
15 to finance that and understand the hedging  
16 activity is critical in that situation.

17 I did want to mention, too, I think  
18 it's of some interest to folks, for what is  
19 typical hedging loans on hog prices, a typical  
20 hedging account for a hog operation is probably  
21 \$20 per head is what some of our lenders  
22 would throw out. On the grain side, a dollar  
23 to a 1.25 per bushel on corn is a typical  
24 hedging account, a loan for hedging account,  
25 and \$2.00 a bushel on soybeans in case people

1 are interested in the more specifics as to  
2 what a typical hedging loan would be for  
3 different commodities.

4 With that pretty quick overview,  
5 but for the sake of time, I will stop there  
6 and certainly be glad to take questions.

7 MR. THORNTON: Thank you for your  
8 presentation. I'll remind folks, when you do  
9 have a question, press the mic to speak. And  
10 then if you engage in conversation, you have  
11 to turn your mic off to let them speak and  
12 vice versa. So I'll open the floor for any  
13 questions.

14 Seeing none, I will -- oh. Paul and  
15 please state your organization.

16 MR. RINIKER: Just a short question  
17 for you, Mike. You didn't mention cattle, but you had  
18 the dollars per cwt. for hogs. Which was it on hogs?  
19 Like \$20? Per cwt? Okay. On cattle?

20 MR. THORNTON: Please turn on your  
21 mic.

22 MR. DUFFY: I didn't have a rule of thumb  
23 on the cattle side. I'm sorry. I didn't  
24 get that. I best not throw one out because I  
25 might be off base on what some of our lenders  
26 would say.

1 MR. THORNTON: Mr. Ullmer, please  
2 state your organization.

3 MR. ULLMER: Kim Ullmer here on  
4 Continental for R-CALF and United  
5 Stockgrowers.

6 I did a survey, went through all  
7 kinds of meetings, cattle meetings. And,  
8 672 people so far have participated, one of  
9 the questions is, do you feel the CME board is  
10 a safe risk management tool for producers?  
11 Three percent yes; 97 percent no. When you  
12 look at: Do you think each trade should be  
13 backed by an asset with delivery options?  
14 Ninety seven percent say yes; three percent say  
15 no. And then when you ask, is it gambling or  
16 is it futures trading? Ninety percent of it  
17 is -- 90 percent of the people think it's a  
18 gambling format instead of a futures contract.

19 And so the request from these people  
20 is they would like to see you guys change it  
21 back from a commodity casino to a futures  
22 option with an asset and a delivery because  
23 it's the number one problem in the livestock  
24 industry that we have to face. So our request  
25 is also some help to set up the American

1 Mercantile Exchange that will be asset-based  
2 and delivery, and my question would be would  
3 you help fund that? Because you have a lot of  
4 producers going out of business. We lost 9  
5 out of every 10 hog producers and now there's  
6 thousands of livestock producers going out of  
7 business. So we need help on the funding side  
8 and we need help getting it asset-based with  
9 delivery so it's a safe risk management tool.  
10 I provided all of the information in studies  
11 for you guys with the same stuff I got.

12 MR. THORNTON: Thank you for your  
13 comment.

14 Matt.

15 MR. HINES: Thank you for presenting  
16 to us today. Just a couple quick questions.

17 Do you have a measure of track for  
18 denials for renewal or increases to credit  
19 lines? Is that anything that you track in the  
20 past few years? There's been some concerns  
21 specifically over this past year just on the  
22 increase in credit like you had mentioned, if  
23 renewals are still happening or if increases  
24 are taking place.

25 And a second question would be, are

1 you seeing more standalone hedge marketing  
2 notes or lines in the past couple years?

3 MR. DUFFY: Thanks. I'll take a shot  
4 at this one.

5 We do look at denials and change in  
6 activity. Certainly it's up somewhat, but  
7 definitely increases in lines. Borrowers,  
8 you know, in some cases the line was out  
9 there. They weren't using it, and now that  
10 they are advancing on it a lot more than they  
11 were for a few years, it's surprising how many  
12 farmers had operating lines and didn't even  
13 use them for a number of years, and that  
14 certainly has changed in the last few.

15 As far as hedging activity, I'd say  
16 over time it's increasing because farmers are  
17 getting larger. On the livestock side  
18 definitely we're seeing separate hedge lines.  
19 Not as much as on the grain side yet.

20 And, like I said, a lot of the more  
21 typical or traditional farmers really are not  
22 as interested in setting up a standalone hedge  
23 account and doing their own hedging. They're  
24 more comfortable going through the local  
25 elevator and not facing the margin calls, which I



1 think is part of it. So large grain farmers,  
2 I'd say, are doing it; most traditional ones  
3 are not. Livestock definitely you see more  
4 standalone hedge lines.

5 MR. THORNTON: Thank you. I'll ask  
6 the operator to un-mute the line for any  
7 questions from the remote participants.

8 Any questions? Thank you.

9 I thank this panel and in the  
10 interest of time -- sorry, Chairman.

11 CHAIRMAN GIANCARLO: I do have a question  
12 for Mr. Duffy. I found your presentation very  
13 compelling for would-be lenders to producers for  
14 their risk management practices. My question is for  
15 the past decade with the consolidation of lenders, and  
16 certainly the lack of new formation of small banks in  
17 agriculture sectors, whether lenders today have  
18 sufficient knowledge about farm economics to be able  
19 to actually get comfortable with making the kind of  
20 lending that we're talking about for risk management  
21 purposes?

22 MR. DUFFY: I would say, you know I hate to  
23 say bigger is better, but in our experience,  
24 the larger institutions probably have the  
25 scale where they can have the people on staff,  
26 and I think we have some institutions, very

1 strong risk management folks very familiar  
2 with markets and hedging.

3 Some of the smaller institutions,  
4 with very small staffs, I think struggle  
5 to -- as we get into more complex marketing  
6 strategies, probably don't have as much  
7 expertise on staff to do that. And so I think  
8 it varies by size of institution in our  
9 situation.

10 CHAIRMAN GIANCARLO: That's very  
11 helpful. I just wanted to make the point. You  
12 do many things with the CFTC. One thing we're  
13 not chartered to do is provide lending, so we're  
14 not a funding institution. Just for your  
15 information there, you mentioned funding some  
16 new exchange. That's one line that this agency  
17 is not statutorily set up to do.

18 COMMISSIONER QUINTENZ: I just have  
19 one quick follow-up for Steve.

20 You had mentioned that half of some  
21 amount of debt in the farm sector reprices  
22 every year. Is that total farm debt? Is that  
23 a specific category of farm debt?

24 MR. KOENIG: That was referencing to  
25 the system's repricing of its loans of roughly

1 50-55 percent of the loans reprice in less  
2 than a year, so that's largely because of the  
3 production credit side but there's -- you know, that's  
4 the whole system's portfolio. There's a lot of lending  
5 that's also to cooperatives and that's off on  
6 a short-term basis.

7 So I have to be a little careful on  
8 that and characterizing that with farmers,  
9 but I'm talking about the whole portfolio of the Farm  
10 Credit System.

11 MR. DUFFY: And I would just add on  
12 the real estate side, obviously, there's a lot  
13 more fixed; it's a much lower percentage.  
14 It's operating and the cooperative credit where  
15 the shorter term financing comes into play where the  
16 funding would reprice annually.  
17 On real estate loans it's a much longer term  
18 and it's a much lower percentage that reprice.

19 COMMISSIONER QUINTENZ: Okay. Thank  
20 you. I think it's an important opportunity  
21 for some of us to keep in mind as we have  
22 continuing conversations with Federal Reserve  
23 presidents and governors.

24 I just want to make a quick point that on a number  
25 of my farm visits around the country in Kansas,  
26 Missouri, Mississippi, Louisiana, Arkansas,  
27 I've heard that access to credit for margin payments

1 is an issue. And I think you've done a great job  
2 of describing both the interest in providing  
3 or ensuring that farmers are appropriately  
4 hedged in that capacity, but also some level of  
5 discomfort with practices around that that can create  
6 questions. I think that's an interesting area to  
7 keep exploring and to try to either further  
8 resolve or get more answers to or more  
9 education around, so thank you for your  
10 presentation.

11 MR. THORNTON: The last question.  
12 Mr. Paul Riniker from National Farmers  
13 Organization.

14 MR. RINIKER: Just for clarification,  
15 the 55 percent number, is that on farm credit  
16 loans that are looking to refinance, or did I hear you  
17 wrong?

18 MR. KOENIG: That's the repricing of  
19 loans outstanding in the system. So it's not  
20 farmers looking to reprice; it's just what  
21 the portfolio looks like at the end of 2017.

22 MR. RINIKER: Thank you.

23 MR. KOENIG: Again, a lot of the credit  
24 is short-term. That would be true with commercial  
25 banks, too, of course. Commercial banks fund off

1 deposits so the deposits tend to be short-term in  
2 nature. Actually, commercial banks are the largest  
3 provider of production credit and the system  
4 is the largest provider of real estate credit,  
5 so that would be very true for commercial  
6 banks as well. A lot of their loans are repriced on  
7 an annual or less basis.

8 MR. THORNTON: Thank you,  
9 Commissioner Behnam.

10 COMMISSIONER BEHNAM: Quick comment and  
11 echoing Commissioner Quintenz' comment and question  
12 that the Chairman had. I'm very happy that you  
13 agreed to come out here. I think this is a  
14 relationship that probably has not existed  
15 between the CFTC and farm credit at all, so  
16 we're very encouraged and open to continuing a  
17 dialogue with you because I think it can  
18 benefit everyone at this table. Definitely  
19 something we hear about and it's one element  
20 of the larger challenges that growers are  
21 facing is the credit issues. And I think with  
22 more collaboration and above all else  
23 education, we can serve our constituents well.  
24 So thanks again for coming out and really  
25 appreciate your presentation.

26 MR. THORNTON: I'd like to thank this

1 panel for their presentation.

2 In the interest of time, we will move  
3 directly to our last and final panel, Block  
4 Trading in the CME Agricultural Products.

5 Thank you. So this is our third and  
6 final panel. Price Discovery: Block Trading  
7 in CME's Agricultural Products. Our panelists  
8 are Tim Andriesen, Managing Director of  
9 Agricultural Products and Alternative  
10 Investments, Business Line Management. Fred  
11 Seamon, Executive Director of Agricultural  
12 Products, Commodity Research and Product  
13 Development. And Andrew Vrabel, Executive  
14 Director and Global Head of Investigations,  
15 Market Regulation Department.

16 I would please welcome your  
17 presentation.

18 MR. ANDRIESEN: Thank you. And thank  
19 you to the Commission, the Commissioners and  
20 this group to give us an opportunity to  
21 share with you what's been going on.

22 Let me just make sure you can hear me  
23 better.

24 I January 8th of this year, we  
25 implemented in agricultural products relationship  
26 based trading

1     which is blocks and crosses.             This is  
2     something that we have in virtually all of our  
3     other products, and most commodities have  
4     these capabilities as well. We know that it's  
5     a change for our agricultural customers, and  
6     what I wanted to do today is walk through a  
7     little bit of why we did this and share a  
8     significant amount of data with you around what we're  
9     seeing in the marketplace subsequent to that.  
10    I'd also like to hand it off to Andrew to talk  
11    about --

12             MR. THORNTON: Can you bring the mic  
13    a little closer? It's hard to hear.

14             MR. ANDRIESEN: And then I'd like to  
15    hand it off to Andrew to talk a little bit  
16    about our oversight activity around blocks,  
17    so...

18             The first thing that I want to do is  
19    reaffirm that our goal is to provide an  
20    additional tool for users of our markets. Our  
21    expectation is that our central limit order book  
22    markets will always be the primary execution facility  
23    and the primary venue for price discovery. Before  
24    I kind of dig into this, I want to clarify for  
25    some people what exactly relationship-based

1 trading is.

2           There are essentially two things that  
3 we implemented. Both of them are  
4 relationship-based trading. It's called that  
5 because what it facilitates is a broker being  
6 able to go source the liquidity for a  
7 transaction. So if a customer can't execute a  
8 transaction, looks at the book, doesn't see  
9 the depth they need or for whatever reason,  
10 they can engage a broker who will go around  
11 and have discussions with other market  
12 participants, market makers, et cetera, around price,  
13 direction, and quantity to execute that trade,  
14 so to find the liquidity to help the customer  
15 execute that trade.

16           There are two types of  
17 relationship-based trading. One are crosses. Crosses  
18 are a market type that is executed on Globex,  
19 essentially, in a cross the broker goes and  
20 finds the two parties for the trade; they  
21 submit that trade into Globex; that trade goes  
22 into the central limit order book. It can be  
23 improved by other participants in the central  
24 limit order book and then the trade is  
25 executed.



1           There is no requirement for a  
2 customer, type of legal status for a customer.  
3 If you have a futures account, you can execute  
4 a cross. There are no thresholds or minimum  
5 size requirements of crosses as well.

6           Blocks, on the other hand, are  
7 slightly different. Blocks are transactions  
8 where a broker goes and sources the liquidity  
9 for the transaction. They find both sides of  
10 the transaction. They execute the transaction  
11 and then they submit it to CME predominantly through  
12 the ClearPort for clearing. Participants who are  
13 using blocks are -- have to be eligible  
14 contract participants. There are a minimum  
15 threshold for blocks, so there's a minimum transaction  
16 size for you to execute a block. And there is  
17 a time requirement that it has to be reported  
18 to the market by, so we want to ensure  
19 that that block transaction is seen by the  
20 market in a timely fashion.

21           One of the questions is why  
22 relationship-based trading? We have very deep  
23 and liquid markets, for the most part. But  
24 there are times when we have customers who  
25 have said to us: Listen, we can't get the

1 volume done; we can't get a particular  
2 strategy done; we can't get done what we need  
3 to do. Typically, it's more likely in the  
4 back end of the curve or in less liquid  
5 products and  
6 over the last years we've looked at  
7 additional -- several different approaches to  
8 addressing this. We've had market-making  
9 programs to encourage liquidity provision at  
10 the back end of the curve and other things.  
11 We believe that this is part of the solution  
12 for that problem.

13           Number 2. Recently, more recently,  
14 we've had customers who have come to us  
15 saying, I need to be able to execute larger  
16 transactions. I'm trying to roll my hedge  
17 book and we're looking for bigger -- the  
18 ability to execute bigger transactions to roll  
19 our hedge book.

20           And thirdly, in some less liquid  
21 products, particularly nascent products, it's  
22 very hard to build initial liquidity and what  
23 we've found, and some examples of this most  
24 recently, is our new Black Sea Wheat contract.  
25 Having a market where you have IDBs,

1 independent dealer brokers promoting the product,  
2 sourcing the liquidity get to build that  
3 initial liquidity. I can tell you we have  
4 struggled when we have launched just pure  
5 CLOB-based products. We come up with a  
6 new product. It's very difficult to get that  
7 initial liquidity. We've seen more success in  
8 trying to use a model where we have brokers  
9 who are out drumming up the liquidity for that  
10 product. So those are essentially why we have  
11 gone down this path.

12 Now, one of the big questions we have  
13 had from customers is, well, wait a minute.  
14 Is this taking transparency away from the  
15 market? Is it creating another market? And The  
16 reality is, there has always been a second  
17 market in the agricultural space; it's an  
18 OTC market. I spent a significant part of my  
19 career in the OTC market. This is a market  
20 where you do swaps or options. It's a market,  
21 obviously, perfectly legal transactions,  
22 but they are predominantly done on a bilateral  
23 basis between two firms. They have an ISDA  
24 agreement in place to facilitate that. They  
25 tend to be much larger firms, and these

1 transactions are not reported in an exceedingly  
2 timely manner to the marketplace. I think the  
3 requirements are they have to be in a  
4 suppository two hours after the transaction.

5 One of the things we believe the  
6 block market will do is hopefully bring some  
7 of these into that market where they can be  
8 seen more readily by market participants.

9 A second element we think is  
10 important, in terms of providing transparency  
11 to the marketplace, is the reporting period.  
12 The most liquid products we have, have a  
13 reporting period requirement of five minutes,  
14 so you will see that reported in a price feed  
15 within five minutes of the transaction.  
16 Interestingly enough, one of the things is  
17 a lot of times people will say, well, hey, I  
18 see something going on in the market; I don't  
19 understand why it's happening. In some cases  
20 in the past, that could have been an OTC  
21 transaction that people were hedging. In this  
22 case, if you see that activity you can look at  
23 a block ticker and see if maybe it was a block  
24 transaction that was getting executed.

25 And then the other thing we would

1 point out is that most of the block  
2 transactions are typically done between a  
3 market participant and a market maker. Those  
4 market makers then, in turn, turn around and  
5 hedge that into the marketplace. So they may  
6 not hedge it directly in the sense that, I've  
7 done something in the back of the curve and  
8 I'm going to put it all in the same contract.  
9 They may spread it around. But the flow from  
10 that activity is, for the most part, coming  
11 back into our market, so market participants are  
12 having an opportunity to interact with that.  
13 So we think that this is something that in  
14 specific cases will be beneficial to our  
15 customers to help them execute.

16 What I'd like to do is walk through  
17 some of the data around blocks and crosses  
18 just to give you a sense of what's going on.  
19 This data is based on all the trade activity  
20 between introduction on January 8th and on  
21 March 23rd, which is the week before last.

22 So if we look at the number of  
23 transactions that have occurred during that  
24 time frame, and we have broken this down by  
25 our major, major products. In that window

1     there were 34 million transactions took place  
2     on CME within these products. Of that 34 million  
3     contracts, 220 were blocks and 1667 were  
4     crosses. So if you look at the numbers, quite  
5     frankly, it's a very, very small percentage of  
6     the activity that took place. You can see  
7     that, you know, for the most part it's just  
8     extremely small.

9             I think what we also want to do,  
10    though, is look at the volume that that  
11    accounted for, not just transactions but  
12    contracts. So again, if we look here, we can  
13    see that during that time period we traded  
14    86 million contracts. Of that, 128,000 were  
15    blocks and 209,000 were crosses. So of the  
16    volume during that period, blocks represented  
17    .15 percent of our volume; crosses represented  
18    .24 percent of our volume.

19            And when we first started talking to  
20    the industry, and as we looked at other  
21    products, we said, you know, if you look at  
22    CME products, in general, blocks where it's  
23    established in the market generally account  
24    for 2, 3, 4 percent of the volume. So right  
25    now we're well, well, well below the numbers

1 that we see in our other products.

2 If we look, more specifically, the  
3 largest product where we're having blocks is  
4 in corn. It's .28 percent, so slightly over a  
5 quarter of a percent of the volume there.  
6 Obviously, you go down to feeder cattle where  
7 none were traded. If you look at crosses,  
8 you know, the biggest number there is soybean  
9 meal where we saw three-quarters of a percent  
10 of the volume there.

11 Let's also look at a bit more  
12 breakdown, in terms of the difference between  
13 options of futures and crosses and blocks.  
14 What this chart shows you -- it is a little hard to  
15 read from here -- but there's two bars for each  
16 commodity. If you look at corn on the left,  
17 the first bar is blocks; the second bar is  
18 crosses. The dark blue portion of the bar  
19 represents futures; the light blue portion  
20 represents options. So you can see of the .28  
21 percent of the volume that was done of blocks  
22 in corn, roughly half of it was futures;  
23 roughly half of it was options. If you look  
24 at all of those, what you'll see is that, for  
25 the most part, cross volume tends to be

1 options and there are kind of a mixed story  
2 with futures.

3 If you look at corn, Kansas City  
4 wheat and soybean oil, you see there's a bigger  
5 percentage of futures than options. On the  
6 other hand, if you look at soybeans, it was very  
7 much different. So, we've seen a bit of a mix in  
8 terms of what's being done. We'd also like to look  
9 at livestock the same way. You can see in  
10 livestock it has a very interesting pattern.  
11 Options are almost -- almost all crosses are  
12 options, and a vast majority of the blocks are  
13 futures.

14 What's also useful is to look at the  
15 size of the trades that have been executed.  
16 So what we have here is a whisker chart. For  
17 those of you who aren't familiar with it, a  
18 whisker chart shows volumes. But, it also shows  
19 the distribution within that volume.

20 So if you look at corn, for example,  
21 you can see that from the bottom of the line  
22 to the top of the dark blue, to the bottom of  
23 the dark blue box represents the first  
24 quartile trades, the dark blue box the second  
25 quartile, the light blue block the third



1 quartile and the top line is the largest  
2 trade.

3 So you can see, if you look at corn,  
4 the median trade has been about 1,000  
5 contracts. It's important when you look at  
6 these, because there's one outlier trade -  
7 there was a 20,000 contract corn trade. It's  
8 important to understand that the way we're  
9 counting this is if it's a spread. It's a  
10 10,000 contract spread, that counts as 20,000,  
11 so you're counting the legs. In some cases,  
12 you could equally, if you had a multi-legged  
13 spread, you could count all 3, 4, whatever other  
14 legs you might do, if you had a butterfly or  
15 something like that.

16 Again, looking at the distribution,  
17 in Live Cattle, the median live cattle  
18 trade was a little over 350 contracts. The  
19 median -- excuse me, that's 150 contracts; the  
20 median Lean Hog contract was about 200 contracts.

21 I'd like to walk you through just a  
22 couple trades, to give you some examples of  
23 how we see customers using this and how we think  
24 this is beneficial for customers.

25 February 28, 2018, there was a block

1 of 250 September Soft Red Winter Wheat futures  
2 done at 522 and a half. At the time that this  
3 was executed, the top of the book was 43  
4 contracts deep. So if you were looking to  
5 execute this at the market, you would have  
6 gotten 43 at the top of the book and then had  
7 to go through the book. The block was done at  
8 the second level of the book. So, in other  
9 words, one tick off the top of the book. Had  
10 that gone into the marketplace, it would have  
11 gone through 10 levels of the book.

12 One of the pieces of feedback we get  
13 from customers is we see these movements  
14 around that we don't understand why that's  
15 happening. In some cases, our analysis has  
16 shown that there's liquidity holes where there  
17 might not be a -- there might be holes in the  
18 liquidity where if you go through a couple of  
19 levels, you don't see a lot of buying. This  
20 essentially has shifted some of that away from  
21 pushing through those liquidity holes to a market  
22 maker who is now going to spread that out and  
23 try to create a bit more orderly market.

24 Second example, March 9th. There is  
25 a block of 250 July-Dec Corn calendar spread

1 options. It was a minus 10 even call spread  
2 done at a quarter. This is a contract  
3 that our commercials have told us is very important.  
4 They want to be able to do options on the spread.  
5 It's also a contract we have struggled to get  
6 liquidity for.

7 So, you know, prior to that trade,  
8 for the whole year up until March 9th, only  
9 419 of these were traded. So, in this case, a  
10 broker was able to go out and source the  
11 liquidity for this customer to do 250, where,  
12 you know, we would guess that it would have been  
13 very difficult to try to do that in the central limit  
14 order book.

15 March 14th, 2018, a block of 300 July  
16 Corn futures traded at 399 and a half. You know,  
17 people kind of looked at this trade and said, well,  
18 wait a minute, July Corn futures? There's  
19 liquidity there. We don't understand why this  
20 was a block. At the time the top of the book  
21 showed 326 contracts. What you didn't see is that  
22 this was one leg of two legs of an  
23 ethanol crush. The other leg of that was 107  
24 NYMEX ethanol futures. We had a customer who wanted  
25 to lock in an ethanol crush and he did  
it through the block market. And then finally,  
the week before last, July 27th, there

1 was a block of 2,000 Sep Corn 290 calls against  
2 March 9, 210 calls. This was kind of an  
3 interesting trade and you actually -- somebody  
4 immediately says, well, wait a minute.  
5 You know, there's liquidity in the front end  
6 of that. If you would have put it in the pit,  
7 I would have easily done the Sep leg. Well, it wasn't  
8 a Sep contract; it was a spread.

9 On the board at the time there was 1100  
10 contracts deep, but there was absolutely no  
11 bids or offers in the second leg of that. So  
12 a broker was able to go out, find market  
13 makers who were willing to take on that risk  
14 and facilitate that trade for the customer.

15 So when we see these, these are  
16 exactly the sort of things where we think that blocks  
17 can help the customers execute transactions to  
18 create more orderly markets and can help them  
19 manage risk more effectively.

20 Real quickly what I'd like to do is  
21 go through commodity by commodity. And I'm doing  
22 this because several people have said, well,  
23 you know, where's the liquidity? Where are  
24 these blocks and crosses taking place? So  
25 what we did is we looked at this data again. We

1 looked at it by contract month by contract  
2 month. So if you made a spread, we could look  
3 at what legs, what contracts the legs of that  
4 spread were in.

5 So if we look at Corn, for example,  
6 where is the distribution of the transactions  
7 across the curve? The percentage that you see  
8 there is the percent of the total volume in  
9 that contract. So in the first case there  
10 you're looking at March of '18, and you can  
11 see that it's .22 percent of that contract.  
12 So if we look at Corn, we can see that there  
13 indeed has been, you know, some volume being  
14 done in the front end, but as well as we see  
15 the volume spread out beyond the curve.

16 The second question and a concern,  
17 of course, is are we -- you know, what impact  
18 is this having on liquidity? I can tell you  
19 that it's impossible to isolate something like  
20 this in terms of overall liquidity for the  
21 marketplace. But what we would tell you is that  
22 if you look at liquidity -- and what this chart  
23 shows -- is the top of the book and the top three  
24 levels of the book, the corn market actually  
25 is more liquid -- and this is comparing Feb of

1 this year in the light blue to Feb of last  
2 year in the dark blue -- so we can certainly  
3 see that the corn market has significant  
4 liquidity.

5           If we look at soybeans, again,  
6 soybeans tell a very different story. Blocks  
7 have not had the uptake in soybeans. You can  
8 see that while the blocks are in the front end  
9 of the curve, they're fairly minuscule in  
10 terms of the size, you know, three-hundredths  
11 of a percent and two-hundredths of a percent.  
12 Again, liquidity overall in the market is  
13 better than it was last year.  
14 Clearly, those are our two most liquid  
15 contracts. As we start to roll into things  
16 that maybe have a touch less liquidity, let's look at  
17 soft red winter wheat. Here we can see that actually  
18 most of the block activity took place in the September  
19 contract and it was spread pretty much across all of  
20 the contracts. Again, in the front end of the  
21 curve good liquidity, back end of the  
22 curve, it's more or less what it was a year  
23 ago.

24           Kansas City wheat, this is a contract that  
25 again is -- you know, probably has a bit more

1 liquidity challenges than some of the other  
2 ones. As you may know, we acquired KC in  
3 2012. This has been growing significantly,  
4 but if you look at the distribution here what  
5 you see is clearly this is a market where  
6 there has been less liquidity in the back  
7 of the curve and you are seeing the block  
8 activity there as well, and the biggest  
9 majority of the block activity there is in the  
10 Dec 18 and the March 19 contract, so this is  
11 exactly what we would expect to see in a  
12 contract like this.

13 Again, if you look at this, you'll see there's  
14 a little less liquidity at the back end of the  
15 curve compared to other contracts.

16 Soybean oil, you know, a bit of a split.

17 There's clearly some activity in the front  
18 end, but then you go all the way back to the  
19 December contract and we're seeing that as where the  
20 vast majority of the activity is taking place.

21 Again, liquidity is a little bit better in  
22 some places and a little worse in others.

23 Soybean meal, again, a spread, but we're  
24 seeing the majority of the block activity taking  
25 place there in the August, Sep, and Dec contracts.

1 You also see maybe a little bit less liquidity back  
2 there in the back end of the curve.

3 Live cattle. The uptake on cattle has  
4 been -- and livestock has not been  
5 significant. I would point out we had crosses  
6 since 2002 in these markets. So actually,  
7 introducing crosses isn't new to these markets. We see  
8 kind of the spread across the curve in terms of live  
9 cattle in the nearby I think that's -- is that  
10 five percent or nine percent? .009 percent. And  
11 it's pretty much spread across the board, and  
12 liquidity is reasonably on par with a year  
13 ago.

14 And lean hogs we see a pretty outstanding  
15 pattern here. The May contract has always  
16 kind of struggled with liquidity, and what  
17 we've seen is block activity that has made up  
18 for that with the rest of the liquidity or the  
19 rest of the activity spread.

20 So, you know, what we see is we see  
21 a market developing. Certainly these are  
22 new. We're looking at them closely. As I  
23 said before, our goal is to ensure that the  
24 central limit order book will always be the primary  
25 venue for risk management and price discovery and,



1 you know, we will continue to watch these,  
2 look at these numbers and, you know, ensure  
3 that that's the case.

4 I'd like to turn things over to  
5 Andrew and he can talk a little bit about how  
6 exactly how we are watching the marketplace.

7 MR. VRABEL: Thank you. Thank you.  
8 Once again, my name is Andrew Vrabel. I'm the  
9 head of investigations in the CME Group's Market  
10 Regulation Department. I haven't met many of  
11 you, so I'd like to take a moment to introduce  
12 what Market Regulation does for CME  
13 Group's markets. I'll spend a little bit of  
14 time talking about the data we rely on and  
15 then specifically how we look at block  
16 activity.

17 We have approximately 160 employees  
18 in market regulation. Those are  
19 predominantly located in our offices in  
20 Chicago and New York. The staff has as diverse a  
21 background as I think you'd want to get in this type  
22 of  
23 industry. There's 2,000 former brokers,  
24 merchants, traders, HFT developers, and people  
25 who have traded their own money, people have  
traded others' money. And a healthy number of

1 data scientists who are working across five  
2 primary functional groups in order to monitor  
3 activity in the market and work with market  
4 participants to be in best compliance with our  
5 rules.

6 We have a rules and regulatory  
7 outreach team, and their primary function is  
8 writing rules and advisories. They also  
9 spend a significant amount of time working  
10 with participants to educate them on our rules  
11 to ensure that they can come into compliance  
12 and not have to interact with myself or my staff.

13 We have a technology team within  
14 Market Regulation. This is a team of data  
15 scientists who build analytical tools that we  
16 need in order to do the surveillance that we  
17 need. I should add that outside of the  
18 technology team within Market Regulation, we have  
19 our IT department where we have almost 60  
20 dedicated IT resources just for developing  
21 regulatory systems. We have a market  
22 surveillance team, and their primary function  
23 is to prevent market manipulation. So they spend a  
24 considerable amount of time looking at  
25 positions of participants, how those positions

1 relate to the rest of the market and attempt  
2 to prevent any future manipulation that may happen.

3 My teams are investigations and data  
4 investigations, and we are looking at all  
5 market activity trying to find trade practice  
6 violations and/or data anomalies.

7 And finally, we have a team of  
8 attorneys that will prosecute the cases that  
9 my team or the market surveillance team refers  
10 to them.

11 There are two important keystones I  
12 think everyone needs to appreciate about  
13 Market Regulation because of what enables us  
14 to do what we do so well.

15 First, we're completely independent  
16 from the business of the organization. While  
17 Tim, Fred, and I may work on initiatives to  
18 improve the integrity of the markets,  
19 everything that we do in Market Regulation is  
20 within Market Regulation. No one outside of  
21 our department knows what we're investigating,  
22 who we're investigating, decisions we're  
23 making. They have no opportunity to opine, provide  
24 input. Everything we do is from the  
25 regulatory perspective making sure that we can

1 preserve the integrity of our markets and also  
2 comply with any regulations that are out  
3 there.

4 We are overseen by an independent  
5 panel of our board which is called Market Regulation  
6 Oversight Committee. We're one of the first  
7 D.C. arms of the United States that have a  
8 dedicated oversight committee at a board level  
9 responsible for ensuring that we have the  
10 resources we need and that we can operate  
11 independent of the rest of the organization.

12 The second component relates to  
13 confidentiality, and this is critical in order  
14 to obtain information from participants. Any  
15 information that we obtain during the course of  
16 fulfilling our regulatory duties is maintained in  
17 confidence. That allows us to go out to the  
18 grain elevator or to a farmer or trading firm  
19 and ask them questions about what they feel is  
20 happening in the market and/or obtain from  
21 them more intimate information about their own  
22 strategies. That information stays within  
23 Market Regulation and goes to nowhere else.

24 The lifeblood of what we do in Market  
25 Regulation is highly dependent on having data

1 and tools at our disposal. With every single  
2 order message that's submitted into Globex, we  
3 have real time access to that data. To put this in  
4 perspective, across all exchange products on a daily  
5 basis futures and options we take in 750 million to a  
6 billion order messages. The ag markets are a very  
7 small portion of that. If I look at corn futures. On  
8 an average day we may see 500 million order  
9 messages -- sorry, 500,000 order messages. So  
10 it's a small piece of the total amount of data  
11 that we're pulling in. But when we receive  
12 this order messaging data we then enrich it with other  
13 information that's necessary for us to do  
14 surveillance.

15 Tim mentioned before that in the  
16 period they looked at, mostly Q1, there were  
17 34 million trades that happened in that group of ag  
18 products. So we, in Market Regulation, have  
19 information on every single cleared trade, including  
20 the ultimate owners of the positions that were  
21 acquired through those trades, whether those were  
22 given up from one firm to another or executed  
23 directly through the account for the owner.  
24 And this includes information on all deals  
25 submitted for privately negotiated trades, which  
26 is block trades.

1           So when a participant logs into ClearPort and  
2     inputs all the information, we have access at  
3     our fingertips to every single thing that goes  
4     into that system. And this is what a deal  
5     sheet would look like for a block trade where  
6     that information is readily available to any  
7     of the 160 people in market reg.

8           Our market surveillance team is  
9     collecting position data from any account that  
10    that has reportable positions. This information flows  
11    into all of our regulatory systems as well.

12          I mentioned the enormous amount of  
13    order messaging data this makes up the  
14    market data that is flowing out to the public.  
15    We spend a lot of time visualizing this  
16    enormous amount of data in order to get it  
17    into a format that's actually consumable.  
18    This visual here for Live Cattle spreads  
19    likely included a half a million rows of data.  
20    In order to take that much data and put it  
21    into a visual is extremely impactful for us.

22          We have tools that we developed  
23    ourselves in order to find specific types  
24    of violations. So for block trade, we have a  
25    suite of tools that allow the investigators to

1 look for particular types of trading  
2 infractions.

3           Into our systems, we take feedback  
4 from participants. Last fall we introduced a  
5 self-reporting portal where block participants  
6 can self-report their late trades. And when  
7 we created this, we had this dropdown for  
8 explanations -- and this is based on kind of our  
9 informed history of doing block trade reviews --  
10 on the reasons this was provided for having a  
11 late report. But then we also added a  
12 free form text field.

13           All of that information whatever is  
14 inputted into this flows into our other regulatory  
15 systems. So if we identify a late reported block, we  
16 also know whether the participant was proactive and  
17 self-reported that.

18           So specifically related to blocks.  
19 We have a dedicated team within investigations  
20 that's responsible for looking at block  
21 trading activity, and they perform five major  
22 functions which I'll run through quickly.

23           So they perform pricing analysis  
24 because any block trade by rule is required to  
25 be done at a fair and reasonable price, so our

1 team is running analytics on block trades to  
2 determine if the pricing is fair and reasonable.  
3 We do that in a number of ways. We look at  
4 Globex was trading and a range around that time. We  
5 look at other block trades executed around that time  
6 and then we also do a cost-to-fill analysis.  
7 Questioning what portion of the block could  
8 have been executed in the order book. If 100  
9 percent of the block could have been executed  
10 in the order book, it gives us reason to go  
11 then look at the pricing to determine whether  
12 that pricing was in line with where the market  
13 was trading.

14 We run a timing analysis, not only looking  
15 for blocks that are late reported, but also  
16 looking for block trades that may have been  
17 misreported. So, for example, if a firm reports  
18 a block as though it was done timely when, in  
19 fact, it wasn't. We look for prohibited  
20 pre-hedging activity, which while we allow  
21 pre-hedging, there's still certain limitations  
22 on the type of pre-hedging that can be  
23 effected in the market and by whom.

24 We look for standardized trade  
25 violations such as money pass activity and wash



1 trades, wash trades that can be used or  
2 effected through block trades.

3 And then the last, is the sixth area  
4 we view, is the team performs analysis on  
5 every complaint received from participants  
6 related to block activity. So on an annual  
7 basis, we take in hundreds of complaints. A  
8 very small portion in that relates to block  
9 trading activity. But every complaint we  
10 receive, we analyze it and we provide feedback  
11 to the complainant on what their observations  
12 were. Either, yes, we have a problem with this  
13 and we've opened an investigation, or no, we do not  
14 have a problem and this is what our  
15 observations are, obviously without revealing  
16 any of the confidential information we may  
17 have or strategies of participants.

18 So just an example. I had this visual  
19 up before showing - you likely can't read the upper  
20 portion. It's a live cattle futures spread  
21 market. The green line denotes the price  
22 traded on Globex at a particular time. I know that  
23 at 9:10 in the morning a block trade was executed for  
24 75 contracts. I know, again, if you can see that  
25 purple dot, that it was executed at the

1 existing trade price that was being executed in  
2 Globex. But then I also know from our data and our  
3 analysis, that had that been executed in the  
4 public market, it would have traded through at least  
5 three price levels.

6 This is the type of analysis the team  
7 is doing on a regular basis for every block  
8 trade that's done that would hit one of our flags  
9 either for timing, pricing, pre-hedging,  
10 money pass, wash trades or is the subject of a  
11 complaint.

12 If we identify violations, we  
13 generally have two courses of action. We have  
14 a summary finding process, which we use for  
15 reporting or recordkeeping violations. If we  
16 determine that the violation is egregious or  
17 there are repeated issues, we can refer the  
18 investigation to our enforcement team where  
19 they can pursue a sanction in front of our  
20 business committee.

21 This example up here is not in an ag  
22 market, but it was from last month where a firm was  
23 sanctioned \$60,000 for a series of late-reported  
24 blocks. We take this very seriously, not only in  
25 how we are monitoring the

1 markets, but the actions we take in order to  
2 get better compliance from markets.

3 Happy to take any questions.

4 MR. THORNTON: Thank you very much.

5 Let's start with Patrick Coyle from  
6 the National Grain and Feed Association.

7 MR. COYLE: Thank you. Andrew, on that price  
8 analysis that you've done, did you come across  
9 any instances where the trades were executed  
10 in the market and based on your analysis that  
11 could it have easily been done in the central order  
12 book? A lot of your examples have shown that had it  
13 gone into the central order book, it would have  
14 dramatically impacted prices?

15 MR. VRABEL: Yes, there are. There  
16 are examples where, particularly, and Tim  
17 pointed out, in corn where you have a fairly deep  
18 order book, both in outright and spreads where the  
19 block trade could have been executed, at the first  
20 price level of the book. When we see those instances,  
21 that's when the pricing becomes most important because  
22 if the block is, you know, off market. It really  
23 questions why the participant would have chosen to go  
24 through the route of blocks rather than putting it in  
25 the central limit order book.

26 Further to that, my team is committed

1 to doing -- we call it a post Q1 analysis of  
2 the block activity. And we will be making  
3 recommendations based on the activity that we  
4 see including potentially some of these  
5 observations for some of the more deep markets where  
6 the block activity likely could have been executed  
7 in the order book.

8 MR. COYLE: Just a quick response. That  
9 wasn't ultimately the goal I think of blocks -- to  
10 take trades that could have been done in the central  
11 order book with liquidity away from the central order  
12 book, correct? That would be something would get a red  
13 flag of why a participant might go and use the block?

14 MR. VRABEL: It may or may not. The  
15 example that Tim noted where there was a corn  
16 and futures trade is a leg of another spread.  
17 They traded ethanol, I think it was. There  
18 are a lot of examples that we see where even  
19 the block size and block trade may have  
20 been able to execute in the central  
21 limit order book at the time. It doesn't  
22 necessarily negate or discount where that  
23 threshold is set. But it's something we're  
24 looking very closely at.

25 MR. THORNTON: Thank you.

26 Mr. Ullmer from R-CALF.

27 MR. ULLMER: Kim Ullmer here on Continental  
1 R-CALF on behalf of Stockgrowers of America.  
2 This is a one-page contract is the  
3 way cattle are handled, that's block trades  
4 a private treaty. Now, here's the 19-page  
5 result book that people in the livestock  
6 industry are supposed to try to understand.  
7 So we see all this stuff about regulation.  
8 Who's regulating these guys? They write a  
9 19-page rule book and the real actual system works  
10 with the one-page system. That's the live  
11 cattle then on the feeder cattle they don't even have  
12 a delivery. Here's a simple one-page private treaty  
13 contract that happens every day of the week and they  
14 take the total delivery out and create a four-page  
15 rule book. Let's work on regulating these guys.  
16 They're creating a false system that you can't even  
17 use. How many farmers on earth could take and figure  
18 out their 19-page rule book when the system  
19 works like this? Ninety million sell a year and we  
20 do it this way? We need help regulating these  
21 people.

22 MR. THORNTON: Thank you.  
23 Mr. Hayden Wands, American Bakers  
24 Association.

1           MR. WANDS:     So just a question on  
2     the block trades because a lot of our constituents  
3     are in the deferred markets.  They're incredibly  
4     illiquid.  I won't even mention Minneapolis Exchange.  
5     So just a clarification.  Let's say that we had orders  
6     in to buy, I'll say, March of '19 wheat at \$5.  Could  
7     a block trade trade at that level or less than that  
8     level we would be executed in the central -- You  
9     see what I'm saying?

10           If somebody wanted to do 2,000  
11     contracts at 499 and three-quarters and I had  
12     an order in there to buy 10 at \$5, could that  
13     block trade essentially trade through my order  
14     and we didn't get filled or could it trade at  
15     my order and we still didn't get filled?

16           MR. VRABEL:   And so block trades do  
17     not elect stops that are resting in the central order  
18     book.  One observation about blocks, separate from our  
19     block trading team, we have a team that's looking at  
20     disruptive trading activity in the marketplace.  And  
21     the best example is looking at live cattle where a  
22     75 lot market order in live cattle can cause  
23     significant price movement.  And often when we  
24     see those large price movements, the market

1 price deviates from the mean and then we'll  
2 revert back to where it was.

3 I can't tell you the number of  
4 complaints we got from commercial end users on  
5 their stop being elected and all of a sudden  
6 being significantly out of the money because  
7 it was elected when the market was in the  
8 reversion pattern. So I think that's one of  
9 the very important reasons why we don't want  
10 blocks to be electing stops. In other words,  
11 you are not going to get a fill if your order is on  
12 Globex and there's a block that's priced  
13 at or through them.

14 MR. THORNTON: Thank you.

15 Joe Kovanda, NCBA.

16 MR. KOVANDA: Yes, Joe Kovanda,  
17 National Cattlemens Beef Association.

18 In general, if you observed over a  
19 period of time the blocks or the crosses  
20 exceeding that level that you see in non ag  
21 commodities 3, 4 percent on a routine basis,  
22 what are the levers that you have to address  
23 in such a situation?

24 And then the second question, maybe  
25 more towards Andrew is, does the existence of  
26 blocks in the question just before incent

1 users of the central order book that  
2 frequently use -- I don't know what other term  
3 you use -- but icebergs where the size is not  
4 displayed explicitly, does the existence of  
5 blocks incent those users to do less use of  
6 those types of orders?

7 MR. ANDRIESEN: Let me take the first  
8 question, and I'll hand it off to Andrew for  
9 the second one.

10 So there are two levers that we have  
11 in terms of increasing or decreasing  
12 participation of the block market. One is the  
13 threshold, so the transaction has to exceed a  
14 certain threshold to be able to be block  
15 eligible. So in theory, if you increase the  
16 threshold, then you're going to take more  
17 transactions away from the block, from their  
18 ability to execute as blocks.

19 And the second are fees. It is  
20 more -- it costs more to execute a block, so  
21 there is an economic disincentive to execute a  
22 block if you can execute it in the central  
23 order book.

24 MR. VRABEL: Is your second question,  
25 Joe, on whether blocks have an impact on



1 displayed order sizes of the book? I haven't  
2 analyzed it. I can say anecdotally speaking  
3 to participants in other markets who have  
4 said, I would have traded at that price for  
5 that size. And my question back was, did you  
6 have that size displayed in your order book?  
7 And they say, no. I say, well, maybe you want  
8 to. So there is that possibility that people  
9 will change their passive order activity in  
10 order to attract more of that volume away from  
11 blocks.

12 MR. KOVANDA: Just a follow-up. The  
13 reason I ask that question, Andrew, is because  
14 in my experience, in talking with market  
15 participants, there's an increased use of  
16 those types of orders. And while the  
17 participant has intentions to get a fill on  
18 the entire volume, the way that they display  
19 it creates counteractions by aggressors in the  
20 market.

21 For example, looking at the market  
22 depth and saying, there's not enough there to  
23 execute what I want to and then they  
24 substitute with potentially a block trade.

25 So it seems to me that this is, just  
26 in my experience in discussing it with the

1 market, this is a potential issue of users of  
2 the market that use these iceberg-type orders.

3 MR. THORNTON: Mr. Barker, NCFC.

4 MR. BARKER: Thank you. As I  
5 interact with our customers -- in my day job I'm the  
6 chairman of an FCM -- our customers are frustrated by  
7 this because the feeling is what Mr. Wands explained.  
8 You can get traded through and not get filled and  
9 the feeling in the country is there's one set of  
10 rules for people who enter five lots, and there's  
11 another set of rules for people who enter 500 lots.

12 And I understand your argument is  
13 we're talking about less than one percent of  
14 the market, but from a hedger's perspective,  
15 deliveries in a lot of cases are less than one  
16 percent of the market, but they're essential  
17 to the price discovery function and the  
18 hedging functionality of our markets.

19 So I don't know that I have a  
20 question, but that's the sense in the country  
21 -- is that you created two different markets where it  
22 may only trade at the top of the book, but  
23 I had an order in there and didn't get  
24 filled and somebody else did because they're  
25 trading larger quantities. So I just want to  
26 express the sense I've gotten from my membership.

1           MR. ANDRIESEN:   If I can respond to  
2   that very quickly.

3           Again, there is an OTC market today  
4   where people, a very small number of people, who have  
5   ISDAs with other counterparties can do that.  
6   And your customers don't ever see those transactions.  
7   Our goal and our hope is that actually implementing  
8   blocks at least brings those into a transparent  
9   market where they can see those transactions.

10          MR. BARKER:   Respectfully, that  
11   argument somewhat falls on deaf ears, because  
12   you're the CME and you control Globex  
13   and Globex is transparent.   And so when I have  
14   an offer out there at 10 on a spread, you expect  
15   to have an opportunity to get filled and the  
16   same entity that controls Globex and controls  
17   that is allowing a tiered system where a 500  
18   lot could trade and I wouldn't get any of it.

19          MR. THORNTON:   Thank you.

20          Mr. Hines, Farm Bureau.

21          MR. HINES:   Thank you, gentlemen, for  
22   coming and presenting today.   Matt Hines,  
23   American Farm Bureau.   Two questions.

24          Within blocks and crosses we talked a

1 lot about where it hits in the book, is there  
2 a price requirement where that has to be filled  
3 at or put in within like an EFP, if I'm going to  
4 exchange with another participant we can take a look  
5 at the daily range, and pick a price in between there.  
6 Is there any type of price requirement on a block or  
7 a cross?

8 MR. VRABEL: There is a price  
9 limitation. The trades have to be executed in  
10 the daily range.

11 MR. HINES: Thank you. Just wanted  
12 everybody else to kind of hear that also  
13 because it wasn't mentioned today.

14 As far as difference between Globex  
15 and ClearPort, for instance, a quote system that  
16 I use it's a FCM derived quote system or a DTN  
17 Prophet X, it's concerning from a participant's  
18 point that I can go back and look at time and sales  
19 on Globex and see every single trade, but the block  
20 trade I have to go to a separate system in ClearPort  
21 to see that trade. there a way or somethingIs  
22 talked about in the future to bring those two and put  
23 them together so that I can see all of  
24 that in one?

25 MR. ANDRIESEN: So it's my  
26 understanding that all of the block

1 information goes out with our data feed, so if  
2 you have a -- I don't know each individual  
3 data system, obviously. But the systems that  
4 we understand and particularly CME Direct, which is  
5 our system. You can bring up a window to look  
6 at block information just as you bring up a  
7 window to look at any other information that  
8 comes out in the data feed. How you see that  
9 is going to be a function of the system you  
10 have in front of you and whether or not it is  
11 designed to provide you with that information.

12 MR. THORNTON: Mr. Gallagher,  
13 National Milk Producers Federation.

14 MR. GALLAGHER: So the trades that  
15 have been happening with the blocks and  
16 crosses, do you know, are they trades that  
17 would have happened otherwise without it in  
18 the swap market, OTC market? Or are these new  
19 executions that are happening because  
20 you've made this change of using blocks and  
21 crosses?

22 MR. ANDRIESEN: I'm not sure there's  
23 a way to answer that question because each  
24 trade is different and what would have  
25 motivated the customer to do that would be

1 different. I can't answer that question.

2 MR. GALLAGHER: But you know who  
3 participants are that are transacting -  
4 can you go back and do a survey and ask them that  
5 question. I think it would be kind of interesting to  
6 know. Is this bringing liquidity from somewhere else  
7 or is it generating new liquidity?

8 MR. VRABEL: So I do know who has  
9 executed every block trade. I can tell you  
10 that I have done some analysis and that there  
11 are participants who are active in the block  
12 market who are not in our markets Q4 of 2017 or  
13 the same time period at Q1 2017.

14 I don't know if those participants  
15 would have come to our market just to trade  
16 blocks or if they were coming to our market  
17 anyway and they started trading blocks.  
18 You're right though; the only way to truly find out  
19 is to send each of those participants an  
20 inquiry letter, which, you know, often causes  
21 some participants to get a little edgy when  
22 market regulation is sending inquiries.

23 MR. THORNTON: Thank you.

24 Mr. Strong, North American Export  
25 Grain Association.

1           MR. STRONG: Thanks. Maybe just a  
2 comment. Maybe Not a question, but a comment for  
3 everybody in this room and the Commissioners.  
4 This issue of block trades has some major  
5 reservations with the NGFA Risk Management  
6 Committee. And it is new and we're working  
7 through it and trying to see whether it really  
8 is good or bad for the market, but there are  
9 many who -- there are some on the committee  
10 who -- take exception that the level to enter  
11 block trades excludes the small consumer of  
12 futures needs or the farmer that might need to  
13 hedge, so an IB with a book of small  
14 business is just totally excluded from this.

15           There are -- while we generally get  
16 the fact that another side of a block is  
17 probably going to come back and re-hedge  
18 themselves in Globex, we are certainly  
19 skeptical of that. At least specifically in  
20 my firm, people are calling us all the time  
21 because they know that we are naturally a,  
22 you know, either short or long in different  
23 commodities so they're just looking to pair  
24 us up with somebody else. And I doubt that  
25 that -- I doubt once they can find a natural long

1 and short, I wonder how much that volume does  
2 come back to Globex.

3 So some of us think that it is taking  
4 order volume off the central order book, which  
5 we don't think is good. We don't -- many of  
6 us don't -- want to go to an outside broker to do  
7 a block simply to execute a larger quantity,  
8 which is maybe not the topic of blocks for  
9 today, but it is a frustrating market  
10 occurrence which we've had many discussions  
11 on. We understand it comes from the K  
12 algorithm, but it is really frustrating to see  
13 20,000 spreads on a bid or an offer and you go to  
14 lift 1,000 and all of a sudden it gets cut  
15 down to eight, and by the time you do your  
16 second thousand you've taken the market bid.

17 We don't really want to go to a  
18 broker that then would say, oh, this commercial  
19 is now rolling their whole soybean or corn  
20 book at these particular prices. We'd rather  
21 be able to operate that -- be able to operate  
22 and execute on the Globex in this anonymous  
23 way that we're used to right now and we don't  
24 really want to pay a higher fee since we're  
25 already members of the CME.



1           We saw some of these slides at the  
2 NGFA risk committee or -- excuse me, I'm  
3 sorry, at the NGFA convention in Scottsdale and some  
4 Tim and Andrew, some subsequent conversation within  
5 the risk committee. We're wondering if the charts  
6 you put up that showed the very small percentages --  
7 That's over a period of January 8th through March  
8 23rd, I think, so it really smooths out the data, and  
9 a lot of us wonder if on specific days where  
10 blocks are more active than others, is it a heck of a  
11 lot more percentage of daily volume? I don't know if  
12 you have that data and can answer or not, but that's  
13 a question -- and you can get back to us if you want,  
14 but that's a question a number of us have had.

15           And I guess I would -- I guess I  
16 would again suggest that maybe the CME could  
17 consider increasing the clip size, so that, so that  
18 commercials - so that people can execute bigger  
19 quantities without using a block.

20           Other people at the NGFA convention  
21 came up to me when I suggested it at the  
22 committee meeting that they also agreed and  
23 thought that that would help the, let's say  
24 this annoyance problem where you get bids  
25 and offers that vaporize because they would have

1 a much more risk of being lifted.

2 So anyway. I think that sums up my  
3 comments. I don't know if I was looking for  
4 anything specific, but I wanted everybody here  
5 to know that there are some in the group that  
6 really, I think the jury is still out with us whether  
7 blocks are a good thing or not.

8 MR. THORNTON: Thank you. And in the  
9 interest of time, because we are now 15  
10 minutes over, I will turn to the Commissioners  
11 and Chairman for any -- quickly, for the call  
12 if there's anybody that needs a question.

13 Any questions? Thank you.

14 Now I'll turn to the Commissioners  
15 and Chairman for any questions or closing  
16 remarks.

17 CHAIRMAN GIANCARLO: Thank you all.  
18 This has been terrific. This is a great  
19 example of all of your determination to  
20 address many of these issues and get these  
21 issues right. And I think it is similarly reflected  
22 in the  
23 Commission's intention to work with you and  
24 bring our focus on these issues. So thank you  
25 all for your participation and look forward to  
many of you that will join us in the

1 conference that begins in a little while. Look  
2 forward to seeing you there.

3 COMMISSIONER QUINTENZ: Just to add  
4 to the Chairman's point. This is my first ag  
5 advisory committee meeting. I found it  
6 incredibly useful, informative. I think  
7 it's -- these meetings provide an opportunity  
8 for education and discussion and feedback not  
9 only for us, but for you, our members, and for  
10 our panelists and I felt that that was  
11 demonstrated in spades today. So thank you for  
12 bringing your expertise to bear on all of these  
13 issues.

14 And I just wanted to reiterate how  
15 much I learned about how important the futures  
16 markets are to the effective operation of the  
17 entire farm safety net system. And I think that  
18 that's something that I will carry with me  
19 throughout my meetings with a lot of diverse  
20 market participants and up on the Hill. So thank you.

21 COMMISSIONER BEHNAM: A quick thank  
22 you to the speakers on all three panels.  
23 Thank you for all of the Committee members for  
24 being here, some local, some traveling. A lot  
25 of questions answered, a lot of questions  
26 unresolved. And we're going to stay focused.  
27 I know the three of us are very engaged on these

1 issues; we care about them very much.

2 We have a lot to look forward to in  
3 the next day and a half. This was a special  
4 meeting for I think the Commission to be  
5 outside of D.C. and have an ag advisory  
6 meeting outside of the Beltway, like the chairman  
7 said, but especially here in Kansas.

8 I certainly want to thank Charlie and  
9 Christa for all of your hard work, the  
10 Chairman for being here, Commissioner Quintenz, as  
11 well. And again, to all the committee members, we  
12 appreciate your engagement. You inform us of what we  
13 need to be thinking about, how we need to be  
14 thinking about it.

15 And as always, as we've always said,  
16 speaking on behalf of Commissioner Quintenz and the  
17 Chairman, our doors are always open and we're  
18 always willing to hear your stories, so we can  
19 help resolve issues and looking forward to the  
20 rest of the event. Thank you. Thank you  
21 for attending this AAC meeting; the meeting is  
22 now adjourned.

22

23

24

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