



Special Executive Report

DATE: September 26, 2018

SER#: 8243

SUBJECT: Industry Survey Regarding Amendments to the Choice/Select Percentage of the CME Live Cattle Futures Contract

Chicago Mercantile Exchange Inc. ("CME" or "Exchange") is soliciting feedback from market participants regarding potential amendments to the Live Cattle Futures contract ([CME Rulebook Chapter 101](#); CME Globex Code: LE; Clearing Code: 48) (the "Contract"). The deadline for the Exchange to receive such feedback is **Friday, October 12, 2018**.

Specifically, the Exchange is in the process of determining the potential benefits of implementing a mechanism to periodically update the Choice/Select quality percentage for the par value of the Contract using a public report published by the United States Department of Agriculture ("USDA").

Background

The contract specifications for delivery of a live or carcass-graded CME Live Cattle futures contract include a fixed percentage of yield and quality grades as defined by the USDA. In 1976, yield grade requirements were incorporated into the Live Cattle contract; yield grades 1, 2, 3, and 4 were classified as deliverable. In 1995 a par unit was further defined, and quality grades were introduced to the par standard of a delivery unit. To reflect the cattle produced in the underlying physical market, par standards were set to yield grade 3 and quality grade of 55% Choice / 45% Select.

Deliveries from this point on were adjusted for variations from par utilizing the "National Weekly Direct Slaughter Cattle – Premiums and Discounts" report published by the USDA ("LM_CT155"). From its 1995 inception to October 2017, the quality grade specification of the contract remained a static 55% Choice / 45% Select.

In order to match the quality improvement in the U.S. herd, the October 2017 contract increased the par quality grade to 60% Choice / 40% Select and the October 2018 contract will adjust the par quality grade another 5% to 65% Choice / 35% Select.

The USDA publishes weekly the "National Steer & Heifer Estimated Grading Percent Report" ("NW_LS196") every Monday showing the breakdown of official USDA quality grade percentages for the week prior.

Exhibit 1 shows the National ("NATL") average percentage of beef graded as USDA Choice, which remained between 50% and 55% from 1996 until 2009 when it increased beyond 60%. From 2009 to the present, the average Choice grade percentage increased from 60% to as high as 74%.

Exhibit 2 shows the weekly NATL Choice grade percentage, a two-year moving average (104-week) of the NATL Choice percentage, as well as the Choice grade of the CME Live Cattle Contract.

As referenced above, the Exchange has made necessary adjustments to the par value of the Contract to ensure that it adequately reflects most of the cattle transacted in the underlying cash market. These previous adjustments to the par Choice/Select value have been implemented on contracts without open interest. Nine (9) consecutive contract months of the CME Live Cattle Futures Contract are listed at any

given time with expirations in February, April, June, August, October, and December. Thus, the two previous updates to contract quality were implemented only on newly listed contracts, and the lag between announcement and implementation can be 18 months. For example, the first quality grade adjustment was announced in August 2016 but not effective until the October 2017 contract month. By the time the October 2017 contract entered delivery, the U.S. average Choice percentage exceeded the new contract rate. The U.S. cattle producing sector has dramatically improved the percentage of high-quality graded cattle it produces, as reflected by the NATL Choice grade reported by the USDA. The par quality grade of the Contract has remained static while the NATL has increased, resulting in a sizable difference between the two. The difference between the two has been as much as 15% as detailed in **Exhibit 3**.

To avoid unquantified and irregular quality grade specification adjustments, the Exchange is proposing to implement a dynamic mechanism to systematically update the par quality grade of the Contract. The Exchange will track, compile, and make publicly available on a weekly basis the NATL quality grade percentages from the NW_LS196 along with a 104-week moving average of the NATL Choice grade percentage ("2-Yr MA") on the CME Group Live Cattle home page.

On the first Monday immediately following the expiration of a Contract (or Tuesday should Monday be a U.S. holiday), the 2-Yr MA calculated from the most recent LS_NW196 report will be used to set the par Choice quality grade for the front contract month. Generally, this will be 30 Business Days or more prior to the First Notice Day (first day of the delivery period) of the lead contract month. The par Choice percentage would be rounded to the nearest 1%. The Select percentage would then be calculated by subtracting the Choice percentage from 1.

Exhibit 4 shows the 2-Yr MA and the NATL Choice average for each week in 2018 through August 17. While the NATL average has had a low of 69.55% and a high of 73.08% this year, the 2-Yr MA has remained a steady 71% throughout the year.

Summary

Utilizing a USDA report to calculate a moving average will present a more timely and efficient way to systematically update the par Choice quality grade of the Contract and better reflect the underlying cash market. The weekly data points will be available on the USDA website as well as on the CME website. As the national quality averages adjust in the US, so will the Contract.

Feedback Item: The Exchange invites comment on the implementation of a mechanism to systematically update the Choice/Select quality percentage of the par value of the Live Cattle futures contract using a weekly public report published by the United States Department of Agriculture ("USDA").

We would like feedback on:

- General views around the automation of the updating of the Choice / Select spread parameters of the contract.
- Is a moving average using two years of USDA data appropriate, or should a different time frame or method be used?
- Is a mechanism that sets the Choice / Select percentage of a contract with open interest roughly thirty days prior to the delivery period appropriate? Or, should the percentage be set earlier than that? Upon listing of a new contract?
- Any other comments or concerns.

CME welcomes comments and feedback from the cattle industry and market participants in our Live Cattle Futures Contract to assist the Exchange in determining whether this change would be beneficial and further enhance the Contract. The comment period is open through **Friday, October 12, 2018**, and respondents may submit written feedback to the CME contacts listed below:

Jim Sullivan
Manager
Commodity Research & Product Development
Jim.Sullivan@cmegroup.com
312-930-2308

Sarah Calhoun
Director
Agricultural Products
Sarah.Calhoun@cmegroup.com
312-338-2888

Exhibit 1

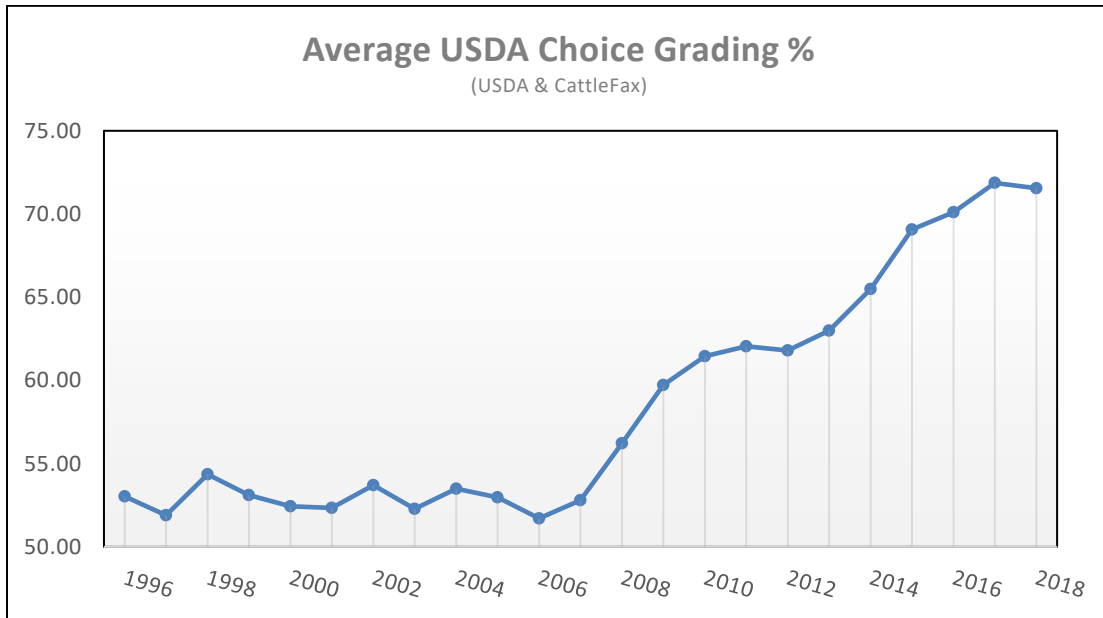


Exhibit 2

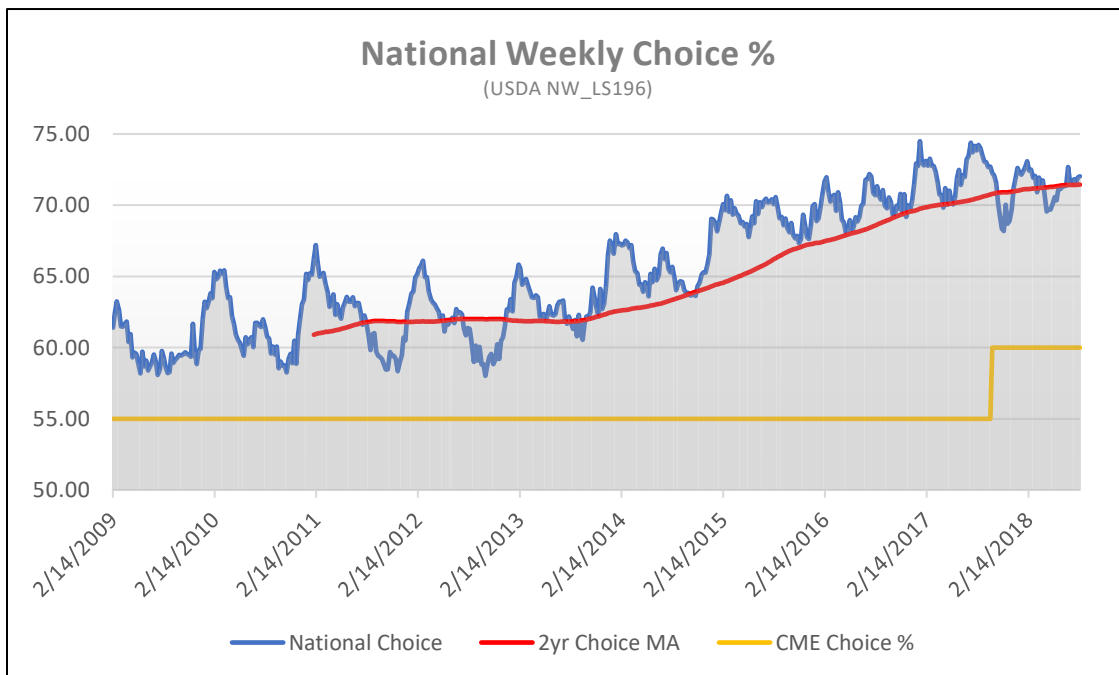


Exhibit 3

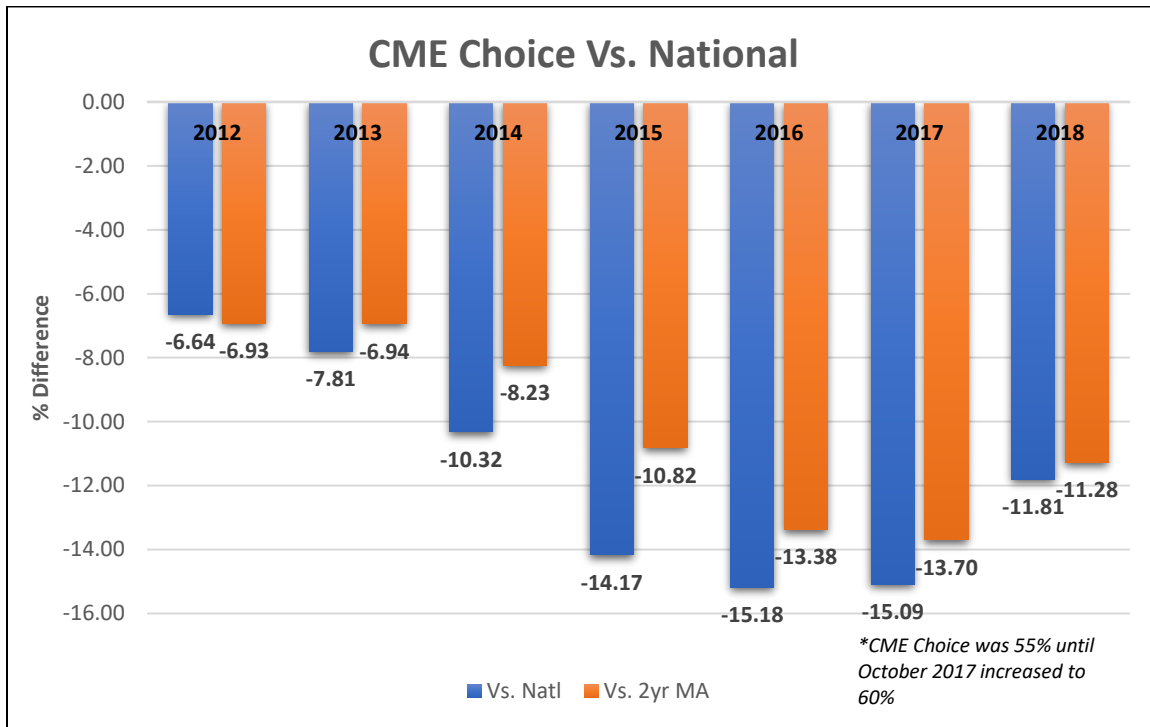
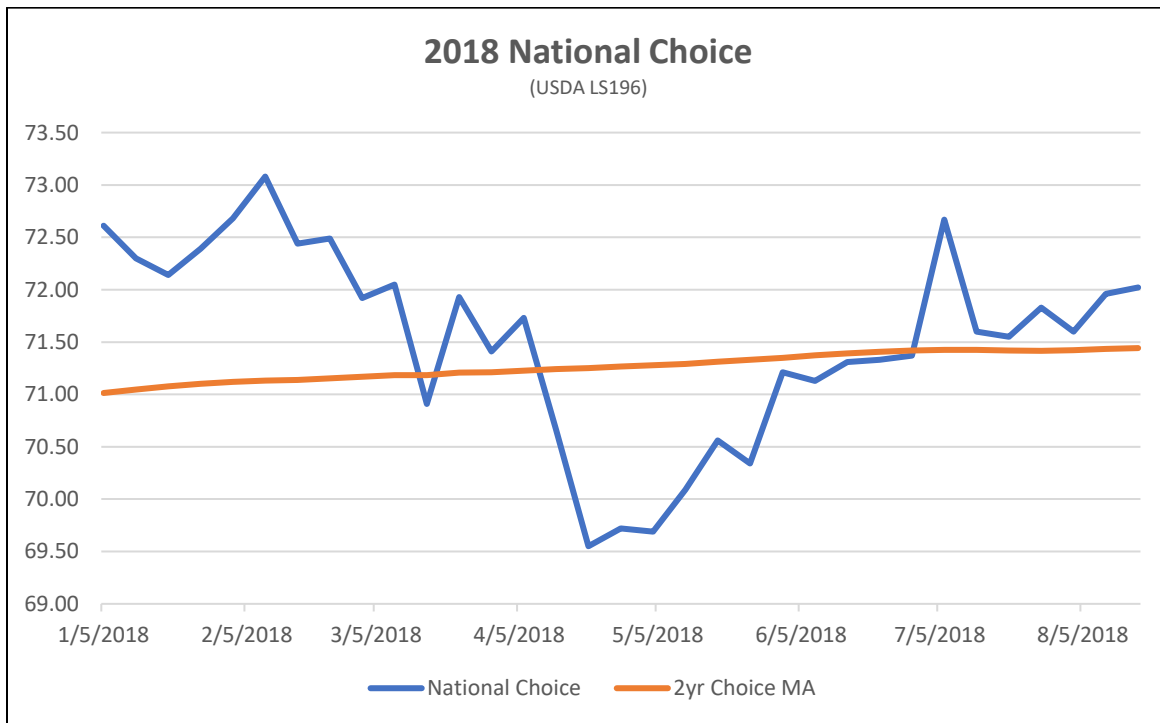


Exhibit 4



Week Ending Date	National Choice LS196	2yr Choice MA
1/5/2018	72.61	71.01
1/12/2018	72.30	71.05
1/19/2018	72.14	71.08
1/26/2018	72.39	71.10
2/2/2018	72.68	71.12
2/9/2018	73.08	71.13
2/16/2018	72.44	71.14
2/23/2018	72.49	71.15
3/2/2018	71.92	71.17
3/9/2018	72.05	71.18
3/16/2018	70.91	71.18
3/23/2018	71.93	71.21
3/30/2018	71.41	71.21
4/6/2018	71.73	71.23
4/13/2018	70.66	71.24
4/20/2018	69.55	71.25
4/27/2018	69.72	71.27
5/4/2018	69.69	71.28
5/11/2018	70.09	71.29
5/18/2018	70.56	71.31
5/25/2018	70.34	71.33
6/1/2018	71.21	71.35
6/8/2018	71.13	71.37
6/15/2018	71.31	71.39
6/22/2018	71.33	71.41
6/29/2018	71.37	71.42
7/6/2018	72.67	71.43
7/13/2018	71.60	71.42
7/20/2018	71.55	71.42
7/27/2018	71.83	71.42
8/3/2018	71.60	71.42
8/10/2018	71.96	71.44
8/17/2018	72.02	71.44