CME Group

David Lehman remarks to Global Grains Conference
J.W. Marriott
Chicago
June 20, 2013
9:00 A.M. CDT

Introduced by Charles Gould, Global Grain Conference Coordinator

Thank you, Charles for that kind introduction. It's a pleasure to be here, and an honor to be addressing such a prestigious conference as this.

I would also like to welcome the Global Grains Conference to Chicago. We're glad our city could host this event, and I hope that each of you visiting from around the globe enjoy your time here.

This conference has long been an event agribusiness has looked to for information, ideas and discussion about issues affecting the grain industry. And much of that discussion centers around international grain markets – prices, volatility, global benchmark contracts – they will all be major focal points over the next two days.

And in that sense, markets have looked to this conference as a barometer for what is on the horizon in the grain industry. What potential threats do grain markets face? Where are the new opportunities? What will most affect supply and demand in the months and years ahead?

This conference is a place of influence, and for that reason, I am glad that Chicago was chosen as the first host for the Global Grains conference in North America.

And I think it's appropriate. Most of you are familiar with our company, CME Group, and the role our markets play in the global agricultural picture. I'll discuss that more in a moment.

But you may not be as familiar with the history of Chicago, and its importance to the grain trade in North America. Chicago was originally established because of its strategic location which provided a connection between the Great Lakes and the Mississippi River.

This helped bridge trade of all kinds, but it most certainly helped the sale and distribution of grain. And with this new distribution, farmers needed a central place to manage the risks of doing business, and guard against wild fluctuations in price and demand for their product. So 11 years after the city's founding, the Chicago Board of Trade was born as one of the first markets for grain futures anywhere in the world.

Today, the Chicago Board of Trade and the Chicago Mercantile Exchange are part of CME Group – the world's leading derivatives marketplace. We feature a variety of futures and options products for many different asset classes, including energy, metals, interest rates, equities, and foreign exchange. But I imagine most of you know us by what we've been the longest – the leading marketplace for trading agricultural commodities.

The Role of Risk Management

We have a special tie to agriculture. And it's because of this that we understand that efficient and transparent markets are absolutely essential to the grain industry.
They offer all kinds of grain market participants the opportunity to manage the risks associated with the unpredictable events that are a big part of the grain business.

No matter where you are located around the globe, all of you here today – as members of the grain industry – share a kinship in that you face the same constant risks. And increasingly, those risks are interconnected. Weather that impacts the local producer also has far-reaching effects on the global grain trade. The same can be said of geopolitical conflicts that emerge, or a sudden change in trade policy in a critical region.

Last year, the U.S. experienced one of the worst droughts in decades – about 80 percent of U.S. agricultural land was under severe drought conditions.

This drastically reduced production levels of corn, wheat and soybeans, and resulted in record prices in those commodities. Good risk management can help reduce the cost of grain, all the way down to what consumers pay at the supermarket. But a drought like we saw last year in the United States can impact food security in the U.S., and with its trade partners as well.

The U.S. Department of Agriculture estimates that food price inflation in the United States will rise half a percent above the normal range this year – even more for meat and dairy products. The United Nations Cereal Price Index in May was nearly 8 percent above the previous year. These figures underscore the interconnectedness of the global grain economy.

When companies can manage risks associated with unexpected, but inevitable events, it's not just the company or industry that thrives. A nation's economic health is helped considerably by the grain industry's ability to keep itself afloat in even the most turbulent times. And the last few years certainly have been turbulent for many in the global grain industry.

It's not only the U.S. situation that's having an impact. When Russia experiences a heat wave and bans grain exports, as they did in 2010, the world economy feels it. South America has emerged as a reliably strong grain producer.

When a drought hits that continent's agricultural regions, as is happening right now in the Northeast part of Brazil, the global grain trade is impacted. Infrastructure is another influencer. We've had record rainfalls in the Midwestern U.S. this year, and that has had an effect on shipping and delivery points throughout the Mississippi River, which can affect prices and exports.

None of the countries represented here today are immune from these issues. And that's why the changing market dynamics and new innovations in the grain industry are so critical.

High Frequency Trading

One of those changing dynamics receiving a lot of attention lately is the market's increasing speed and electronification – usually identified as "high frequency trading."

This is a critical change in market structure that has grown with the rise of electronic markets over the last 30 years, and it's changed both trading execution and strategy for every kind of market – from equities to foreign exchange to agricultural commodities. Technological innovation has been a hallmark of our commodity markets since the first grain futures contracts were introduced more than 160 years ago. And in that way, algorithmic or high-frequency trading is a natural evolution of the marketplace.

But while HFT has helped spur growth in global grain trading, I recognize it is a concern for many of you sitting in this room, and it is not yet something everyone is entirely comfortable with.

We understand that.

So I'd like to talk about a few risk management issues that I think are key going forward in the electronic marketplace.

First, the definition and the way we approach HFT.

When we hear the term "high-frequency trading" it is most often in reference to trades happening in fractions of a second. But even in that category, some traders are faster than others. And as long as exchanges have existed – long before we used computers to trade – some traders have been faster. That's nothing new.

News about HFT is often about the problems we've seen with sudden, dramatic price drops in equity markets. And the assumption is often that high-frequency trading is something that has damaged market integrity, or even has allowed a small number of firms to manipulate all kinds of markets.

It's important that in whatever way HFT is defined, that we not do traders and investors a disservice by claiming it is harmful to markets.

The fact is markets are safer than ever. Overwhelming academic evidence has shown that high frequency trading and the technology that enables it provide added benefits to markets by:

- Increasing liquidity,
- Reducing volatility, and
- Tightening bid/offer spreads

But like any kind of trading, it should only be fully embraced when the proper protections are in place.

HFT should be regulated. And it is.

At CME Group, we provide multiple levels of protections and risk controls to detect and prevent market moves that do not tie to legitimate market dynamics.

These include:

- Automated tools like stop logic and velocity logic, which provide a cooling off period that gives participants time to react to what is taking place and ensure markets are able to remain liquid. Stop logic, for example, was one of the tools that reversed the trajectory of the flash crash in 2010.

- Second, a messaging policy designed to eliminate excess messaging without damaging liquidity. That's good for everyone – good for the market because messaging becomes more efficient, good for firms that have less market data to consume, and good for investors that benefit from real liquidity instead of extraneous messages.

- In addition, we detect and prosecute trading behavior that doesn't comply with our rules. We have developed an exceptionally granular audit trail of market activity and powerful and flexible data query and analytical tools that allow our regulatory staff to examine real-time and historical order, transaction and position data, maintain profiles of markets and market participants, and to detect trading patterns potentially indicative of market abuses. This helps us stay ahead of the curve and provide efficient markets for our global customer base.

HFTs are liquidity pools, but they're not good liquidity pools if they're not well managed. Efficient markets must have the necessary controls in place to guard against technical issues and human error, as well as controls that allow us to identify compliance issues sooner.

That's a big focus for us. We spend over $40 million a year policing these markets – this is in <u>addition</u> to what the government does – just to make sure these are credible markets. If we don't have credible markets, we don't have a credible company.

We recognize this is an area of concern for many grain market participants, and that's why we regularly communicate with the grain industry on this issue. Our COO, Bryan Durkin, also serves on the CFTC's Technology Advisory Committee that handles issues such as high-frequency trading and the regulatory questions it raises.

HFTs provide many benefits to commodity markets. But more important than the technology or trading strategy used, is a complete market ecosystem that includes soundness, safety, and liquidity and promotes fair, open access to all participants - no matter who they are, where or how much they trade. As long as we have that, we'll have a healthy market structure.

Wheat Trade/KCBT

But as you all well know, technology is only one area where grain markets today are changing. At CME Group, we are constantly looking to establish new futures and options products that benefit all grain market participants, which in turn benefit the global grain trade.

One of the ways we've done this over the last year is through our acquisition of the Kansas City Board of Trade, home to the Hard Red Winter Wheat futures contract.

Some will look at this deal and see another example of a company growing through mergers and acquisitions. And no question this will help our business grow. But this deal is also a story about the global wheat business, and how the needs of agribusiness have changed, too.

The global wheat trade is very much about usability. And Hard Red Winter Wheat is by far the most exported grade of wheat in the United States. It accounted for about 38 percent of total U.S. exports in 2012. In fact, almost 394 million bushels of HRW wheat were exported in the 2011/2012 marketing year compared to just under 160 million bushels of Soft Red Winter wheat, the world's most traded wheat contract, located at the Chicago Board of Trade.

Certainly, the integration of Kansas City with CME Group benefits both organizations. But a merger like this wouldn't make sense if it didn't also benefit those in the agribusiness supply chain who must hedge their wheat risk.

In fact, managing global wheat risk has never been more efficient than it is today.

Having both exchanges under one roof allows us to develop synergies for additional liquidity in both the KCBT Hard Red Winter and CBOT Soft Red Winter Wheat contracts. It allows producers and commercial participants to hedge their risk in both benchmarks in one place – and through a single clearing house. In April, the two exchanges finalized clearing integration, which produces cross-margining benefits and other cost savings for those using our markets.

The combination of HRW products with SRW futures and options will provide new trading opportunities for grains market participants around the world – on the trading floor and on the screen. It will also enable our customers to execute spread trades in a more cost-effective manner to manage risk associated with the price differentials inherent between these two classes of wheat.

Options on those spreads, and options on Hard Red Winter Wheat and the Minneapolis Grain Exchange's Hard Red Spring Wheat will be available beginning July 1.

Lastly, our acquisition of KCBT allows for development opportunities for both of our client bases – not only in futures, but also in options, where we'll be introducing a variety of cost-effective solutions to help market participants manage event risk like weather and USDA reports during the crop year. These include Short-Dated New Crop Options, which are already seeing healthy trading volume – having touched over 160,000 in open interest. This new breed of options gives market participants the opportunity to hedge with a lower cost than the traditional options contracts but for a shorter period of time. These shorter maturities mean less time value and lower options premium than standard options.

We first introduced short-dated new crop corn and soybean options in June of 2012, while similar wheat options were listed in September. And on July 1, we're making available weekly options in the HRW contract.

The KCBT trading floor will be moving to Chicago the first of July as well, making Hard Red Winter Wheat the first futures product to be added to our trading floor since 2005, and the response from our traders has been extremely positive.

But this is more than about the venue where these products trade. Part of the efficiency of our markets comes from the ability to trade on the floor and electronically. However, our primary commitment is to the end users and physical grain customers across the globe who rely on our risk management products. The KCBT floor is moving to Chicago, but this is much more about bringing together 300 years of combined experience to offer customers an array of tools to manage wheat price risk. That is something that wasn't possible before.

Another of those tools is the Black Sea Wheat contract we launched a little more than a year ago. That is a region that today is one of the world's leading exporters of wheat when only 10 years ago, it represented just 3 percent of global exports. Because of the region's growing importance to the global grain industry, we believe a contract that converges with the grade of wheat there is essential to help producers in the region manage their price risk. And to that end, we've gone to Ukraine to meet with a variety of hedgers and members of the agribusiness community to discuss markets and share the basics of trading and market fundamentals.

Conclusion/Global Connections

I mention our growing wheat complex because these are developments that will impact the wheat trade globally. But by no means does the discussion about the growing global grains marketplace end there. It extends to many locations and to many other marketplaces.

And I would like to close today by discussing why all this matters. Why should markets embrace the technologies that help trading move faster and more safely through the financial system? Why is the expansion of grain contracts so important to global trade?

Because – as I stated at the beginning of my remarks today – we don't know exactly what will most affect supply and demand for grain in the near future, and in the long term. So it goes back to managing those common risks that we all face.

We're on our way to 9 billion people. That will require expanded grain production, processing, exports and a host of other needs. Those firms will require safe, efficient, liquid and transparent markets to grow their business and maintain access to capital no matter where they are located.

Over the last decade, we've seen demand coming from places like China and India. That demand may shift to new regions. But the principles that have guided the grain trade on our markets for so long will remain. That is why we need to make sure that markets have the technology and tools in place to ensure an effective market for all participants – no matter who you are, where you are located or how much you trade. It's why markets must continue to expand their product offering to meet the changing needs of the grain industry. We've done this through the advancements in our wheat offering, but there will no doubt be many more grain offerings to come.

The grain industry is faced with the task of providing for a growing global population. That is why it is so important that markets evolve and grow: to help manage the risks we all know so well. Thank you for your time, and I would be happy to take a few of your questions.