

Kansas City Board of Trade: 150 Years of Commodity Markets Evolution



Western Historical Manuscript Collection
Kansas City

Charles N. Kimball Lecture

Jeffrey C. Borchardt
April 19, 2006

The Charles N. Kimball Lecture Series

is a tribute to our late friend and civic leader, Dr. Charles N. Kimball, President Emeritus of the Midwest Research Institute, to acknowledge his support of the Western Historical Manuscript Collection-Kansas City (WHMC-KC) and his enduring interest in the exchange of ideas.

Charlie Kimball was a consummate networker bringing together people and ideas because he knew that ideas move people to action. His credo, “Chance favors a prepared mind,” reflects the belief that the truest form of creativity requires that we look two directions at once—to the past for guidance and inspiration, and to the future with hope and purpose. The study of experiences, both individual and communal—that is to say history—prepares us to understand and articulate the present and to create our future—to face challenges and to seize opportunities.

Sponsored by the Western Historical Manuscript Collection-Kansas City, the Series is not intended to be a continuation of Charlie’s popular *Midcontinent Perspectives*, but does share his primary goal: to encourage reflection and discourse on issues vitally important to our region. The topic of the lectures may vary, but our particular focus is on understanding how historical developments affect and inform our region’s present and future. The Lectures will be presented by persons from the Kansas City region semi-annually in April, near the anniversary of Charlie’s birth, and in October. Additionally, presentations may occur at other times of the year, if opportunities present themselves.

WHMC-KC appreciates the substantial financial underwriting and support for this Series provided by the **Charles N. Kimball Fund** of the Midwest Research Institute and by other friends of Charlie Kimball.



1911-1994

INTRODUCTION

to the April 19, 2006 Charles N. Kimball Lecture

David Boutros

Associate Director, WHMC-KC

Good afternoon and welcome to the Spring 2006 Charles N. Kimball lecture. My name is David Boutros, Associate Director of the Western Historical Manuscript Collection, host of the Charles N. Kimball Lecture series.

In thinking about my remarks, it struck me that today's lecture on the history of the Board of Trade suggests an example of the research collections held by the Western Historical Manuscript Collection.

WHMC-KC first received the records of the Board in 1981—only a year after we opened our doors. Over the next several years, additions to the Records come in, eventually totally some 372 linear feet.

The Records contain the operating papers of the Board, including the Articles of Incorporation, Constitution, Rules, Regulations, Minutes of the Board of Directors and the Open Board of Trade, Arbitration Cases, Financial Reports, and Annual Statistical Reports. General files include Legislation and Contacts with the Legislature, the National Recovery Association, the Federal Farm Board, and Public Relations and News Releases. The Records of the Board's Transportation Department contains Investigation and Suspension Dockets (I&S), Interstate Commerce Commission (ICC) Dockets, and Tariffs—all dating from ca. 1873 to ca. 1980.

I remember packing the Records at the Board offices. They were stacked on shelves and on the floor, in filing cabinets and binders in a large storage room. We brought in boxes, arranged the material the best we could and made a handwritten inventory of the contents of each box. In particular I remember a large section of documents related to the tariffs charged by the railroads to move grain throughout the country. Now, the railroads were the bane of industry in the 19th and early 20th centuries—absolutely necessary to the growth and success of any enterprise, especially agribusiness. But like the price of gasoline today, the price of shipping by rail then could have a profound impact upon the profitability of a farm or business. In Kansas City, when the cost of rail transportation went up, the civic leaders rallied to improve the wharf and ship the city's goods by barge. In any case those boxes of rail tariffs have always intrigued me as a challenging source for research.

So far no historian has ventured into the tariffs, but others have looked into the economic and social role of the Board in our city and hinterland. And, of course, this year marks the Board's 150th year with a new book due out soon to celebrate that achievement.

Let me take a moment to remind you that this lecture series is dedicated to the memory of Charlie Kimball. His role in this city truly cannot be underestimated as a thoughtful and consistent promoter of the reality and potential of our community. You may know that he was one of the forces behind the "Prime Time" campaign of the 1970s that sought to market Kansas City to the nation and world and defined Kansas City as a livable city. It is our hope that this lecture series honors his trust and belief in Kansas City's past, present, and future.

To introduce our speaker today is Mr. Daniel L. Gibson, Chairman of the Kansas City Board of Trade....

Daniel L. Gibson**Chairman of the Kansas City Board of Trade**

Thank you for inviting us to share our story this year. It is indeed my honor to be the chairman of the Board of Trade this year. When people ask me how I became the chairman, I tell them the truth, that I was out of the country when they chose me and I couldn't decline nomination. The chairman of the Board of Trade is chosen from the one hundred and ninety-two members. Traditionally the chairman serves one year as chairman following two years on the executive committee. Our tenure as officers and chairman is short—we do help set the policy for the Exchange, but it is the staff, and particularly the President of the Exchange, who actually are in charge of the day to day running of the Exchange. It has been my good fortune during my year as chairman, to have as President and Chief Executive Officer, Jeffrey C. Borchardt. I would say that with his taking care of the day to day business it has made my job easier, and with his also taking care of affairs like this, it has made my job easier because I can sit back down, and enjoy the lecture.

Jeff is a native of Saint Joseph, Missouri. He graduated from Northwest Missouri State University in 1982 with a BS in accounting, and earned a CPA certificate in 1984. He has been with the Board of Trade since 1982 starting out in the department of audits and investigations. He was named Vice President in 1987, Senior Vice President and CFO in 1994, Executive Vice President and COO in 2000, and in February 2004 he was named President and Chief Executive Officer. In addition to his duties with the Board of Trade, Jeff also serves on the Board of Directors of the National Futures Association and the National Grain Trade Council, which are both very important to our industry. He also regularly lends his expertise to various industry working groups around the country. It is indeed my pleasure to introduce him at this time, Jeff Borchardt.

Kansas City Board of Trade: 150 Years of Commodity Markets Evolution

Jeffrey C. Borchardt

President & CEO of the Kansas City Board of Trade

April 19, 2006

Good afternoon. It is truly an honor and privilege for me to speak to you today about one of Kansas City's oldest institutions dating back to around the time when Kansas City was first named. In 1850, the community was named and chartered as the "Town of Kansas" and in 1853 renamed and incorporated as the "City of Kansas."

Just three years later in 1856—the same year the first bank was opened in the city—a group of local merchants formed a voluntary association that met on the river banks at the confluence of the Kansas and Missouri rivers to try and develop a more organized method of buying and selling grain. This association also served in the capacity of a chamber of commerce by promoting regional trade until an official chamber of commerce was chartered late the following year. We recognize this association by its current name, the Kansas City Board of Trade.

So this year we are celebrating our sesquicentennial or 150-year anniversary. To acknowledge this landmark achievement, we secured the services of a delightful local author, Ms. Heather Paxton, to write a book about the 150-year history of the exchange. Ms. Paxton has to her credit books written about the history of the American Royal & Jewell Ball. The text of the book has been completed (with some final additions to include our 2005 record achievements) and is now in the art layout stage at the publisher in preparation for going to print. I expect completion of the hard-cover book by late spring. Much of the historical information you will hear about today is the result of Ms. Paxton's extensive historical research.

Getting back to our origin, initially the association served its members as a place to exchange information and maintain uniformity of prices among merchants. It wasn't until thirteen years later, in 1869 that the association was chartered under the name of the Commercial Exchange and later in 1872 renamed the Board of Trade. The first president of the exchange in 1869 was a thirty-year-old named Thomas King Hanna. The title of president from 1869 to 1985 actually represented the position of chairman of the board. The title was changed in 1985 to chairman.

The Commercial Exchange was chartered with 67 founding members during a period of explosive growth in Kansas City. The population in 1865 was 3,500, and by 1870 grew nine-fold to 32,000. Much of the "boon" can be attributed to one of the most important events in the city's history—the opening of the Hannibal Bridge in July of 1869—which made it possible for trains to cross the Missouri River. After all, who wants to ride a horse or covered wagon across the prairie when you can take a train? This encouraged the linking of railroads to the city and later connected three railroads from the east with three railroads leading to the west. It also sparked investment in the city's infrastructure, including numerous platted additions, street expansions

and improvements, and the first paid fire department. The members of the Commercial Exchange were responsible for guiding many of these growth and expansion efforts.

It was in 1872 when the Commercial Exchange was renamed the Board of Trade, that the organization shifted its attention and began focusing on the grain trade, and rightly so. The production of wheat in Kansas rose from about 168,000 bushels in 1860 to 25 million bushels in 1875. The Kansas City market grew from handling 687,000 bushels of wheat and 350,000 bushels of corn in 1871 to 9 million bushels of wheat and 5 million bushels of corn just 7 years later. The increased handling of grain is attributed to the expansion of the railroads, construction of grain elevators, and importation of a new wheat variety, Turkey Hard Red Winter.

During the 1870s, Mennonite farmers from Russia immigrated to the U.S., bringing with them Turkey red wheat seeds. They left Russia because they thought a revolution was inevitable; they were about 40 years early, but ultimately proven correct. They planted this red wheat in Kansas and found it particularly suitable to the harsh Midwestern climate.

Despite the advantage of Turkey red's high protein content, there initially was resistance due to its darker color and difficulty to grind because of the hardness of the kernel. However, the latter problem was alleviated in the 1880s when millers began using steel rollers to mill the red wheat.

As mentioned earlier, the construction of grain elevators in the Midwest assisted in the grain storage and handling process. The first such elevator in the Kansas City area was built in 1871 by Henry Joseph Latshaw and R.W. Quade. The elevator had a 100,000 bushel capacity and cost \$22,000 to complete. Unfortunately it was made of wood and burned down two years later in 1873, ironically the year that Mr. Latshaw served as the third president of the exchange.

A great many things happened in 1876, 20 years after the association's founding. In May, the association was incorporated and formally organized under specific rules and regulations. In July, formalized grain trading was opened as the Board initiated "grain calls" where grain was sold at auction several times each day. This was the genesis of what became futures trading. It would evolve into specific standardized trading months when delivery would be accepted on the contracts traded. Finally, in August of that year, construction began of the first Board of Trade building at Fifth & Delaware Streets. The building contained a trading hall 60 by 110 feet and twenty one offices occupied by grain merchants, and cost \$67,000 to build. The 5th & Delaware building served as the exchange's home for 12 years, until a new building was constructed in 1888 at Eighth & Wyandotte Streets. This modern fireproof structure with large arched windows cost \$700,000 to complete and would house the exchange through 1924.

As I just mentioned, futures trading began in 1876. This would probably be a good time for me to call an historical "time out" if you will and explain how futures contracts work. Futures contracts are risk management tools that transfer risk associated with the price movement of a particular commodity—and on our exchange that commodity is hard red winter wheat, which is the predominant "bread" wheat. A futures contract is an agreement between a buyer and a seller to receive or deliver a fixed amount of the commodity on a future date at a price that they negotiate today. The agreement is standardized as to delivery period (meaning the contract month), contract size (meaning the amount of the commodity—in our case, each contract of wheat is for 5,000 bushels), and quality of the product. What sets futures apart from cash trading is that the futures market represents a temporary substitute cash transaction. Consequently physical delivery of the commodity in fulfillment of the futures contracts occurs in less than 1 percent of the contracts traded. The vast majority of contracts are liquidated in advance of the delivery obligation period.

As an example, if John Doe owns cash wheat that he intends to resell at a later date, he is exposed to falling prices. The futures market affords him the opportunity to lock in a selling price in advance of his subsequent cash sale. Today hard red winter wheat is trading for around \$4.00 per bushel. Let's say John owns 10,000 bushels of wheat. To transfer the price risk, he sells two futures contracts (remember each contract is for 5,000 bushels) at \$4.00 per bushel to lock in the

sales price. Over the course of the next month, the price of wheat drops to \$3.50 per bushel. John sells his wheat in the cash market for \$3.50, a price less than what he might have received if the grain had been sold the prior month. However, at the time he sells the cash grain, he liquidates (buys back) his futures contracts at the current prevailing price of \$3.50 for a profit of \$.50 per bushel. This \$.50 futures contract profit is then added to the cash selling price of \$3.50 per bushel for a total price received for the grain of \$4.00, the price that the grain was originally sold for on the futures market. The futures market allowed John to transfer the price risk associated with the grain until such time as the actual cash sale was completed.

The pricing takes place on the trading floor of the exchange in an open-outcry or open auction fashion, where buyers and sellers clad in colorful jackets shout out their bids and offers. The prices at which they consummate their transactions are what we call price discovery. The key benefit of this price discovery function is market transparency. By that I mean that anyone with access to a quote screen (back in the old days a telegraph or ticker tape machine) would know the price for hard red winter wheat being traded on the exchange, which represents the benchmark price off of which cash wheat transactions are priced. Futures contracts offer standardized trading months so that, in the case of wheat, it can be priced throughout the crop year.

Settlement of futures contracts occur daily, where each contract is brought to market. As an example, John Doe buys a wheat futures contract on day 1 for \$3.50. On day 2 the price increases to \$3.51. John's trading account is credited for \$50 (5,000 bushels x \$.01 gain) which represents the difference between where John purchased his futures contract and the current prevailing price. If on day 3 the price drops to \$3.49, John's account balance will be reduced by \$100 which represents the 2¢ price drop from the prior day's settlement price of \$3.51 multiplied by 5,000 bushels. Now that we have all completed our futures 101 express course, I will return to the late 1800s:

During the late 19th & early 20th centuries, one of the biggest problems that plagued exchanges was bucket shops. These were illegitimate businesses that advertised themselves as commodities brokerage firms, but in reality were gambling dens. These fictitious firms would buy or steal the exchange quotations from telegraph companies and display such quotations on chalkboards for their customers to place bets on the direction of the market. However, in most cases the quotes would be manipulated or delayed to the disadvantage of the customer placing the bet. Victims of these scams would unfairly blame the exchanges, whose reputation would suffer.

This resulted in the exchange contracting with telegraph and cable companies, agreeing to provide them with exchange market quotations if they would require any customer receiving such quotes to sign an application attesting that they were not operating a bucket shop, and would not allow any person to use the quotes for any such purpose. As another deterrent, in an attempt to keep undesirable bucket shop operators from becoming exchange members, the exchange membership application asked the question: are you now or have you ever been connected with any bucket shop? That's like asking the question, have you ever perpetrated fraud on the public? I can only imagine that those foolish enough to answer yes were immediately ushered to the nearest building exit.

Now it was during these earlier years that some exchange members would begin businesses that would span generations. These prominent Kansas City families would be recognized not only for their business prowess, but also for their contributions to the community. William T. Kemper was just 34 years of age when he became president of the exchange in 1900. His businesses included Kemper Grain Company, Kemper Loan & Investment Company and various real estate holdings. His sons and grandsons would later run City National Bank (now UMB Bank) and Commerce Trust Company (now Commerce Bank). His great grandsons are active today in running these institutions.

William B. Lincoln came to the board of trade in 1907 employed by Home Grain Company. In 1925, he and John J. Wolcott formed Wolcott & Lincoln, a commission merchant member that also

traded cash grain and operated grain elevators. Mr. Lincoln served as president in 1932. His son-in-law Gunnard A. Johnson joined the exchange in 1920, became president in 1942, and remained very active in exchange governance and direction until his death in 1985. He was so well respected for his exchange guidance over the many years that his trading badge initial "J" was permanently retired, the first and only time this has been done. Two of Mr. Johnson's grandsons are active in the business today; David Gibson who was chairman in 1984 and Daniel Gibson who is chairman this anniversary year.

Of course there are many other well-known Kansas City families with Board of Trade roots. B.C. Christopher, in whose name a long-time Kansas City brokerage business operated, was president of the exchange in 1903. John A. Theis in 1928 started what would become four consecutive generations of exchange presidents. Paul D. Bartlett, Sr., whose descendents still own and operate Bartlett Grain Company—his son Paul Bartlett, Jr. holds the distinction of being the longest tenured current KCBT member—since 1947, nearly 60 years. The Sosland family founded the *Southwestern Miller* publication. Their descendents today operate Sosland Publications, including exchange member Morton Sosland. And finally Paul Uhlmann, whose family operated Standard Milling Company. There are many others, but this gives you an idea of a few of the community names associated with the exchange over the years.

Up to 1899, all trades were settled daily through the exchange directly between the trading firms, which exposed each firm to the creditworthiness of the firms holding opposing market positions. But in 1899, the Board of Trade Clearing Company was created. The purpose of this new entity was to eliminate counterparty risk by serving as the intermediary to each exchange futures transaction for settlement purposes, in effect becoming the buyer to each seller and the seller to each buyer. Clearing member firms would now settle their financial obligations each day directly with the clearing company, who would guarantee fulfillment of all financial obligations. In the event a clearing firm could not meet its settlement obligation, the clearing company would cover the shortfall out of its own resources. We are very proud of the fact that in the 107 years that the clearing company has guaranteed the financial fulfillment of trades, not one customer has ever suffered a loss as the result of a default by a clearing member firm.

Over the years, domestic and international events have had an effect on wheat prices which in turn impacted production. In 1901, when U.S. President William McKinley was shot and subsequently died, wheat prices rose from the 60s to over 70 cents per bushel. In the years that followed, wheat prices reached \$1.00 per bushel which led farmers to plow up millions of acres to plant wheat. In 1917, when the U.S. entered World War I, wheat prices soared to over \$2.00 per bushel. With the higher prices, production grew, leading to surpluses that (with the exception of World War II) lasted for most of the 50-year period that followed, leading into the 1970s when surpluses were exported.

Regulation of exchange trading activities prior to 1922 was solely a self-policing function. However, in 1922, Congress passed the Grain Futures Act which brought the first presence of government regulation to the industry. That presence would increase in the late 1920s and early 1930s as the government attempted to force the stabilization of agricultural commodities prices; an act tantamount to price fixing. Needless to say, that did not sit well with exchange members, whose very existence was dependent on free market policy and who argued that the government was interfering with the market economics of supply and demand. The Commodity Exchange Act of 1936 created the Commodity Exchange Authority which operated as sub-agency of the U.S. Department of Agriculture (USDA). The Authority was given jurisdiction over various agricultural contracts and set up procedures for pre-approving proposed exchange agricultural futures contracts and changes to exchange rules and regulations. Finally in 1974, an independent government agency

was established with jurisdiction over all futures and options markets, the Commodity Futures Trading Commission. The CFTC continues to regulate the industry today.

In late 1923, construction began on the third Board of Trade building at 10th & Wyandotte Streets. Upon completion at the end of 1924, it was the largest grain exchange building in existence. In addition to its large trading hall, the 14-story structure boasted 800 rooms. The construction cost was pegged at \$1.5 million; more than double that of its predecessor. It would remain the home of the Board of Trade for 40 years. The building at 10th & Wyandotte remains today and is being converted into residential lofts.

Probably one of the most ill-timed business ventures in exchange history began in June of 1929, when a stock exchange opened for purposes of trading local stocks. It would only take about 4 ½ months before they would begin to fully appreciate the flaw of their market timing as the stock market crash of 1929 ensued. The local stock market flagged along for just a few years following the crash, but was ultimately disbanded.

Grain storage in Kansas City was non-existent in 1870. But the explosion of grain production in the late 1800s and early 1900s necessitated large-scale grain storage facilities. By 1910, there were 35 grain elevators with a total storage capacity of 11 million bushels. By 1923, total capacity had increased to over 31 million bushels. Despite the depression, Kansas City continued to expand storage capacity, and in 1931 alone increased from 46 million to over 61 million bushels, surpassing Chicago to become second only to Minneapolis in total storage capacity. The Santa Fe Elevator alone had a capacity of 10 million bushels and held the distinction at the time of being the biggest in the country. Many of you may recall seeing it as you drove along Interstate 635 at about Kansas Avenue. It remained until the mid-1990s when it was torn down to expand the Santa Fe rail yard.

The attack on Pearl Harbor on December 7, 1941, sent wheat prices the next day up the maximum 10¢ daily limit. It was believed that the war would be of long duration, that many agricultural workers would join the military, and that the needs of the military would be great. The years to follow would prove all of these market sentiments true.

The summer of 1945 began what would become a recurring event over the next few years. There was a surplus of grain and a shortage of both boxcars to transport it and elevators to store it. Not until the post-war economic recovery and the Marshall Plan, which involved the exportation of foodstuffs to Europe, did the grain industry receive the boost it needed.

Peace did not last long however, and grain prices surged once again at the outbreak of the Korean War in June, 1950. But the war zone faced by the Kansas City grain industry occurred thirteen months later, ironically on Friday the 13th of July, 1951, when the Kaw River flooded the entire river bottoms area. Several grain elevators were withdrawn from being able to deliver on futures contracts due to the heavy damage they sustained. As a result, the local cash wheat trade was virtually paralyzed. To give you some idea of the extent of the flooding, Jay B. Dillingham, the president of the Livestock Exchange, ordered the evacuation of the Livestock Exchange building at 1600 Genessee. He remained until 9:00 that night when he left by motorboat—from the third floor!

Turmoil returned to the Board of Trade in 1964, this time not in the form of a natural disaster, but rather over their lease on the building at 10th & Wyandotte that had been home to the Board of Trade for 40 years, which was scheduled to expire on December 31, 1964. Negotiations with the building owner (The Bruening Company) over an extension of the lease came to an impasse. The Board of Trade announced plans to move to a new building at 4800 Main Street that would be jointly owned with the J.C. Nichols Company. This caused the Bruening Company to issue an ultimatum, either sign a lease extension until July, 1967, or be out by the end of the year. This presented the exchange with a serious problem since the new building would not be completed until the spring of 1966.

To the rescue came Pat Uhlmann, president of Standard Milling Company, who graciously offered to lease the exchange the ground floor of their building for just \$1 per square foot per year until the new building was completed. So 221 West 10th Street served as exchange headquarters for 16 months until the new building was completed on May 1, 1966. The exchange opened for business the following day and remains at 48th & Main Streets today, 40 years later.

At the time constructed, the building was touted as a state-of-the-art facility. However, some firms on the floor continued to interact with their building office from the trading floor by way of pneumatic tubes. These pneumatic tubes were used on more than one occasion for practical jokes. The grain samples displayed on the trading floor attracted mice. These live mice were sometimes caught and transported to an unsuspecting pneumatic tube recipient who was in for a real surprise. Throughout the history of the exchange, dark humor and practical jokes have provided welcome relief during times of extreme market stress and helped pass the time during slow market periods. Whether lighting a newspaper on fire while being read, pouring grain into the gaps in the back of shoes, a crank telephone call, or just a witty quip, no one was spared their turn at the receiving end of the amusement.

The summer of 1972 was a guessing game of Russian grain purchases. In July, President Nixon announced that the Soviet Union would purchase \$750 million worth of grain over the next three years. Several Board of Trade member firms were making large sales to the Russians cloaked in secrecy. The impact of these sales on the market was significant. The price of wheat rose from roughly \$1.50 to \$2.25 in just two months. Morton Sosland, the editor of *Milling & Baking News*, received a series of telephone calls from a man claiming to be with the *Financial Times* in London who conveyed details of the Russian grain purchases in advance of their being made public. After a time, the accuracy of the information afforded *Milling & Baking News* the confidence to report these advance notices in their publication. It was later confirmed that the caller was not with the *Financial Times*. To this date, the true identity of the caller remains a mystery.

The 1970s saw the introduction of financial futures contracts on the Chicago markets. Currencies and interest rate futures contracts on government-backed mortgages and treasuries began to take hold. However, in the late 1970s a group of members at our exchange began developing a new product that would prove to be one of the most innovative financial products ever traded. The concept was a futures contract traded on an index of stocks, which in February of 1982 resulted in the KCBT launching the world's first stock index futures contract on the Value Line stock index. For the first time, investors and institutions were provided a means of hedging against adverse stock market movements as an alternative to selling the individual shares. If copying is the most sincere form of flattery, we have been well flattered by the proliferation of stock index contracts world-wide. So while the title of this lecture might imply that the development of this innovative financial contract was a natural evolution of the futures markets, we like to think of it as "intelligent design."

Something that in hindsight seems remarkable when you consider how far technology has come in recent years, chalk boards were used to display price changes on the floor of the exchange until 1981, when the first electronic dot boards were installed. The increased volume of futures trade was the main reason for changing to the electronic board, which cost \$400,000. Today the old chalk boards still hang on the wall behind our electronic display boards.

In 1984, the government lifted its ban on options contracts and the exchanges began offering options on futures contracts. An option is a contract that gives the buyer the right, but not the obligation to buy futures (in the case of call options) or sell futures (in the case of put options) at a particular strike price, meaning price interval. The premium paid for the option is the most that can be lost on the contract. Whether the option is thereafter exercised into a futures contract at the strike price is solely the decision of the option buyer. Since 1984, options contracts have become a critical adjunct to futures contracts in providing flexibility in managing price risk.

During the remainder of the 1980s, the exchange weathered two significant events that impacted our markets. First, the Chernobyl nuclear reactor disaster of 1986 that briefly sent wheat futures prices soaring. Second, the stock market crash of 1987 in which the market spiraled downward, losing 20 percent of its value in one day. For quite some time thereafter, stock index futures suffered setbacks in volume as the result and the Value Line contract was no exception.

With the evolution of technology in the securities and commodities industries, the exchange in the mid 1990s began looking at electronic trading systems for purposes of shifting the Value Line contract from floor to screen and also to provide after-hours access to our wheat market. The problem we faced at that time was the tremendous costs involved with either developing technology internally or licensing a technology provider's system. We had to make sure that the technology deployed by the exchange had good industry acceptance or connectivity in order to maximize participation. In addition, we desired contract terms that would allow us to offer the technology without running in the red or passing the costs on to our members in the form of increased fees or assessments. As we moved into the late 1990s there was a proliferation of dot.com companies demonstrating their technology to us, but we were apprehensive both because of their lack of industry acceptance or use and their capitalization relative to their monthly burn rates. I can't count how many times we were told that they would escrow the code so that we would have access to it in the event they went out of business.

The dot.com bust a few years ago eliminated most of these "fly by night" providers and made clearer the handful of legitimate global technology suppliers. From our years of study, we knew that the best fit for our wheat contract would be the platform used by the Chicago Board of Trade because of the similarity of our grain user base and also because of the spread trade between our wheat contracts. As luck would have it, when the CBOT changed technology providers at the beginning of 2004, it opened the door for us to have our products hosted on their platform at a reasonable cost, which we did beginning in December, 2004.

More importantly, it provided us with an insurance policy for the future, meaning that we had a platform for trading wheat electronically during regular market hours if and when that choice of access was required in response to industry demands or competitive threats. During 2005, electronic trading volume steadily increased. We considered the volume a success given the intended purpose. Even so, it amounted to less than one percent of our annual trading volume.

The year 2005 was one of trading records for the exchange. Total exchange volume for the year came within 46,500 contracts (roughly 3 day's volume) of reaching 4,000,000 contracts, eclipsing our previous record year of 2002 by 17 percent. Trade in wheat futures alone was 3.7 million contracts, more than double the 1.5 million contracts traded in 1994. Wheat futures volume in recent years has been on a steady increase, setting annual trading volume records in 10 of the last 12 years. The year 2001, which was one of the two years in which we did not break a record, was on pace to be and likely would have been a record year had it not been for the tragic events of September 11, 2001.

Monthly volume records were also achieved last year. February set a new volume record for any month in history, only to be surpassed by November which stood as our best month ever at over 472,000 contracts traded until February of this year when we traded over 500,000.

A new daily trading volume record was set on February 22, 2005, when we traded 35,000 contracts (or 175,000,000 bushels of wheat). This record was surpassed twice in February of this year when we traded over 36,000 and 37,000 contracts respectively.

Another record established during 2005 was open interest, meaning the number of open and outstanding contracts in all trading months. The prior record of 91,000 contracts was set in June of 2001. The first half of 2005, we were carrying open about 70,000 contracts. But after harvest, our open interest began to steadily increase, breaking the existing 91,000 contract record on August

4, surpassing the 100,000 contract mark on September 15, and peaking on November 8 at 134,000. This year we have exceeded 155,000 open contracts.

The reason for the increase this past year of both volume and open interest, I attribute to three things:

1. Liquidity—the local traders in our wheat futures market are providing the deepest and tightest markets in the history of the exchange;
2. There has been a marked increase in global commercial wheat futures hedging activity;
3. The most significant impact has come from fund participation in our market, both index funds and hedge funds. Index funds are funds that buy a cross-section of commodities in order to profit from an increase in the price of these commodities. They are usually tied to or benchmarked against a standard commodity index like Goldman Sachs, Rogers, CRB, etc. Hedge funds I will define as actively managed funds that trade off of technical signals and thus can either be long or short commodities markets in order to try to maximize investor return. While funds have been in commodities markets for years, it has only been in recent years with lackluster equity market returns that we have seen a significant increase in commodities fund participation.

Yet another record realized last year was membership prices. During my earlier years at the exchange, membership prices were rather stagnant and traded at a fraction of book value. In 1993, we eliminated annual dues and member exchange fees and membership prices began to rise. In 1999, the exchange (being a Delaware for-profit corporation since 1973) declared and paid its first shareholder dividend based on a fraction of the previous year's consolidated earnings. The clearing corporation eliminated member clearing fees in the early 2000s. In 2004 the exchange began significant cost cutting and revenue generating efforts. One example of these efforts was contracting with the Winnipeg Commodity Exchange (Canada's only agricultural exchange) to provide clearing processing services. For the first time, the exchange was outsourcing its expertise and systems capacity. This monumental agreement significantly increased clearing revenues. Also in 2004, the board determined that the amount of retained capital to guarantee trades was sufficient at present and accordingly began to pay out most of the prior year's earnings to shareholders in the form of dividends. The result on membership values was significant.

Memberships were trading at about \$37,000 in 1992, when book value was about \$108,000. Prices started to increase in 1993 and steadily rose to record levels. In 2005, membership prices not only reach a record high of \$175,000, but for the first time traded in excess of book value of about \$154,000. They have since traded to \$192,000 so far this year.

The final record worth mentioning is the record dividend declared and paid at the beginning of this year based on 2005 earnings. It was \$7,000 per share, representing a 4 percent return using the last 2005 membership sales price of \$175,000. It was the 8th consecutive year that we have paid a dividend to our shareholders.

So you can see from the trading records established both last year and this year that the KCBT is flourishing during a time rife with industry change. The larger exchanges are utilizing their electronic trading capabilities to promote point and click market access. This has proven particularly successful with financial contracts, where the underlying cash markets are traded electronically, namely equities and government securities. Further, many of these larger exchanges have already or are in the process of becoming publicly traded companies. The inherent result of becoming a publicly traded company is that decisions are made based largely on maximizing share price. With so much money invested in electronic trading wherewithal, this leads to the encouragement of electronic systems use over floor-based, open-outcry execution in order to cut costs by supporting only one type of trading venue.

Up to now, agricultural commodities have been shielded from the threats of electronic trading, because electronic access was only offered after hours as an adjunct to floor trading. However, shareholder pressure is forcing the Chicago Board of Trade to consider offering electronic access

during floor trading hours, what is referred to as side-by-side trading. CBOT Directors will begin discussing this matter at their meeting next week. Many feel that the discussion will focus not on whether they will offer side-by-side trading, but rather when and in what form.

The question this poses is how will this affect the Chicago and Kansas City grain markets? While certainty is obviously absent, we do have some limited industry experience that might provide some insight as to the possible outcome.

In an agricultural market with a deep, liquid floor population, open outcry might well continue to be the venue of choice. The Chicago Mercantile Exchange livestock complex is an example of a side-by-side market where over 98 percent of the trade is still conducted on the trading floor.

Contrast this with an agricultural market with limited floor liquidity like the Winnipeg Commodity Exchange. They made the bold decision in late 2004 to eliminate the trading floor and embrace electronic market access. This decision was probably the correct one for a market where few floor traders resulted in the inability to provide the depth and liquidity necessary to both support the growth of their existing products and offer any new contracts to the marketplace. Initially, the elimination of the trading floor resulted in lower trading volumes. As the year 2005 progressed, the exchange was able to contract with a few firms to act as liquidity providers in order to facilitate the continuous market needs of commercial traders. By the end of 2005, the exchange recovered the earlier lost trading volumes and set a trading volume record for the month of December.

So what does the future hold for the Kansas City Board of Trade? If agricultural commodity industry precedent is any indication, it is likely that our exchange will remain an open outcry market for years to come. Why is this, given the transition of financial markets to electronic trading?

It might very well be the dependence of the agricultural markets on the tremendous amount of information that is exchanged in the open outcry arena. Customers and intermediaries can ascertain from their floor representatives market factors influencing price direction, the types of players in the market, and the size of their trades, all useful information in determining the timing and extent of contemplated market transactions. The electronic trading world of anonymity is devoid of such information, providing only price transparency and leaving market participants to glean what information they can from select contacts rather than the collective marketplace.

This is not to say that electronic access has no place during floor trading hours. It might very well be that providing electronic access will bring new market participants into the agricultural markets not previously represented, namely the point and click traders. As an example, there are retail and proprietary traders who only trade electronically and desire to expand their trading operations into other product classes, one of which is agricultural commodities. These new electronic customers, coupled with those who would trade both venues in order to capture price disparities between the two (called arbitragers or spreaders), may prove a compliment to the existing system, resulting in the peaceful coexistence of the side-by-side markets and continued growth of the exchange well into the future.

I would like to thank all of you for your kind attention this afternoon and a special thanks to Mr. David Boutros and the good people at the Western Historical Manuscript Collection for this opportunity. I will be happy to answer any questions you have at this time.

Questions and Answers

Question: I'm Jason Clemons (sp?). I worked at the Board in the late 1980s on the value line pit. You mentioned that historically there was a trading limit. At some point you talked about losses being 10 percent and trading suspended at that time. Are there still bans within which trading is limited, or are there circuit breakers currently?

Borchardt: That is exactly what they call them. That is a great question. In wheat, you have daily price limits that are established for the contract and wheat is 30 cents per bushel per day, which means that today if wheat is \$4.50 a bushel then tomorrow the price can get no higher than \$4.80 and no lower than \$4.20. But in the case of value line, like the gentleman was asking about, it is a stock index futures contract. We coordinate with the other stock index contracts around the country as well as the equities markets and we implement "circuit breakers." This are not limits, so to speak, but rather pauses in order for the marketplace to better digest the information that is causing a price correction—to gather their thoughts and come back in without the chaos and volatility that you have when a market has a continual slide. Right now the demands are still based on the Dow Jones Index. They have their 10 percent and 20 percent limits. What we do with the value line contract is take 10 percent of its contract value, or the index value, and you can go no lower than 10 percent for the first pause, and then 20 percent, which is the daily maximum. This is a big amount—it is like 240 index points. Ironically, there is no upside limit because no one in Washington D.C. and the House of Representatives and the Senate receives any bad telephone calls when the market goes up.

Question: Has it always been the case, since the value line was begun?

Borchardt: No, back in the early 1980s, value line actually started out with a 5 point limit, which is by today's standards very narrow. But you have to remember that back then the index value was only about 100 to 120 points. So 5 points on 120 is a pretty good move. Today the index value is closer to 2,000 points, so 5 points would not be adequate. It's changed throughout the years. I think we later increased it to 10 points and after that instituted the "circuit breaker" structure." We are co-coordinating this with the Chicago Mercantile Exchange, the Chicago Board of Trade, and the New York Stock Exchange, so we are kind of the tail on the dog. We listen to what they are coming up with and we try to do the same. It's changed quite a few times, but right now the 10 and 20 percent bands have been in place for about 8 years now.

Question: You mentioned over and over the computer technological competition to the side by side of a floor trader. What is the future for the floor trader? You did say they had the current information and you couldn't talk to the computer, but is there other...is it going out of style? How many floor traders do you have now compared to its peak?

Borchardt: Actually I think we have more floor traders in the pit now than we ever had. We have probably about 100 traders, both locals and brokers in the pit. You are asking what their future is—we don't know because we are waiting for the Chicago Board of Trade to make a decision on side by side trading which they likely will, and we will likely follow suit, so we'll offer it side by

side with our open outcry trading. Personally, I truly believe that the liquidity will still rest in the trading pits during open outcry, but what you may see is that some of the small orders, that are more of a nuisance to the pit than they are a help, may bleed over to the electronic system to be executed. You'll have retail customers that may come in, the "point and click" traders, you'll have some proprietary, arbitrage houses who like to trade electronically who will come into the electronic side. But the liquidity will still reside in the pit. When I first came to the exchange back in 1982, you'd go down to the floor, and if someone was trading 10 or 20 contracts, that was a pretty good size. And 50 contracts was huge! Now everybody in the pit will trade 50, and most of them will trade 100, and there is a core group of people down there who will trade 300 to 500 contracts at a time. They're the true liquidity providers, the depth that's needed for the big commercials and for the financial monies that are flowing into the exchange. Since those people are going to stay in the pit, they're not going to go over and make their markets on the electronic system. I would couple that with the information that's so crucial—the information exchanged on the trading floor is so crucial because the local co-ops, the farmers, the terminal elevators, they're so accustomed to this information flow... "Why is the market up 6 cents today? Who is in there buying? How much are they doing? Who are the other players?" There's a lot of information you won't be able to get on a computer. It's not going to tell you why the market is up 6 cents; it'll just show you where you can buy it or where you can sell it if you want to click. So, in my opinion, the pie is going to get bigger. I think we'll bring in new participants on the electronic side. I think certainly there will be people that will trade between the two, because as the prices get out of whack between the two there's opportunity there to trade and to get them back in line—the spreaders and arbitragers. I see the pie getting bigger, but I don't see any time soon that the liquidity and the larger orders going over to the electronic system. Mr. Gibson, if you'd like to offer your opinion as a trader on the floor...

Gibson: Several years ago my son came to visit the exchange; he was back from college and he hadn't been there for a few years. I was explaining to him what was going on. He started giggling and said, "there must be a better way of doing this!" I think that probably it will be electronic, primarily. But, we do believe in the free market there. We're going to put both systems up and see what works. I agree with Jeff, I think initially the "open outcry" system will probably be where most of the orders go. It's interesting in the exchanges where they trade a high volume of screen-based, or electronic trading in the futures contract, still on those contracts where they offer open outcry options trading the vast majority of it is done open outcry, and that is because in options contracts the options are so complicated and the strategies are so complicated that it takes a human to do it. The orders come to the pit and somebody has to respond to that, and it just doesn't seem to work that well right now electronically. Are agriculture future contracts traded more than one month actively all the time? Most of these electronic contracts trade the front month and it's just basically all in one month. So, are agricultural futures contracts, are they closer to the options or are they closer to the other? We're going to find out. I think it's 50-50.

Question: As a long-time Kansas City resident, I appreciate the Board very much for what it has brought to us. If I have a \$1,000, as kind of Joe Average investor, and would like to invest that \$1,000 into some kind of entity that relates to the operation of the Board, what would I tell my broker? Is there anything available to the average investor that relates to the day to day operation of the Board of Trade?

Borchardt: You could buy a share in the Board of Trade for investment purposes, but the offer right now is \$200,000, not \$1,000...

Reply: I was thinking something a little bit less than \$200,000!

Borchardt: I can't really, off the top of my head, think of anything for you to invest in our exchange specifically, other than purchasing a membership. We have 192 class "A" memberships.

They're not only the memberships that give you the right to trade on the floor, and to trade for member fee prices on the exchange, but they're also equity shares in the exchange, common stockholders. The only avenue for gaining the benefit of the dividend distributions would be to come up with \$200,000.

Question: Maybe I should ask then, can I invest in the futures market as an average investor?

Borchardt: If you're talking about the overall futures market, sure you can. There are venues for doing this. You can invest in individual commodity futures or options contracts or your money can be pooled with others and invested in a cross-section of commodities contracts. Even retail investors can get involved with commodity pools. I would want to evaluate their track record and compare the returns to other types of investments. You want to be careful, commodities trading is risky and not suitable for all investors. I feel compelled to offer that disclaimer.

Question: Is the portion of trading that's done by hedge funds in the wheat market relatively stable, or is it increasing significantly?

Borchardt: Actually one of the largest drivers of our increased volume in open interest over the last year or so has been the fund participation. Right now, as an example, we have about 130,000 open contracts; long contracts and short contracts both together. Of that about 44-45,000 contracts—about a third of the long side open interest, or about one-sixth of our total open interest. So, they represent a significant chunk. They used to be in past years probably 10,000 of our open interest, when we had 70-80,000 contracts open. Now they're 45,000. They've been as high as 60,000 at one point, close to that, so yes, a very significant portion.

Thank you.

Previous Charles N. Kimball Lectures

The Charles N. Kimball lectures may be found on the Western Historical Manuscript Collection-Kansas City web site at www.umkc.edu/WHMCKC/. Also located there is the full text of the Midwest Research Institute's *Midcontinent Perspectives Lecture* series from 1974 to 1993.

- April 20, 1995 - Robert A. Kipp, *Crown Center: An Emerging Vision for Urban Development*
April 22, 1996 - Albert P. Mauro, *The Realization of a Dream: The Development of Hospital Hill*
April 21, 1997 - Dr. Robert H. Freilich, *To Sprawl or Not to Sprawl: A National Perspective for Kansas City*
April 21, 1998 - Mr. James M. Kemper, *Community Banks and Their Role in Civic Planning*
October 21, 1998 - Mr. Donald H. Chisholm, *The Philanthropic Philosophy of Arthur Mag*
April 21, 1999 - Ms. Vicki Noteis, *Visions of a City: Kansas City's Planning Legacy*
October 21, 1999 - Mr. John A. Dillingham, *It's All About Eating: Kansas City's History and Opportunity*
April 24, 2000 - Mr. Gerald W. Gorman, *Ilus Davis: Exemplar of "The Greatest Generation"*
October 23, 2000 - Rabbi Michael Zedek, *One Man Views the Heartland: A Critical Study of Character and Community*
April 23, 2001- Dr. Kala M. Stroup, *Kansas City and Higher Education: A Partnership for Prosperous Citizens and Cities*
October 22, 2001 - Mr. Robert R. Wheeler, *A Review of Education in 2001: And a Look Forward*
April 30, 2002 - Dr. Charles J. Carlsen and Dr. Wayne E. Giles, *The Peoples College: Community Colleges in Kansas City*
October 22, 2002 - Dr. Carol A. Mickett, *History Speaks: Visions and Voices of Kansas City's Past*
April 21, 2003 - Mr. Andres M. Dominguez, *A Latino Presence in the Heartland: Challenges and Opportunities*
October 27, 2003 - Mr. Landon H. Rowland, *Arthur E. Stilwell: The Legacy of an Entrepreneur*
April 21, 2004 - Mr. Carl J. Schramm, *Kansas City: Its Past and Future as a Cradle for Entrepreneurs*
October 20, 2004 - Mr. John Madgett, *"Old Miserable:" A History of the Missouri River in Kansas City*
May 2, 2005 - Dr. Elson S. Floyd, *UMKC: A Great University for a Great City*
October 20, 2005 - Ms. Carol Marinovich, *Consolidation: A Green Flag, Not a Checkered Flag*

WHMC-KC

The Western Historical Manuscript Collection, a joint collection of the University of Missouri and the State Historical Society of Missouri, contains primary source materials for research and welcomes use by scholars, students and the public. Our network allows for the full resources of the Collection—the holdings of all four branches in Columbia, Kansas City, Rolla, and St. Louis—to be available to researchers throughout the state.

The Kansas City office opened in 1980 with a mission to collect, preserve, and make available for research, documents relating to the history and culture of Kansas City, western Missouri, and the Midwest. Since that time, approximately 12,000 cubic feet of documents have been acquired. The Collection owns the papers of important **civic and political leaders** such as Charles Kimball, Ilus Davis, Charles Wheeler, Oscar Nelson, H.P. Wright, Lou Holland, William Volker, and L. Perry Cookingham; the records of **businesses and industries** such as the Kansas City Board of Trade, the Kansas City Stock Exchange, and the J.C. Nichols Company; a very large collection of materials relating to **Kansas City's built environment**, including the records of the architectural and planning firms of Hoit, Price and Barnes, Wight and Wight, and Hare and Hare, among others; the records of **not-for-profit civic and social organizations**, including the Chamber of Commerce of Greater Kansas City, the Kansas City PTA, the Woman's City Club, and the National Council of Jewish Women; the papers of **scholars and historians** who have researched and written on Kansas City's history, including materials from the Kansas City History Project, and the papers of Bill Goff, Lyle Kennedy, A. Theodore Brown, and James Anderson; and a variety of other collections dealing with such diverse topics as labor unions, the Battle of Westport, music and cultural arts in Kansas City, neighborhood development, civil rights, Kansas City school desegregation, and the overland trails.

Questions about the use of or donations to the Collection should be directed to David Boutros, Associate Director of the Kansas City office. (816) 235-1543; WHMCKC@umkc.edu.

www.umkc.edu/WHMCKC/

Cover photo: May 2, 1966—opening day on the floor of the Kansas City Board of Trade “Pit”, in the new building at 4800 Main Street. *Board of Trade of Kansas City Records (KC0063), WHMC-KC.*

Western Historical Manuscript Collection-Kansas City
302 Newcomb Hall
University of Missouri-Kansas City
5100 Rockhill Road
Kansas City, Missouri 64110-2499