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before the

Agricultural Advisory Committee
Commodity Futures Trading Commission

July 19, 2000

Commissioner Spears and members of the Advisory Committee, the National Grain and Feed Association appreciates the opportunity to present its views on CFTC's New Regulatory Framework. I am just returning from a meeting of our Risk Management Committee where we discussed this proposal at great length. Our committee is comprised of 15 persons from mostly country elevators and large commercial hedgers, but also includes several representatives from the brokerage community (both IBs and FCMs), and even an electronic exchange. This group is a strong cross-section of the commercial sector and obviously well qualified to offer input on this subject.

In concept, the CFTC proposal appears to be sound. It is designed in a way that recognizes the wide range of risk management products and gives the regulated community the right to make choices on preferred levels of regulation from a business perspective.

We commend the CFTC on this market-responsive regulatory initiative, but we would raise two additional issues that need additional attention by the CFTC, Congress or both:

1. Should the CFTC permit regulatory flexibility for agricultural markets? What will happen to the exchange-traded agricultural contracts if current regulations remain in place while all other markets are granted substantial relief?
2. Should the CFTC be addressing the need for greater "legal certainty" for off-exchange forward agricultural contracts, similar to what CFTC has proposed for over-the-counter instruments?

Concerning the issue of regulatory flexibility: While the CFTC and its staff are credited with the specifics of this deregulatory proposal, the motivation for this rulemaking came largely from the President's Working Group on Financial Markets. Because of this group's focus on financial markets, it made no specific recommendations on the ag contracts. However, the same market forces creating new competition for regulated financial markets are present in agricultural markets, and we believe they should be addressed simultaneously. Failure to do so entails significant risks: 1) If transaction costs on agricultural futures exchanges stay at current levels while costs in all other markets are driven lower, institutional investors will avoid the ag markets; these investment funds are an important source of liquidity, particularly in the deferred months (beyond one year). A decline in liquidity in deferred months could reduce the bids for those months and impede the viability of multi-year contracts; 2) Commercial commodity interests will seek lower cost alternatives to hedging products, including: electronic exchanges, private contracting, agricultural swaps, or vertical integration (accomplished through ownership, joint ventures or contracting), thereby also reducing the participation in regulated futures exchanges; and 3) A long-term downward trend in trading in central, open futures market over time could threaten price transparency, an important protection for everyone from farmers to consumers.

NGFA plans to support a change in the proposed regulations that would grant the exchanges the flexibility to have agricultural contracts regulated as "derivative transaction facilities (DTFs)." We believe that with proper exchange self-regulation and CFTC oversight these markets can properly handle this new level of responsibility and the benefits would be broad. Customers of today's futures markets are protected most by the controls and financial strength of the exchange members and clearing corporation. We also plan to ask that the agricultural markets not be permitted to be bifurcated into more than one regulatory level based upon type of trader. The flexibility provided by the CFTC proposal for DTFs allows a single facility to serve all classes of market participants.

Concerning the need of the market for greater legal certainty for cash forward contracts: The President's Working Group urged greater legal certainty in the treatment of OTC instruments, and the CFTC has proposed regulations to achieve this. However, there is still a need for greater legal clarity in off-

exchange agricultural contracting too. In the grains sector, cash contracting has been, and continues to be, the predominant form of price risk management used by producers. With the growing importance of specialty crops, crop segregation (biotech, end-use traits, etc.), and the need for greater market coordination to meet customer demand, cash contracting will likely grow in importance. Thus, it is imperative that the regulatory and statutory lines be clearly established as to what is permitted in contracting, what is subject to CFTC jurisdiction, and what is not.

Some examples of legal uncertainty in cash contracting: A farmer uses a cash forward contract to sell his anticipated crop at planting time, but fails to make a crop with a drought. Consider the following:

- Does CFTC consider it legal for the farmer and elevator to cash settle the contract?
- What if the farmer only loses ½ of his crop, but needs the production to feed livestock on the farm; does CFTC consider it legal to cash settle the contract?
- What if the farmer actually grows the crop, but discovers a much more attractive market at harvest; how would the CFTC view the farmer and the elevator mutually agreeing to a cash settlement of the original contract?
- In the case of total crop failure, does CFTC consider it legal to “roll” the contract into the following year for delivery? If so, how many rolls are ok?
- Does CFTC consider it legal for the elevator to specify an administrative fee of “X” cents per bushel in the event of crop failure and the parties mutually choose to cash settle a contract? Would such a fee ever be considered a premium, and therefore be classified by CFTC as an illegal option?

Many other examples could be offered, but the important point is that such legal uncertainty creates litigation risk for commercial companies and reduces the offering of risk management tools made available to farmers and others. This issue is a serious impediment to new product development.

One strategy for addressing a portion of the legal uncertainty issue is to amend legislation as follows:

FUTURE DELIVERY---The term future delivery does not include any sale of any cash commodity for deferred shipment or delivery between persons who have the capacity, directly or indirectly, to make or take delivery through any bona fide means of conveying legal ownership.

This change would not solve all legal clarity issues, but would make substantial progress in our viewpoint.

Other related issues: In pursuing reasonable deregulation of regulated markets and greater legal clarity for cash contracts, we would recommend the CFTC consider: 1) Establishing levels of regulation more consistent with the level of risk (example: The type of agricultural trade options allowed under the regulated pilot program entail less risk to the farmer than many of the statutorily exempt cash contracts, but are treated much differently from a regulatory perspective); 2) Correct inconsistencies in regulation (example: The level of net worth required to be exempt from CFTC regulations on agricultural swaps is \$1 million. The exemption level for the narrow range of agricultural trade options permitted in the pilot program is \$10 million.); and 3) Permit the agricultural marketplace to have at least some of the regulatory freedom given to other markets in order that commercial participants can develop improved risk management tools to better serve the needs of farmers and others. Exemption levels (such as that for swaps) contained in regulation and in proposed legislation are fairly consistent, but rely heavily on net worth or asset levels as the determinant of market sophistication. Net worth or asset levels are appropriate when gauging financial performance, but are clearly an imperfect measure of sophistication by market participants. The Senate bill provides that the Commission can consider “any (other) person that the Commission determines to be eligible in light of the financial or other qualifications of the person.”(emphasis added). We would recommend CFTC consider other measures of adequate sophistication in an effort to be less discriminatory toward smaller firms or qualified individuals who happen to have lower financial resources.

In conclusion, it appears to us that virtually the entire futures and options industry is about to receive substantial regulatory relief, with the exception of the enumerated agricultural commodities. If this is the outcome, we believe it is a critical mistake.