01-03
NC1

COMMODITY FUTURES TRADING COMMISSION

AGRICULTURAL ADVISORY COMMITTEE

29th MEETING

Wednesday, March 28, 2001

1:40 p.m.

Three Lafayette Centre
Suite 1000
1155 21st Street, N.W.
Washington, D.C. 20581

MILLER REPORTING CO., INC.
735 - 8TH STREET, S.E.
WASHINGTON, D.C. 20003
(202) 546-6666

P A R T I C I P A N T S

MEMBERS PRESENT:

David D. Spears, Commissioner, Committee Chair

Trenna R. Grabowski, American Agri-Women
John Blanchfield, American Bankers Association
Neal P. Gillen, American Cotton Shippers Association
Bob Metz, American Soybean Association
Richard Gupton, Independent Community Bankers
Brian Dierlam, National Cattlemen's Beef Association
William P. Roenigk, National Chicken Council
Susan Keith, National Corn Growers Association
William A. Dodds, National Grain and Feed Association
Elizabeth Haws, National Grain Trade Council
Robert L. White, National Grange
Gary C. Martin, North American Export Grain Association
Phyllis Honor, USDA, Risk Management Agency

ALSO PRESENT:

James E. Newsome, Acting Chairman CFTC
Thomas J. Erickson, Commissioner
Melinda Schramm, National Introducing Brokers Association
Jack Dougherty, Kent Feeds, Inc.
David Lehman, Chicago Board of Trade

C O N T E N T S

P R O C E E D I N G S

CHAIRMAN SPEARS: Good afternoon. It's time to get started. We're missing a few members that are supposed to be here. I'm sure they'll come in in a few minutes. I want to start by first thanking all of you for attending this 29th Meeting of the Commission's Agricultural Advisory Committee. I recognize that participating in these meetings means a significant commitment of time, effort, and expense on all your parts and for all concerned.

We certainly want you to be aware that the commissioners and the staff of the CFTC truly appreciate your contributions to the Commission's decision-making process. Today's agenda consists of topics about which the Commission is very interested in getting input from the committee members.

In addition, I have included other topics that are more for informational purposes for the committee members themselves.

The first topic today addresses the Commodity Futures Modernization Act, the CFMA, of 2000, which Congress passed at the close of its last session. The CFMA represents the most significant change in this country's futures regulatory system since the 1974 legislation that created the CFTC.

On March 9, the commission published the first of several rulemaking proposals necessary to implement the CFMA. Our first speaker today, Paul Architzel, Chief Counsel of the Division of Economic Analysis, has been the commission's point man in developing the new regulatory structure mandated by the CFMA.

Paul will brief us on the provisions of the CFMA and the proposed rules that are of particular significance to the agricultural community.

As I noted, these rules were published on March 9 with a 30 day comment period. Therefore, we are within the 30 day comment period which expires April 9, and the transcript of this portion of the meeting will be used as part of the official record in regard to the comment period.

Following that, Ron Hobson, also a member of Economic Analysis staff, will review a particular CFMA provision aimed specifically at agriculture entitled "Special Procedures to Facilitate and Encourage Bona Fide Hedging by Ag Producers."

Following that, we will have a topic entitled "Review of Ag Trade Options and Other Risk Management Alternatives in Light of the CFMA and Proposed Regulatory Changes." During that time period, we will have a panel of speakers who will hopefully provoke ideas and debate for an open dialogue among the committee members and the Commission in regard to ag trade options and ag bilateral transactions.

I hope that portion of the meeting will provide significant opportunity for input. As I mentioned, we will have presentations today both for receiving input from the committee members, which will be vitally important to the Commission, as well as presentations that will be utilized for information purposes for the committee members, such as the presentation on the Warehouse Act of 2000 and its implications for agriculture.

In addition, we're fortunate to have USDA's Risk Management Agency here today , and they will provide an update on their activities as well. We'll also have Commission staff reporting on recent developments in electronic trading facilities across the country.

I look forward to a productive meeting today. I'd like to get started by introducing my fellow commissioners and then we'll have introduction of the committee members themselves.

First, I'd like to introduce Acting Chairman Jim Newsome. As you know, Jim is no stranger to this group. He's been part of agriculture for a number of years. So, Jim, any comments you might have.

ACTING CHAIRMAN NEWSOME: Thank you, Chairman Spears, and they will be brief. I wanted to echo Commissioner Spears' welcome to this group. I want to thank him and his staff for the tremendous amount of time and effort that they put into organizing and chairing this most important advisory council at the commission.

Personally I want to thank everyone for sacrificing time away from their businesses and/or offices to be here. We recognize that that is a real sacrifice and we very much appreciate the opportunity to discuss issues of mutual importance to both the commission and to all in the agricultural community.

I think obviously this advisory committee is extremely important, not only to the commission, but also to our authorizing committees. As each of you are totally aware, the only carveout in the new act came from the ag commodity side, and I think that's due to the respect you have from the commission and to the respect that you have from Congress.

I wanted to thank each of you for the visionary approach that you all took in looking at the Commodity Futures Modernization Act and for allowing the flexibility, as Congress drafted that act, and then for also entrusting your faith in the commission to move forward with a flexible approach in the future and to continue discussion over regulatory needs and having the capability of decreasing that regulatory touch if it becomes necessary in the future. I think that's a very important part of the act, and certainly one that will lead to much more discussion as time and technology continue on.

So we very much appreciate you taking time to be here and I know I for one look forward to the discussion today. Thank you, Dave.

CHAIRMAN SPEARS: Thank you, Chairman Newsome. I want to also introduce Commissioner Tom Erickson. Tom, any thoughts or comments you want to add at this point in time?

COMMISSIONER ERICKSON: Thank you very much, Dave. It is a pleasure to be here and I just echo your welcome to everyone who has come today. Agriculture is certainly changing as rapidly as any other sector of the financial economy that we've got responsibilities over, and I look forward very much to your input on issues we're facing. Thank you.

CHAIRMAN SPEARS: Thank you, Tom. The fourth commissioner, Commissioner Barbara Holum, the senior commissioner at the Commission, unfortunately could not be here today. She planned to be here, but she called in this morning with a family emergency, so she sent her apologies, and I know that she's very much interested in input from this group as well. Her staff is here, and they will, I'm sure, provide her with input as to what happened at the meeting.

Let's start then with introductions around the table. As is our tradition, we will have each member introduce himself or herself and the organization they represent. So I'll start to my right with Trenna. Trenna, if you'll start and introduce yourself and the organization you're with. I might note that, as most of you know who have been here before, after you speak, please turn the microphone off. We have a problem, if there are more than two or three mikes on at one time, they don't work.

So after you get done speaking, please just hit the button and turn it off. So, Trenna.

MS. GRABOWSKI: Thank you. I'm Trenna Grabowski with American Agri-Women.

MR. BLANCHFIELD: I'm John Blanchfield with the American Bankers Association.

MR. GILLEN: I'm Neal Gillen, the American Cotton Shippers Association.

MR. METZ: Bob Metz. I represent the American Soybeans Association.

MR. GUPTON: Richard Gupton with Independent Community Bankers.

MR. DIERLAM: My name is Brian Dierlam with the National Cattlemen's Beef Association.

MR. ROENIGK: Good afternoon. I'm Bill Roenigk with the National Chicken Council.

MS. KEITH: Susan Keith with the National Corn Growers Association.

MS. HAWS: Elizabeth Haws with the National Grain Trade Council.

MR. DODDS: Good afternoon. I'm Bill Dodds representing the National Grain and Feed Association.

MS. SCHRAMM: I'm Melinda Schramm with the National Introducing Brokers Association.

MR. DOUGHERTY: I'm Jack Dougherty with Kent Feeds.

MR. WHITE: My name is Robert White and I represent the National Grange.

MR. MARTIN: Gary Martin with North American Export Grain Association.

MS. HONOR: My name is Phyllis Honor and I'm with the U.S. Department of Agriculture's Risk Management Agency.

CHAIRMAN SPEARS: Again, thank you all for being here. I also want to give at this point a special thanks and recognition to my staff who put this meeting together, starting with Debyn Brown, who serves as my administrative assistant. She did most of the leg work putting the meeting together and it would not be possible without her help. And also I'd like to recognize Alan Ott and Don Heitman from my staff who have also been very helpful in the process.

Let's start then with the first item on the agenda, if there are no questions, and that is with Paul

Architzel. As I mentioned earlier, Paul is going to provide an update to the committee regarding the Commodity Futures Modernization Act of 2000, which Congress passed late in the session.

As I noted, we just put out for comment on March 9 the first of several proposed rulemakings in regard to that Act. So with that, Paul, I'll turn it over to you to provide an update to the committee with regard to how the CFMA pertains to agriculture.

MR. ARCHITZEL: Okay. Thank you. It's a pleasure to be here and to brief you on the Commodity Futures Modernization Act, our implementing regulations and how they relate to agriculture.

One of the comments that we heard about the Commodity Exchange Act before the most recent amendment was that it was very complicated and hard to understand, and thank goodness we have this amendment because now it's really very clear.

[Laughter.]

MR. ARCHITZEL: What I would like to do is go through and give you a very brief overview of the act, of the rules that we've proposed to implement the markets part of the market transactions, execution facilities part of our proposal to implement the act, and to highlight how they relate to agriculture.

First of all, let me start with an overview of the CFMA. The purposes for the CFMA were to reduce systemic risk, to provide greater flexibility for trading of futures and options, and that includes making the law more flexible with regard to new technologies, structural changes in the business organization of the exchanges, and to permit stock futures to trade.

Also, to move the commission from a direct to an oversight regulation and to provide legal certainty for OTC instruments.

The new statutory framework was based on the same concepts and structures as recommended to the commission by the commission's task force which I spoke about last year to the Ag Advisory Committee.

The task force had four recommendations, actually five here. One, to use core principles and statements of best practices; to separately address various functions in the futures industry, namely trade execution, intermediation and clearing; that the regulations and the law should reflect the nature of the commodity, the nature of the market participant, and whether or not intermediation was used in executing the transaction and in clearing the transaction; that markets based on their characteristics should be able to choose the regulatory tier in which they want to operate; and that CFTC recognition should be reserved for markets that meet minimum international regulatory standards.

All of these concepts to some degree or another have been incorporated into the CFMA and now are operative in the law governing futures contracts.

The statutory framework itself now as amended by the CMFA is governed by two items, one, the commodity and how susceptible the commodity is to manipulation, and secondly, the participant. Is the participant an institutional trader? Is it a commercial or is it a retail trader?

Based on the commodity and the participant, these two variants, there are various exclusions or exemptions from the act or the trading of OTC derivative instruments and there is tiered regulation for exchange traded instruments, and I'll go into each of these separately.

Let's begin looking at the OTC markets, those that are excluded or exempt from CFTC regulation. The first exclusion is the Treasury Amendment exclusion, and these are for instruments that are based upon foreign currency, government securities, repos, mortgage purchase commitments and other similar instruments.

Now, these instruments are excluded from the act unless they are traded on an organized exchange, they are traded by retail type traders, non-eligible contract participants, or they are traded other than on a principal to principal basis.

In addition, the new act provided that retail traders trading FOREX, it would be legal to trade FOREX through an FCM, a broker dealer or a bank. Otherwise, it is not legal to trade them OTC with regard to retail trading.

Okay. Now there is an exclusion from the commission for bilateral OTC transactions. If it's a financial commodity, if it's a financial futures type commodity, traded by eligible contract participants, it's excluded from the act. If it's a physical commodity or one of the more exotic commodities--and examples would be oil, or an exotic commodity might be broadband--it's excluded from the act if it's traded bilaterally between eligible contract participants and it's subject to individual negotiation.

Now, those physical commodities may also be exempt from the act if they're not subject to individual negotiation, but basically if it's a financial future and it's traded bilaterally or it's a physical commodity, other than agricultural, and it's traded bilaterally, it's excluded from the act.

We also have an exclusion from the act for electronic trading facilities that are trading those kinds of instruments. First of all, if it's a financial future or a financial type commodity, and it's traded principal to principal between eligible contract participants, it's excluded.

If it's a physical commodity like oil or like broadband, and it's traded principal to principal between eligible commercials, it's not excluded from the act. It's exempt from a lot of commission regulation, but it's subject to a number of requirements relating to the potential manipulability of the instruments, and those are the anti-fraud provision, the anti-manipulation provision, of course, a recordkeeping requirement, a price dissemination requirement, and reporting requirements.

So if it's something like oil, it can be traded electronically principal to principal by eligible commercials and it will be subject to those kinds of requirements, but it will not be affirmatively regulated by the commission.

Now that leaves agricultural commodities. Agricultural commodities are a separate category of commodities in this OTC world. The act did not address agricultural commodities, and we're not talking about the enumerated agricultural commodities which are listed in the Commodity Exchange Act from 1936 forward.

This is an undefined term and it says agricultural commodity. So it's broader than the ones we're used to thinking about under the act. It's broader than the list of wheat, oats, et cetera, and it includes the international soft commodities and any other commodity which is agricultural. Again, it's an undefined term.

Now, because it's not mentioned in the act, it comes under our current swaps exemption, and our swaps exemption is found in Part 35 of the Commodity Exchange Act.

So, again, if it's agricultural, it's not exempted or excluded in the act. Instead you have to look to commission regulations. Now, we have in our rules in Part 35 a swaps exemption, and here are the requirements to qualify for it.

It can only be between eligible swap participants. It can't be fungible. It can't be standardized. Creditworthiness has to be material consideration. It can't be entered into on a multilateral transaction execution facility, MTEF or exchange, and it can only be cleared pursuant to permission from the commission subject to a petition.

Finally, it's subject to rules on the agricultural trade options which will be a discussion for later in the meeting.

So this is the existing Part 35. As you can see, it has more requirements than the exclusion provided for financial instruments and more requirements provided for than the exemption for physical instruments that are traded bilaterally.

The issue for future consideration is whether or not the commission's regulation for these OTC bilateral instruments for agricultural commodities, whether Part 35 should be amended to make it look more like the exclusions and/or exemptions for bilateral transactions in the other commodities.

Originally, when we put out our framework as a final rule back in December, and that was withdrawn when the act was amended, when that was enacted, bilateral contracts between eligible parties not traded on an exchange on MTEF were exempt, and that was the only requirement. The other requirement was that if they were cleared, that the clearing organization be overseen by federal regulator.

So that's what the commission had proposed for all commodities. What we have now is the act has excluded financial commodities and physical commodities. It hasn't done anything for agricultural commodities, and the question is should we amend Part 35, the existing Part 35, to make it look more like the treatment that's given to other commodities?

Now, there also was a proposal that the commission made to clarify that the above criteria that would have been applied under the withdrawn rules would apply to OTC agricultural options by any party meeting a $10 million exemption level without any other criteria applying.

So despite the fact Part 35 has a lot of bells and whistles, we had proposed that if you were above $10 million, then whatever the rule was for bilateral transactions generally, it would apply for options on agricultural commodities. And that proposal was put out and is pending.

So the bottom line is should Part 35 be amended? Now it applies only to agricultural commodities, and the question is what should that rule look like? Are there any questions on the OTC part? Okay.

Let's go on then to exchange traded futures and options. Under the act, there are two regulated markets: designated contract markets and registered derivatives transaction execution facilities.

We also have two exempt markets: the exempt board of trade and exempt commercial market. Now, in the regulated markets, the designated contract market, any trader can trade in that market and any commodity can be listed for trading, and the requirements are going to be core principles which are included in the act.

If a designated contract market adheres to the core principles, then it legally can trade any commodity any trader can trade in a designated contract market.

Now, enumerated agricultural commodities must be traded on designated contract markets under the CFMA unless the commission adopts a rulemaking permitting otherwise. So the rule, right now the rule of thumb is if it's an enumerated agricultural commodity, it must trade on a designated contract market.

CHAIRMAN SPEARS: Paul, would you please just briefly mention what those enumerated ag commodities are?

MR. ARCHITZEL: Sure. The enumerated agricultural commodities are those that are listed in the act and they are those which are the largest commodities, I guess, that are traded and they're the ones that currently are traded on contract markets.

They would include wheat, rice, livestock, livestock products. What other big ones have I left out? Corn. Corn, soybeans. What else? The soybean complex. Cotton.

Okay. The ones that are not included would be the international soft commodities like cocoa, sugar and coffee. Those are not enumerated in the act.

We have a few that we've designated in the last couple of years that also are not enumerated like there's a Gulf shrimp contract. There's a high fructose contract. Those are not enumerated in the act. Most of the ones that are trading on designated contract markets today and that were trading in December are enumerated.

Okay. Now, our implementing rules--I'm going now into our implementing rules, how we're going to implement the CFMA. The first thing we've done is give some guidance for designation of new entrants by applicant. If you currently are a contract marketer or a contract market, you're automatically grandfathered, and under the new act, you stay a contract market.

But if you want to get into the business of being a contract market, we have rules now that we're proposing for what you need to do in that application. The application requires that you demonstrate compliance with Section 5(b) of the act, the core principles, the Part 38 rules which are the rules we are proposing, and that you provide us a copy of the rules and an explanation of how you meet the requirements if it's not clear on its face.

One of the things we did in--okay--the procedures that we are using, under the act it's 180 days to get approved. That's how much time Congress said that we should take. Instead, we have a fast track provision which we've used in the past with very good results. It basically provides that after 60 days a new applicant is designated as long as there are no amendments to their application.

As part of this process, we interpreted some of the core principles because the provisions in the act didn't apply in all cases or they may have been unclear in one respect or another. So we included some interpretations in the rules on how these would apply.

The first one is that preventing manipulation, that requirement, that core element, includes the requirement that there be a dedicated regulatory apparatus at the exchange.

Secondly, the fair and equitable trading rules that's provided for in the core principle includes the requirement that market participants have available to them information on prices, bids and offers. The bids and offers part of the equation was not included in the act, and we, as a matter of rulemaking, have interpreted bids and offers to be included in what Congress meant had to be included in the fair and equitable trading requirement.

We also said that disciplinary procedures in non-intermediated markets can be satisfied by denial of access. This is looking forward to the new kind of market structures that we may have. We may not always have intermediated markets and where we don't have an intermediary or where there is no FCM trading in the market, then discipline may take the course, the form, of just denial of access to the market.

We also address fitness standards and said if it's a nonmembership type of exchange, the fitness standard applies to the owners of the facility. So that if someone has an exchange which they own, that owner has to meet a fitness requirement, the same as members do today.

And finally we provided general guidance on the meaning of all the core principles in an appendix. Okay. The rules on product listing are found in a new part of our rules called Part 40.

Now, under the CFMA, any rule changes to contracts in the enumerated agricultural commodities that affect a month with open interest have to be submitted to the commission for prior approval. So this is the current situation that we had before the CFMA was that all material rules had to be submitted to the commission--terms and conditions of the contracts--for approval.

Under the CFMA, as it's amended the act, only rules affecting those enumerated agricultural commodities affecting months with open interest need to be submitted to the commission for prior approval.

If it's not, what we've done in the rulemaking is we've defined what material means because only material changes had to be submitted to us, and we said the following kinds of rules weren't material: rules relating to trading hours, lists of delivery facilities, rule changes relating to options on futures, and deductions in tic size.

Any other rules that affect a month with open interest would have to be submitted to the commission for prior approval, and we would use the same kind of fast track rulemaking procedure that we have in place now, which is if it comes in and there are no changes, it's approved after 30 days.

We also permit--the act permits voluntary submission of rules for commission approval. It says prior to their implementation. The commission has by this rulemaking said they actually can submit rules for approval at any time. It doesn't have to be prior to their implementation.

This is not the agricultural rules that must be submitted. It would be all others. So if it's a rule affecting, let's say, a trading month that didn't have open interest so they're not required--the exchange is not required to submit it to us for approval--they can if they want to voluntarily. What we said is you don't have to submit that for approval before you put it into effect. You can submit it at any time.

Now, why would an exchange choose to put a rule into effect first and then submit it for approval? Well, it may be a situation where if there is no open interest and the change needs to be done very quickly in order to prevent or to address a situation of deliverable supply, let's say, they may choose to put into effect and then submit it for approval, and that would be permitted under the proposed rule that is out for comment now.

Finally, the act, the CFMA says that all other changes, all changes to rule terms need to be certified by the exchange that they meet the requirements of the act and the commission's rules. And what we've done is we've said not all rules have to be certified. We've applied a rule of reason and said there are some rules that don't have to be certified because even before not all rules had to be approved by us, so we're saying only those rules which are really material, which are really important rules, need to be certified.

There are kinds of rules like relating to the color of jackets people wear, administration, things like that, that don't have to be certified. You just have to give us notice at some point.

Okay. We have a couple of additional requirements. One is that upon request, information relating to the business of the contract market be provided to us, and that includes trade details so that the kind of audit trail information that is provided in the course of trading needs to be provided to us and any other information which we request.

And upon request, the exchange would need to make a demonstration that it complies with core principles. And that's basically how the new world applies to designated contract markets. It won't look too different from how things are now. The main difference is the rule approval process. Are there any questions about that before I move on? Okay.

Then let me move on next to DTFs. DTFs, we have rules and a new proposed Part 37. Now, the first thing is the CFMA says that the enumerated agricultural commodities may trade on a DTF only following a rulemaking by the commission to permit them to do so.

At the current time, no agricultural commodity can trade on a DTF because we haven't done a rulemaking to permit them to. So there are no procedures in place for them to list that kind of enumerated agricultural contract on a DTF.

The proposed rules that we have reserve a space for those in the future. Now, Congress didn't say we must-- in some of the clauses, Congress said we must do rulemaking to allow this kind of activity to occur, and sometimes they've given us deadlines where you must do it within six months.

In this case, there is no mandate by Congress that the commission do rules to permit agricultural commodities to trade on a DTF. Instead it's permissive. It says you can't trade those kinds of contracts on the DTF unless the commission does a rulemaking to permit it, and it's an open question of whether or not it's a good idea.

The issues that would be considered, I think, in looking at that is how do DTFs develop? Do we have those kinds of markets? Will they develop so that you'll have multiple markets trading the same commodity and will that affect centralized pricing? And once we have some of those questions answered, then the next question becomes would this be a good thing to apply to the enumerated agricultural commodities?

So this is something which the commission in the future may consider, but certainly at this point, the rule is agricultural commodities would only be traded on a designated contract market.

Nevertheless, I'd like to just highlight for you very quickly what's in the DTF section of the act and the commission rules so that when we do get to that point of considering it, if we do, you'll have an idea of what a DTF would look like.

First of all, the characteristics are again broken down to market trader, commodity, and the requirements. Okay. A DTF can be a DTF. There's two ways for it to be a DTF. One is by the nature of the trader. And if they are eligible traders, and this would be mostly institutional traders, and if there are any retail traders that are trading through an FCM having $20 million of net capital, and which is a member of a clearing organization, then they can trade the following commodities.

Number one, as I said before, no enumerated agricultural commodities right now. There would have to be a nearly inexhaustible deliverable supply or a deliverable supply sufficiently large and highly unlikely to be manipulated, or one with no cash market.

The commission by rules has proposed a rule to say that if it's one of those commodities that's excluded from the act for purposes of OTC trading, it satisfies these delivery tests. So what we've done is we've said those excluded commodities, the financial futures type commodity, meet the tests for A, B and C.

The other kinds of commodities that could trade on this eligible trader DTF include security futures and on a case-by-case basis, depending on the market and surveillance history, those commodities which are highly unlikely to be manipulated. Now, commodities that could try and make that case-by-case demonstration to the commission would include the non-enumerated agricultural commodities. So those would be things like coffee, sugar, cocoa. Other ones which are not listed in the act could qualify right now to trade on a DTF if they could make this case-by-case demonstration.

There's another kind of DTF. This DTF has different criteria to be eligible to be a DTF. The first is that it be only for eligible commercial entities. So this market is for eligible traders, eligible commercials. If they are commercial traders in this market, only commercial traders, then a different set of commodities can trade there.

The commodities that eligible commercial traders can trade are any commodity except for the enumerated agricultural commodities. So you can be a DTF in one of two ways, either the top way, which is the institutional trader, retail traders trading through a higher level FCM, and you can only trade certain commodities, namely the financial futures, or if you do it on a case-by-case basis, those particular ones that the commission approves, or if you trade in a DTF only having commercial traders there, it can be any commodity other than enumerated agricultural commodities.

Again, the commission will in the future be able to address this issue about whether enumerated agricultural commodities could trade here.

Now the requirements again are for registration it's a DTF or core principles. So in that respect, they are very similar to designated contract markets, but there are fewer core principles than the designated contract markets. The DTF is more of a disclosure-based market and the core principles tend to reflect that, that there is more flexibility in the trading rules permitted.

Okay. Let's just talk briefly about the registration procedures for a DTF. Again, there are no new enumerated agricultural commodities that currently can trade on the DTF, but those markets who are currently designated contract markets could notify the commission and by notifying us could thereby become eligible to operate a DTF.

If you wanted to form a new market, you can apply to us for registration. And the time for having that application acted on under the act is 180 days and under our rules would be 30 days under a fast track provision, again, having no amendments.

Okay. Again, the market upon request would have to provide the commission with a demonstration that it complies with core principles and this market operates differently in that we would rely on special calls for information from people for our market surveillance function. The designated contract markets would operate just as they do today and are operating just as they did yesterday, in that the large trader reporting system is required of all people trading in the market with reportable positions.

In the DTF, on the other hand, the commission would be relying on special calls to the DTF itself, to FCMs if there are intermediaries involved, or to participants. We also would rely upon the market serving any foreign brokers or traders with any subpoenas or request for information from the commission.

Finally, there are two types of exempt markets which are exempt from commission regulation. There are exempt boards of trade, exempt commercial markets, and neither of them can list agricultural commodities.

Just go give you a very broad overview of these, the exempt board of trade is only for eligible contract participants. The commodities that can be traded on it are those with nearly inexhaustible deliverable supplies, and there are certain requirements that attach to them. One is that they notify the commission of the fact that they're operating, there's an anti-fraud provision, anti-manipulation, there's a price discovery provision, and it has to operate a separate subsidiary from contract markets. So if you're an exchange, and you want to operate an exempt board of trade, then you'll have to operate it as a separate legal subsidiary and a separate market.

Again, you won't have agricultural commodities in the exempt board of trade. In order to meet these tests, it must be one of the financial futures type of instruments.

The exempt commercial market I already discussed somewhat. Those would be for eligible commercial entities trading principal to principal on an electronic facility, they would be for the exempt commodities, and there are a number of requirements that attach to those.

Finally, with regard to implementation of our rules, the CFMA already is enacted and is in effect and our rules provide that while they're proposed, the commission will not take action against anyone. We've provided a no action for those people who adhere to the proposed rules.

Now, of course, in the way rulemakings go, the rules could be changed later on and then you would have to comply with the final rules, but for now, if you adhere to the proposed rules, then that will satisfy the requirements of the law.

The last thing I'd like to just touch on is where the other rulemakings stand that we initially withdrew in December. The clearing rules should be reproposed shortly. The rules on intermediaries, the amendments to Rule 1.25, which is what FCMs can do with segregated customer funds, has already become final. The rule on predispute arbitration provisions is being proposed as part of the market rules that are now currently out for comment.

And the remaining rules on intermediaries will be considered and reproposed at some time in the future.

Finally, the rules on bilateral transactions, on swaps, which was withdrawn in December, would be under consideration, and I understand it's on the agenda for this group to discuss later, and this is the difference from what we proposed in December to now.

In December, our rule on swaps would have applied to all commodities and now the rule only applies to agricultural commodities because the law itself applies to all other commodities.

CHAIRMAN SPEARS: Thank you, Paul. I know that was a very complicated issue to get through in a few minutes, and you did an excellent job. I also know that there were a number of the committee members getting writer's cramp trying to keep up with you. I would assume, Paul--am I correct--that people could get copies of your slides later on at some point in time for committee members that are interested?

MR. ARCHITZEL: If people have email, the easiest way would be to--I can email them to you, email you the presentation, and that probably is the most efficient way. So if you have a business card, and you want to hand it to me, or Debyn.

CHAIRMAN SPEARS: Or my staff. We can make sure that you get copies.

MR. ARCHITZEL: We'll be happy to get it to you.

CHAIRMAN SPEARS: And again, Paul is going to be available later on in the discussion as we get into the topic regarding the OTC market and ag trade options. Paul will be available because he touched on some of those issues just briefly there.

The bottom line, a couple of quick things. As you would expect, I think it would be fair to say that the rules that Paul outlined are consistent with the Act that Congress passed, and I think consistent also with input from prior Ag Advisory Committee meetings, where you guys provided comments about rulemakings and contracts with open interest and those kind of things.

So, from my perspective, I think it's fairly consistent with what this committee has advised the Commission in the past.

Again, we'll come back to the OTC market in a little bit, but are there any questions or comments about the rules that Paul outlined, the CFMA itself and how it applies to agriculture? As he pointed out very clearly, ag is kind of special. We already know that, but ag is treated differently compared to all other commodities in the act. I think that was by design, certainly from the wishes of the ag community, but I think it's important the agriculture community recognize that everybody else is somewhat different than agriculture.

MR. GILLEN: Mr. Chairman.

CHAIRMAN SPEARS: Yes, Neal.

MR. GILLEN: Could I just correct the record and note that the recommendations reflect the opinions of some of the committee?

[Laughter.]

CHAIRMAN SPEARS: Point of order well taken. Also, in your packet, I think there is a document like this little chart put together by Don Heitman on my staff. That also attempts to outline what we just talked about in two or three pages. So for your members, it kind of outlines, I think pretty simply how commodities are treated and how ag is treated compared to everybody else.

I also just want to note quickly here, as you recognize, Paul is an invaluable resource to the Commission. And I wanted to note that last year, Paul was chosen to receive the Presidential Rank Award for Distinguished Excellence by a public servant. So Paul received that award last year for the year 2000, and it was very well deserved, Paul.

The next topic on the agenda I wanted to take a few minutes and have Ron Hobson, Senior Economist of our Economic Analysis Division, outline for information purposes a provision that was added in the Act specifically entitled "Special Procedures to Encourage and Facilitate Bona Fide Hedging by Agricultural Producers."

I believe this provision was added by Congressman Nick Smith from Michigan, and it's section 4p of the Act, and I've asked Ron Hobson to summarize that and make this committee aware of that provision because it has ongoing implications. So, Ron.

MR. HOBSON: Thank you, Commissioner Spears. We thought that before we finished discussing the Commodity Futures Modernization Act, we'd bring to your attention a rather obscure provision of that act that you might be able to help us with.

As Commissioner Spears indicated, we're kind of seeking long-term help here. We don't expect you to come up with any solutions today but maybe in future meetings this could be a topic of discussion.

Specifically, Section 121 of the CFMA adds a new Section 4p to the Commodity Exchange Act, and this new section is entitled "Special Procedures to Encourage and Facilitate Bona Fide Hedging by Agricultural Producers."

I believe each of you, each of the committee members, was provided with a copy of this provision, and there were copies out front as well. I'm not going to go through and read it. I want to kind of summarize it and bring up some of the issues that we're concerned with.

As Commissioner Spears mentioned, this provision was introduced or inserted in the act by Congressman Smith, and my understanding is that he was also responsible for, at least partly responsible for, the risk management education provision of the 1996 Fair Act, and so that may give us some insight into the objectives of this provision because there is no legislative history. It kind of appeared out of nowhere in some respects.

As the title of this new provision suggests, the title again, "Special Procedures to Encourage Bona Fide Hedging," the purpose is to encourage agricultural producers to use futures and options for hedging.

This is a somewhat different slant as an objective for the commission since we are a regulatory agency and not a promotional entity. Nevertheless, the commission has always put a value on educated market participants as an important component of a well functioning market. Toward this end, the commission and its staff have participated over the years in numerous educational activities and have attempted to provide information on the markets to the public.

In particular, the commission recently revamped its web site. I don't know if you've had a chance to look at it. This has just been within the last month or so, and the objective of that revision was to provide more market and regulatory information in a more easily accessible form to the public.

In addition, for the past five years, the commission has been an active participant in the USDA Risk Management Education Initiative, which was mandated by the 1996 Fair Act.

Since it appears, as Commissioner Spears mentioned, it appears that this provision provides for kind of an ongoing obligation on the commission--we have to provide a report to Congress at the end of a year, but that doesn't appear to be the end of it. And given that ongoing obligation from the standpoint of this overall objective of this provision, the encouragement of hedging and futures and options, the most valuable input that this committee could provide us would be guidance concerning possible additional educational activities that the commission might undertake in the future to further facilitate the markets.

Going from kind of the general to the specific, we would also--and maybe even more so-- appreciate your input on some of the specific provisions of this new section. Basically these provisions relate to contract terms on delivery and quantities. They also relate to costs of transacting relating to margins and also to educational activities as they're undertaken by the exchanges.

On that last point, I should mention that the exchanges in general, the futures exchanges in general, and the exchanges on which agricultural products are traded in particular have historically done a very good job of providing educational materials and information to the public. They undertake educational courses and provide, of course, data on the markets, and so even though this provision, new provision of the act, directs the commission to encourage the exchanges to engage in these activities, it shouldn't be misunderstood that the exchanges have not pursued these activities vigorously over the years.

It's in their interest to have commercial participation in their markets. With regard to a couple of the other specific provisions of the act, of this provision of the act, 4p, there is a provision that talks about the importance of providing for orderly delivery as a prerequisite for commercial hedging participation. We've always been mindful and the exchanges have always been mindful of the importance of economical and commercially sold delivery provisions.

My concern in kind of reading this provision might be that it is suggesting that additional delivery points be added to futures contracts, and while that might be useful in some circumstances, the commission and the exchanges have always also been very mindful of the importance of the tradeoff between contract specificity and basis risk.

So these are kind of the issues that we're kind of grappling with with regard to this new provision, and as we attempt to respond to Congress with a report on these issues, the committee's input and guidance would be most helpful. Thank you.

CHAIRMAN SPEARS: Thank you, Ron. Again, as Ron pointed out, this is kind of a new obscure provision, but I wanted to certainly make the committee aware of it because it could come up in future discussions with the Congressman or with the Ag Committee. At this time, We'd be open to any initial comments. This might be the first time you guys have heard of this provision. You may have seen it before, but are there any initial comments or feedback to the committee or to the commission at this point in time, and we look forward to other comments in the future?

MR. GILLEN: Mr. Chairman, I would just like to have the record reflect that the word "orderly" does not mean additional in the context of delivery points.

MR. WHITE: Mr. Chairman.

CHAIRMAN SPEARS: Yes.

MR. WHITE: I have a question as to the understanding when he said additional delivery points. Could he clarify that a little bit for me?

CHAIRMAN SPEARS: Yeah, Ron, would you please do that?

MR. HOBSON: I just, again, we have no legislative history on this, and I've been the only one kind of that's really focused on this here at the commission. And like I say, we've always been mindful of orderly delivery provisions. The "additional" is kind of my speculation as to why this general language might have been put in this provision, considering that the title of the provision is "Encouraging Producers to Use Futures and Options."

There have been market observers and participants in the past who have claimed that the markets would be more useful if there were more delivery sites for certain contracts, and my only point is that that may not always be the case, that there is--and I am kind of--like I say, I'm kind of speculating as to the motives behind this provision. That may not have been Nick Smith's intention at all, but my first point was that we've always been very careful about delivery.

MR. GILLEN: I would just point out that there is a greater majority viewpoint that a proliferation of delivery points debilitates the contract.

MR. HOBSON: Well, and I'm highly aware of that. That's why I made the point that there is a tradeoff between delivery points and basis risk.

CHAIRMAN SPEARS: I think it's fair to say that that was, Ron, your personal speculation--

MR. HOBSON: Yeah.

CHAIRMAN SPEARS: --at that point in time.

MR. HOBSON: That was my personal speculation of what was intended here because it wasn't clear to me what otherwise what the intention was. So--

CHAIRMAN SPEARS: But this is an issue that we're going to have to wrestle with, I think, as we go forward over the course of the next year and make a report to Congress at the end of this year.

I would expect this to come back before this committee at a future Ag Advisory Committee meeting. But as we go through this time period, any thoughts that committee members have, they can provide to us today or in the future, not necessarily at a meeting, but just pick up the phone. Give me a call or any of the commissioners a call, or EA staff. It would be very helpful, because we're kind of wrestling with what to do with this. There are other agencies out there providing similar efforts, and so there is no need to duplicate things, but we also need to be mindful of what Congress asks us to do.

MR. HOBSON: Yeah, this is kind of the whole point was that this is a fairly vaguely worded provision, and we need some help.

CHAIRMAN SPEARS: Tom, do you have something?

COMMISSIONER ERICKSON: Just briefly, Mr. Chairman. I appreciate the last comments you made because one of the things we're going to be looking at is the one year deadline and that, I think, is December 21. So any help we can get from this organization would be helpful from my perspective. Thanks.

CHAIRMAN SPEARS: Brian, do you have something to add?

MR. DIERLAM: Yes, sir, Mr. Chairman. I was fortunate, or depending on how you look at it, was at the markup when this language was inserted into the bill, and it's my understanding in his characterization of this, Mr. Smith's characterization, was that the current 5,000 bushels per contract for some producers wasn't enough to make it worthwhile to enter into a contract, which is where number three of this provision, the minimum contracts, minimum quantities so that other producers that don't meet that level would be able to participate in contracts and then would be able to deliver that amount at some location.

And it's my understanding that at some point, he had some constituents or some folks that had had some problems trying to engage in using futures and things. It just didn't work out so well for them, which is my understanding of where the genesis of this temporary storage cost issue came from.

CHAIRMAN SPEARS: That's very helpful, Brian. Bill.

MR. DODDS: I have had a couple of phone calls on this subject. Being a Michigan resident, I'm surprised I didn't get more.

[Laughter.]

MR. DODDS: A couple of things that came up in the conversations with his staffers. One was commodity Chicago Board of Trade prices relative to cash grain prices. Two was the size of the contract he thought was too big for the small players which is what our colleague down the table said. And three, they thought they didn't understand the margin requirements relative to trading a Chicago Board of Trade contract.

And I would guess because of where Mr. Smith is from, there are some tales of the old Toledo discussions that exist, and my personal opinion is the present contract is working fine.

CHAIRMAN SPEARS: That's very helpful, Bill, and do I take it that you're volunteering to head up a task force to address this?

[Laughter.]

MR. GILLEN: Mr. Chairman, one of the things--we will address this later on--and the issue of agricultural trade options where contracts can be tailored for producers to deliver quantities lower than the contract specification, but the commission in its wisdom precludes such practices.

CHAIRMAN SPEARS: That provides a perfect segue into the next topic, Neal, thank you. The next agenda item does deal with ag trade options and other ag risk management alternatives such as ag swaps. And to help frame the topic, let me just briefly review the rather complicated history of ag options.

As most people in this room know, going way back to 1936, problems blamed on speculative abuses led to a statutory ban on all options trading. The ban applied to both on and off exchange options. When the CFTC was created in 1974, it was given expanded jurisdiction over futures and options on all commodities.

However, the statutory ban on ag options was left in place. Only after the commission's 1982 reauthorization was that statutory ban lifted allowing the offer and sale of exchange-traded options. Even then, the commission let stand a regulatory prohibition on off-exchange ag trade options even though trade options in all other commodities could be offered to commercial users subject only to anti-fraud rule.

In 1997, the Commission finally proposed lifting the regulatory ban and permitting off-exchange ag trade options. Rules to allow ATOs were published in April 1998, but no firms took advantage of the ATO program.

In December 1999, the ATO rules were further amended to permit cash settlement and streamline registration and disclosure requirements. As was pointed out previously, issues concerning ATOs and other ag derivative contracts are particularly relevant today in the context of the CFMA and the proposed rules that Paul outlined.

The CFMA excludes or exempts bilateral transactions in most commodities from CFTC regulation, but does not address bilateral transactions in agriculture commodities, as Paul outlined.

This raises the question of whether and to what extent bilateral transactions in ag commodities, such as ag commodity swaps should be exempt from regulation? Furthermore, if bilateral transactions are given regulatory relief, should ag trade options be given consistent relief?

Discussions of ATOs is particularly appropriate at this time because, number one, the Commission needs to consider more thoroughly just how ATOs fit within the new regulatory framework, and number two, as noted, the current ATO program even with the December 1999 amendments to simplify the program has seen very limited use, with only one firm thus far registered as an ag trade option merchant, and that is Kent Feeds, Inc.

In my mind, the bottom line boils down to--and this is where we especially need your input--two issues. One, as Paul outlined, to what extent should bilateral transactions in ag commodities such as ag swaps, be exempt from regulation?

And number two, tied to this but a separate issue, is what to do with the ATO program given its limited use so far? The question is, why it has had such limited use? Is it due to market conditions? Is it due to the regulations and restrictions on the program as some have suggested? Is it a combination of the two? Or are there other reasons?

Now, I've asked Paul to be available to assist us during this discussion. Again, we're looking for input from the committee members as to what to do with bilateral transactions on ag commodities and what to do with the ATO program. Paul, I think, in his comments did a good job outlining those issues, and as we get into discussion later on, Paul will be available to address it further.

I've also asked--as I mentioned, Kent Feeds thus far is the only registered ATOM offering ATOs to producers. We're fortunate today to have Jack Dougherty of Kent Feeds with us, and we've asked him to describe their option program and their experiences to the committee members.

In addition to Jack, I've asked Bill Dodds, who is a member of this committee, to outline NGFA's views on ATOs and OTC contracting issues. As we all know, NGFA has long been in the forefront as to the proposals addressing this issue.

And finally, in the course of reviewing these issues, it's also important to look at risk management in a broader context. Particularly, we should look at issues involving Introducing Brokers, the frontline providers of derivatives based risk management services to farmers. Thus, I've asked Melinda Schramm of the National Introducing Brokers Association to join us and join the panel to give us the IB perspective on these issues.

At this point, I would like to have each of the panelists, Jack, Bill and Melinda, take about ten minutes or so to give us their perspective, their experiences. And I hope to use the remaining portion of the time to discuss these issues and to provide input to the Commission from committee members regarding bilateral transactions on ag commodities and ATOs.

So, with that, I'd like to turn the program over to Jack first. Thank you, Jack, for being here. As with all committee members, Jack and Melinda as well, have volunteered their time and their effort and their expenses to come in to present this information to the commission. So I want to thank Jack in advance for being here and, Jack, I turn over the program to you.

MR. DOUGHERTY: I'd like to thank the committee for the opportunity to at least let people know what we're doing. It's kind of an honor to be number one, but sometimes it's a little bit of a problem to be the only one. Kent Feeds is a feed manufacturer that's located in the Midwest with a history that goes back to 1927.

For many years, we were driven by demand for swine feeds. In the last few years, we've seen that market change dramatically, concerning the raising of hogs. We've always targeted as a company the independent producers with our products and sold them exclusively through dealers.

1998 hit the independent hog producer very hard and many of our customers exited the market, and it was at that time that we developed quite a concern to see what we could do as a company to help some of these independent producers at least manage their risk and stay in business. As we checked with customers and people that we knew were in the business, and what they did for risk management, quite frankly we found that many of them didn't do a whole lot.

Futures contracts and options would have provided these people with adequate protection to avoid the disaster of 1998, but they didn't use them. We began to explore ways that we could help our customers make better use of these risk management tools. The most attractive instrument from our standpoint was an option contract. The mind-set of many of our customers is, yeah, I'd like a guaranteed price, but if the price goes up, I want to be sure that I can participate in the up side.

And we developed a program that allowed hog producers to purchase options from Kent Feeds and to lock the price of feed in to raise the appropriate amount of animals for that option.

A program would not have been possible under the current conditions without some changes that were made in the 1999 Federal Register, one of them being cash settlement. Under the original provisions, to operate a program like that, we would have had to take delivery of the hogs and that was virtually impossible for us to do. We would then have had to turn around and market them ourselves.

That was beyond the scope of what we wanted to do. With that change in the cash settlement provision, we could now enter into agreements with our customers and provide them with put options. The only band of the spectrum that we use in this whole program is lean hog put options. So any of the things that deal with grain, we don't handle any of those. Just a very, very narrow band, and just puts. We don't deal in calls.

This change allowed Kent Feeds to go forward and register as an ATOM. The registration process itself was from our standpoint quite simple. NFA was very helpful. The form was two pages, and it was mailed to us as soon as it was ready and we became registered on March 6 of 2000, as the first and to this date as the only ATOM.

We also registered at that time three individuals as associated persons, and there again encountered no problems with that process.

Meeting the other requirements has been a little bit of a discovery process for us. And the commission has been as helpful as possible in giving us direction where to send reports and items like that, and I think we're still in a little bit of a discovering mode on that.

Kent uses, like I said, this is a very narrow option. And our program is geared towards the independent hog producer with the idea of establishing a floor price for him. We've tailored our program to be flexible in that it allows various size contracts with our customers. We set a minimum as 200 hogs which is roughly about the size of one contract, but after that, it's any number of hogs that individual wants to do.

Our main interest in this whole program is to sell animal nutrition, and we saw this as a vehicle by which we could ensure these people to stay in business and use our products. We do want to make it clear that in no way is

Kent Feeds attempting to be a broker in any sense of the word.

The only thing that we offer is put options on hogs. If our customers want to do something else, if they want to do some kind of straddle position, if they want to do a futures contract, that's not our business. And we'd be happy to tell them that they need to contact people that are in that business. We are just doing put options.

We only offer that one form and the ability to customize the program to fit the need of the user was a great advantage of the ATOM as we saw it. Kent Feeds, the way that we manage the risk it's just extremely simple. We sell the producer the option and then we turn around and cover the option on a vehicle traded by CME. It's a pretty simple process.

We do our deal with the producer himself. When that's done on the phone, that's done. He knows exactly what he pays. It's not a bid ask process. It's a quote, and he takes it or he doesn't. The amount of exposure to us is virtually nonexistent even though we may have a few hogs here or there that don't quite fill a contract, but in the long run that comes out to be pretty even.

We've been registered as an ATOM just over a year now, and we see the program works, but the dynamics of the hog market have changed in the past year. Quite frankly, prices have improved quite a bit. So we've seen a very limited use of our program.

We still feel that it's a very viable risk management tool in the way that we're using it because it does satisfy the need of providing a basic amount of protection. We plan to continue the program and look at ways that we can make people more aware of it. We do use our dealers to let people know that we do have this program available, and the only other thing we may look at is if there is some way for us to facilitate this in the cattle side of things, but it becomes a little harder for us because the size of the contract doesn't allow enough, whereas the hog contract at 200 plus is a contract size, where the cattle one about 30, 33, is the only amount of cattle that can be on there.

We feel that the program is really underutilized by our customers. It's relatively easy for us to manage everything. Everything is on a segregated basis and we don't feel any pressure that we would be extra-scrutinized for running the program and for having anything looked at.

In fact, we've been fairly pleased with the cooperation of the commission. Those are pretty much the comments that I had as far as how we're running the program and what we're doing with our particular segment of the ATOM.

CHAIRMAN SPEARS: Thank you. Are there any particular questions before we get into open discussion for Jack about their program as it stands today? Thank you, Jack. I Look forward to your participation and further discussion with the committee members.

Next, I'd like to have Bill Dodds speak. As I mentioned earlier, NGFA has long been active in this arena dealing with this issue, and I'd like to have Bill put forth in a few minutes, Bill, your perspective as a committee member, but also NGFA's position in regard to this issue. Thank you.

MR. DODDS: Commissioner Spears, other commissioners, members of the Ag Advisory Committee and guests, the National Grain and Feed Association appreciates the opportunity to present its views on agricultural trade options and other risk management alternatives.

However, the National Grain and Feed Association believes that the ATO issues are simply a part of a much broader issue, the need for greater legal certainty for off-exchange forward agricultural contracts.

The National Grain and Feed Association has commented repeatedly on these issues in the past several years in statements made to this committee, in proposed rulemaking and in congressional testimony. Such comments have centered on the fact that cash forward contracting is the predominant form for price risk management used by grain producers and others. But there is uncertainty about how the CFTC views certain contract terms, and unless steps are taken by the CFTC, the perceived litigation risk may diminish the use of some beneficial contracts.

To illustrate the effect of some legal uncertainties, consider the following examples. And I would say these examples come up at our risk management committee meeting within National Grain and Feed. They come up at the National Grain and Feed Country Elevator Council meeting where we have 700 country elevators, and we have producers, country elevators, terminals, and we have our lawyers there also.

The farmer has forward contracted a certain amount of grain with an elevator and experiences crop problems, maybe a crop failure. Several questions always arise. Is it legal and permissible for the elevator and the farmer to settle that contract with cash?

What if the farmer only has a partial crop lost and needs the balance to feed his livestock? Is it okay to settle that contract for cash?

Is it okay for the farmer and the elevator to roll the contract forward to the next crop year? Let's say the farmer rolls it to the next harvest period, can he then roll it to another delivery period? If so, how many rolls are considered legal?

What if the elevator has an administrative fee stated in 00000the contract to apply to any situation where the farmer and the elevator mutually agree to contract cancellation?

What if the farmer actually grows a normal crop but decides he has the better market opportunity somewhere else? Is it okay for the elevator and the farmer to mutually agree to contract cancellation and let him deliver his grain somewhere else?

Example two: A farmer and an elevator enter into a hedge-to-arrive contract for delivery of grain at a fixed futures price, the basis to be determined at a later date.

Market prices increase during the summer. The farmer decides that he wants to cash settle the contract and wait until the market increases more, and then reprice the commodity again. Is it legally okay for the elevator to accommodate the farmer?

How many repricings are okay from this perspective of the CFTC and the Commodity Exchange Act before a hedge-to-arrive contract is viewed as an illegal futures?

Example three: A farmer and an elevator enter into a multiple year contract for grain at fixed futures prices, again, the basis to be determined later. Is a multiple year fully fixed futures price contract legal and acceptable?

What if the nearby futures are more attractive than the futures of the following crop year and the farmer desires to price 50 percent of the next year's crop with the current crop year futures? It that legal?

In terms of public policy, then it is imperative that the regulatory and statutory lines be clearly established as to what is permitted in cash contracting, what is subject to CFTC jurisdiction and what is not.

Part of the resolution of this issue may lie in a viable agricultural trade option program. After several years of offering the program, only one entity has registered to be an agricultural trade option merchant. Clearly something is wrong with the design of the program. The very narrow participation is not a legitimate test of the program and the kind of trade option contracts and their benefits that could be offered to producers.

We could offer theories of what is wrong with the program, but the fact is that if the CFTC wants a viable pilot program for trade options, the commissioners and staff need to approach the commercial sectors of the grain, cotton, livestock and other commodities and ask a simple question:

What changes are needed in the program to attract your business to begin writing trade options?

This question has to be posed to the commercial sector. Why the commercial sector? They are the market makers. Those entities can best tell the CFTC what impediments must be lifted to achieve a viable test of trade options in the agricultural sector.

One final point needs to be made. Agricultural trade options, particularly under the structure traded at the CFTC that only permits producers to purchase agricultural trade options. In there simplest form, trade options add a single new feature to the cash forward contract: the right of the seller of cash commodities to not deliver.

Who in the market place is most likely to confront a situation where delivery is very difficult or very expensive or whatever other reason? Certainly, the farmer is at most risk because of potential crop failure. Establishing a price up front for non-delivery simply allows the farmer to market earlier in the crop year and maybé more aggressively, taking advantage of market situations that might otherwise be passed up.

Thus, from our perspective, we would continue to challenge the farm organizations to examine the potential value of agricultural trade options. If you agree that agricultural trade options hold considerable promise, we would encourage those farm organizations to make its views known to the CFTC.

And I would just add after listening to Jack's presentation that that is a very viable good service for his livestock producers knowing what I know about price risk management. Thanks.

CHAIRMAN SPEARS: Thank you, Bill. I think when we get into general discussion, I may ask Paul to respond briefly. I don't think we can respond to all the questions in your testimony, but we can try. I think Matt is probably going to hand them out. But I know what you're trying to accomplish and I appreciate that.

But I may ask Paul to briefly touch base on it if it's appropriate at that point in time. As I mentioned earlier, an important sector dealing with ag risk management and dealing with agricultural producers is the IB community, and we've asked Melinda Schramm, who is--I believe your title, Melinda, is executive director?

MS. SCHRAMM: I'm the chairman of the board of directors.

CHAIRMAN SPEARS: Chairman of the board-- I'm sorry--of the National Introducing Brokers Association. So with that, Melinda, without any further introduction, would you please provide us your thoughts and comments?

MS. SCHRAMM: Thank you, Commissioner. You'll excuse me. I'm at that age, so I'm going to have to take these off in order to read my prepared statement. I'm Melinda Schramm. I'm the president of the MHS Capital Resource, Inc. It's a CFTC registrant and NFA member located in Chicago, Illinois.

I've been a part of the futures industry for about 25 years. My company specializes in writing for the financial industry professional and for lobbying the interests of those professionals.

I'm also the founder and chairman of the board of the National Introducing Brokers Association, or the NIBA, which is celebrating its tenth year in existence this year. The NIBA counts among its members both guaranteed and non-guaranteed introducing brokers along with 11 futures commissions and five domestic exchanges.

It's organized as a not-for-profit association whose mission is to help the futures professional and specialist stay in business at a highly professional level. We do this at our annual conference, our newsletter and regularly scheduled meetings and councils with our regulators, Congress, and others concerned with issues affecting the industry.

The NIBA has been asked to testify in the House of Representatives regarding issues including risk management education, the CFTC Act itself, and hedge-to-arrive contracts in the grain industry.

We have also prepared statements for the CFTC regarding such diverse topics as exchange delivery points, the Commodity Futures Modernization Act, the advent of security futures, required disclosure documents for managed accounts, and ethical standards and behavior in the industry as a whole.

The NIBA board of directors consists of eight to nine elected IBs, elected by the membership for a three year term, plus two representatives from our FCM members and representatives from our exchange members.

Before I address the specific topics that the commission has laid out for our panel, I wanted to take a few minutes of my time to draw this committee a visual picture of the IB. Many of you may have never met any other IBs except myself. Many of you may not have other dealings, other business dealings with introducing brokers. In order to help you make some decisions which will greatly affect our business lives, I wanted you to know who we are and what we do, what kind of clients we service, what products we trade.

In May of 1999, I wrote a book called The Complete IB Handbook, which was published by the Chicago Mercantile Exchange. The purpose of the guide was to put all the information that anybody might want who wanted to start an introducing broker business into one book.

I covered such topics as creating a business plan, registration requirements, selecting an FCM, negotiating contracts with sales people, and even surviving your first NFA audit. I gathered the data through personal interviews and a written survey of industry registrants and our regulators. 127 introducing broker offices responded, and those responses came from all over the United States.

Here is the some of the information that they shared with me. An IB owner is typically a college educated male. In 1999, less than six percent of the total number of introducing broker offices were owned by women. Nearly every owner had a college education at the minimum with about half of those majoring in an ag business or a farm operation and most of the others in economics, accounting, or other financially related areas.

Less than 30 percent of the IBs registered at the time of the survey were registered as independent introducing brokers. Those often considered themselves specialists in one kind of market such as the energies or in cotton or in the particular style of trading such as in managed accounts.

The IBs who registered as guaranteed gave us the following reasons generally: They believed it was less expensive. They believed there was less paperwork and reporting required. They believed that there was less direct compliance responsibility. They also said that the IB principals were generally less experienced or had no experience at running their own business. And finally, guaranteed introducing brokers were thought to get more support in their sales and marketing efforts from the FCM or from the broker himself than the independent introducing brokers.

In 1999, Illinois was the state with the most IBs registered and members of the NFA. And that number was 248.