99-34
(13)

secretary

From: oconnork@vt.edu
Sent: Wednesday, September 29, 1999 4:04 PM
To: secretary@cftc.gov
Subject: Agricultural Trade Options

1999 SEP 30 A 7:58

CFTC.doc

Letter from Wayne Purcell as an attachement in Word and also as a part of this text:

<<CFTC.doc>>

September 29, 1999

COMMENT

Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, DC 20581

Agricultural Trade Options

In general, I would observe

(1) The proposal changes to your interim rules go too far and reduce the probability that these off-exchange instruments will be handled and managed in a way that protect the interests of final users;

(2) There is too much concern about easing reporting requirements, reducing paperwork, etc., to the exclusion of ensuring well-managed procedures and providing important information;

(3) A degree of naiveté in attributing lack of use to "lack of familiarity" and in the Commission getting involved in "education" to correct this problem, this in the presence of a massive effort by exchanges, universities, and private and public agencies in education about futures across the past 35 years and about options across the past 12 years;

(4) A reliance on "cash settlement" in (it would appear) commodity areas in which there is no provision for cash settlement in underlying futures instruments and in markets with often extremely high levels of concentration that could conceivably be subject to manipulation by large participating firms; and

(5) No attention (that I observe) to what will and will not be viewed as "hedging" by IRS with related significant implications to the deductibility of any losses tied to futures/options/derivative use.

With regard to specifics:

I would advise keeping the registration requirement. Advocates of easing this requirement may be interested in reducing their costs and enhancing profitability at the risk of exposing their customers to risk. The integrity and credibility of the organized exchanges is at risk here because those hurt by "failed" procedures relating to any lax oversight by CFTC will seldom assign the fault totally to the provider of the instrument, but they will also blame the existing exchanges. I counsel against eliminating the registration requirement.

Limiting "filing requirements" to principals who exercise direct control might be advisable in the interest of simplicity and reduced paperwork if the registration requirements are maintained and strictly monitored and enforced.

I would strongly oppose deleting the mandatory six-hour training course. Rather, I would support strengthening this requirement. The CFTC has ample history and evidence (the hedge-to-arrive disaster) that shows participants will not take the responsibility ensure adequate knowledge. Thus, I cannot imagine CFTC's acceptance of a situation where "each ATOM would decide the amount and nature of the training it will require of its sales agents."

The CFTC does not need to get involved in processing of registration applications--the procedure in place involving the NFA has apparently worked well for decades.

Reducing the net worth requirement to $50,000 is, for all practical purposes eliminating it. I would counsel against such a radical change.

Permitting cash settlement begs several important questions that the CFTC may not have fully addressed. There is a trend of huge proportions pushing commodity markets toward concentration and consolidation. In these markets, the question "what cash price (index)?" must be considered. To date, the exchanges have often moved to a moving average index with the moving average representing as many as five business days so that the cash index cannot be manipulated and/or to ensure enough observations in the calculations. The net result of this "smoothing of the cash price data is to create a situation where basis performance is so erratic that hedging performance is totally offset or greatly reduced. In risk management, it does no good to substitute cash-price risk for basis risk of a similar magnitude, and this can happen to a producer who is selling only once or a few times per year. If you go forward with cash settlement, it would appear the Commission needs to work with the organized exchanges and make sure any trade option mechanisms are tied to and use exchange-traded futures and options. If that is not done, your efforts to improve access to effective risk management alternatives could be totally offset in terms of net impact.

Your proposed changes go too far in trying to eliminate filing requirements, paperwork, and reports to the Commission. To excuse proper notification and avoid written arrangements under the guise of "too burdensome" or "would occur during harvest" is simply unacceptable. Computerized capacity to generate and handle these needs is $5,000 or less, and expertise to set up the software and procedures is widely available. Information from the exchanges on settlement prices to go into accounts is widely available and costs virtually nothing. An annual report of activities would, as the Commission appears to recognize, be essentially worthless for analytical and oversight purposes. And as the Commission notes in its Federal Register materials, the hedge-to-arrive disaster was largely due to lack of written instruments, inattention to detail, and a lack of knowledge on the part of the seller in particular.

Having commented on the Commission's specific proposed changes that I find most important, I would close with a question and related observations:

What are we trying to accomplish here?

There seems to be an implicit assumption that producers, who are badly in need of effective price/cost risk management strategies, need an intermediary between themselves and the futures and options trade on the exchanges. Why? The trade on the exchanges is in a competitive, totally accessible environment for which the CFTC has oversight and regulatory authority. The Commission made a decision to allow trade options for agricultural commodities, but you find little activity by firms or organizations stepping up and offering new instruments. In the proposed changes now under review for comment, the Commission is assuming that the reason for that lack of activity is because requirements and oversight is too burdensome--your proposed changes are designed to relieve those "burdens" with the implicit assumption that use of these trade options will then increase and grow to your earlier expectations.

The Commission should consider an alternative hypothesis. The inactivity is due not to any major barriers to access to the new risk management instruments--the futures/options on the exchanges have been there for decades and are totally accessible--but to a continuing malaise on the part of producers that has also been there for decades. If this hypothesis is the correct one, and I believe it is, there is no logical support for the moving away from accountability and responsibility on the part of the firms offering any new off-exchange instruments. When a representative of the National Grain and Feed Association (NGFA) contacted me several months back and noted they were going to move to offer these instruments, my question was "why?". I was told that producers would only avail themselves of these opportunities if agents such as NGFA offered them on a more nearly personalized and close-up basis, but I believe this is wrong. I know of no producer who is a serious manager of his or her sizeable and significant farming business who has experienced any major problems or impediments using exchange traded futures and options in risk management programs. The decision to allow trade in off-exchange trade options has been made, and I will not go back and presume to critique that decision in this forum. But I strongly oppose a weakening of the requirements for responsible business activity and accountability on the part of new providers of these instruments in an effort to motivate activity.

We need to be careful, I believe, with changes that are motivated by potential offerers of new instruments who are looking for an income source. If requirements are reduced toward a zero cost, net worth requirements are reduced to minimal levels. We may then see agents emerge who charge the option premium to clients in the form of lower floor prices and never buy the underlying put. This creates a very dangerous scenario in my opinion, and the CFTC should avoid moving in that direction in any significant way.

It should be clear from my observations on the specifics that I see most of your proposed changes as without merit and without, to my knowledge, any support by good research and good science. Access is better than ever, and access to traditional risk management instruments will explode with the Internet and electronic techniques. Producers exposed to increasingly volatile markets will move to risk management strategies as a matter of necessity and survival, and we need to make sure we have rules of the game in place that encourage access but protect the integrity and credibility of the process. We do not need to risk a repeat of the "hedge-to-arrive" catastrophe with lax and relaxed oversight and requirements.

Sincerely,

Wayne D. Purcell
Alumni Distinguished Professor and Director
Research Institute on Livestock Pricing

WDP/ko

Karen S. O'Connor
Program Support Technician
Agricultural & Applied Economics
Virginia Tech
(540) 231-4879
oconnork@vt.edu