

**Commodity Futures Trading Commission
Agricultural Advisory Committee
30th Meeting, July 21, 2004
Status Report on Agricultural Trade Options**

Introduction

At the last meeting of the AAC, Paul Architzel, Chief Counsel of the Division of Economic Analysis, was available to answer your questions concerning agricultural trade options (ATOs). Now that Paul has left the Commission, I seem to have inherited the title of resident legal expert on ATOs. I approach this role feeling rather like a house painter who's been asked to stand in for Vincent Van Gogh. Nevertheless, I will do my best to bring you up to date.

I have been asked to give the committee a status report on agricultural trade options issues. I will cover three main points: (1) a brief statutory and regulatory history of ATOs; (2) a recap of the ATO discussions from the last meeting of this committee; and (3) some questions and issues regarding ATOs and other over-the-counter agricultural contracts that the committee may wish to consider at future AAC meetings.

Statutory and Regulatory History of ATOs

Going all the 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 in the basic agricultural commodities – the only commodities then regulated. When the CFTC was created in 1974, it was given expanded jurisdiction over futures and options in all commodities, including plenary authority over options trading in non-agricultural commodities. The Commission used that authority to allow exchange-traded options in **non-agricultural** commodities.

However, the statutory ban on agricultural options was left in place. Only after the Commission's 1982 reauthorization was that statutory ban lifted, which allowed the Commission to authorize exchange-traded agricultural options. **Even then**, the Commission let stand a regulatory prohibition on **off**-exchange agricultural trade options (ATOs) – even though trade options in **all other** commodities could be offered to commercial users subject only to an antifraud rule.

It was not until 1997 that the Commission finally proposed lifting the regulatory ban and permitting agricultural trade options. Rules to allow ATOs, subject to registration, disclosure, recordkeeping, reporting and other requirements, were published in April 1998. The rules met with what we in Washington would characterize as “limited success,” which is to say that **nobody** participated in the ATO program. In December 1999, the ATO rules were further amended to permit cash settlement and streamline registration and disclosure requirements. Under the amended rules, one firm has registered as an agricultural trade option merchant.

Recap of ATO Discussions from Last AAC Meeting

At the time of the last AAC meeting, in March 2001, a little over three years ago, the Commission was considering new regulations to implement the provisions of the Commodity Futures Modernization Act. Thus, the relevant agenda item was entitled, “Review of agricultural trade options (ATOs) and other risk management alternatives in light of the CFMA and proposed regulatory changes.” The committee heard from a panel of three speakers, Jack Dougherty, of Kent Feeds, Bill Dodds of The Andersons (and NGFA) and Melinda Schramm, Chairman of the National Introducing Brokers Association.

The Committee asked Mr. Dougherty to appear because his firm, Kent Feeds, was (and still is) the only firm to register as an agricultural trade option merchant. Mr. Dougherty explained that Kent Feeds developed its ATO program to help their feed customers – independent hog producers – manage their risks and stay in business. By offering put options to producers, Kent allows them to lock in a minimum price for their hogs and, at the same time, they can lock in a price for the amount of feed necessary to raise the number of hogs covered by the option. The program is fairly simple and straightforward and Mr. Dougherty said Kent had not experienced any problems complying with the Commission’s regulations. He did note that the program would not have been possible without the 1999 amendments to allow cash settlement of ATOs, since the original rules required the option grantor to take delivery of the physical commodity, which would have been impractical for a feed manufacturer such as Kent Feeds.

Mr. Dodds stated the NGFA’s view that “ATO issues are simply a part of a much broader issue, the need for greater legal certainty for off-exchange forward agricultural contracts.” He noted that cash forward contracting is the predominant form of price risk management used by grain producers and others, but uncertainty about how the CFTC might view certain contract terms, and the resulting perceived litigation risk, may reduce the use of otherwise beneficial contracts. Mr. Dodds submitted hypothetical examples of a number of contract terms and asked how the Commission would view each example. The Commission’s Division of Economic Analysis responded to Mr. Dodds’ questions on August 1, 2001 and a copy of that letter was sent to each member of the AAC. With respect to the ATO program, Mr. Dodds suggested that the Commission should approach commercials in the grain, cotton, livestock and other commodity sectors and ask what changes are needed in the ATO program to attract them to begin writing trade options.

Ms. Schramm expressed the view of the NIBA that the ATO program is under-utilized because “the current large players in the gain trade” are reluctant to open themselves up to registration with the Commission or other regulation. Instead, they are “hid[ing] behind the forwards exclusion” and offering transactions that are very “ATO-like,” but are doing so without the disclosures and other customer protections offered by the Commission’s regulations. Ms. Schramm suggested that, if the ATO regulations were further relaxed, “the atmosphere for fraud on the customer would definitely be increased.”

Questions and Issues Concerning ATOs and Other OTC Agricultural Contracts

My third and final topic is questions and issues regarding ATOs and other agricultural contracts that might be appropriate for the Committee to consider at some future meeting. Let me just read through this list. Some of these are questions that were sent out to the Committee in advance of the last AAC meeting and still remain unanswered; others have come up since that last meeting.

Agricultural Trade Options

1. Why hasn't the current ATO program been more utilized? Is the program's limited use a function of the ATO rules? Is it due to the generally low commodity prices experienced since the rules came into effect (i.e., why use an option to lock in a loss)? Or is it due to competition from government price support programs (i.e., why pay a premium for something you can get from the government for free)?
2. Should the ATO rules be amended so that the exemption from the rules is based only on the \$10 million net worth requirement, rather than the current three-pronged test (thus allowing hedge funds to participate in ATOs and provide liquidity to the OTC agricultural derivatives market)?
3. The CFMA's thrust is to have tiered regulation based on the nature of the participant. As noted, the ATO rules provide for an exemption for participants with \$10 million net worth. Should the ATO net worth exemption level be set at a lower level – perhaps \$1 million as some have suggested?
4. Would such an approach disenfranchise smaller producers? That is, if ATOs could be offered to producers with \$1 million net worth and above without any regulatory requirements, would elevators or other option grantors have any incentive to offer the regulated instruments to smaller producers?
5. If the ATO program is further modified, should the Commission retain the prohibition against producers writing ATOs (and thereby assuming the potentially greater risks associated with granting options)?
6. Should the Commission drop the ATO program altogether and allow trade options in agricultural commodities to trade without any regulatory restrictions, subject only to a general anti-fraud rule, just like trade options in other commodities?
7. Would allowing unrestricted trading in ATOs (or imposing some lesser level of deregulation) increase the potential for fraud against producers?

Other Agricultural Derivatives Contracts

1. Is any significant amount of business currently being done in bilateral agricultural commodity swaps?
2. The CFMA's swaps exclusion, § 2(g), does not apply to agricultural commodities. Agricultural swaps remain subject to the more restrictive provisions of Part 35 of the Commission's rules (the pre-CFMA regulatory swaps exemption). Part 35 remains on the books solely to govern agricultural swaps. Should Part 35 be amended to allow bilateral agricultural swaps to trade subject to the same conditions as bilateral swaps in other commodities (e.g., allowing agricultural swaps to be fungible and standardized)?
3. The CFMA allows for future CFTC rulemaking to permit the enumerated agricultural commodities to trade on DTFs. At what point in the development of B2B trading platforms should the Commission consider such rule changes? What criteria should the Commission look at in proposing ground rules for agricultural commodities on DTFs?