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February 14, 2000

COMMENT

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Jean A. Webb, Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
21st Street NW.
Washington, DC 20581

Re: RIN 3038-ZA01
Proposed Revision of the Commission's Procedure for the Review of Contract Market Rules

Dear Ms. Webb:

The purpose of this letter is to state the views of ContiGroup Companies, Inc. relative to the proposed amendments that would allow contract markets (hereafter, "exchanges") to place a new rule into effect the business day after the Commission has received submission of the rule (hereafter referred to as "Streamlined Procedure.")

ContiGroup Companies (formerly Continental Grain Company) has existed as an agribusiness firm for over 185 years. We have been clearing members of the Chicago Board of Trade since 1922. We use the futures markets extensively to reduce the commodity price risk associated with the commodities that we trade or produce.

We primarily use the agricultural futures markets as a hedging vehicle, but we also use the futures in our forward basis contracting; therefore, any position we take relative to proposed changes in these contracts is ground in the question:

> Will this proposed change increase or decrease the hedging effectiveness of the futures or option contracts we use and will the proposed change lessen the basis volatility and facilitate convergence in the cash and futures prices.

Summary
From a hedging perspective, we **strongly oppose** this Streamlined Procedure for the adoption of new rules. To us the issue is striking a balance between the needs to the exchange and the needs of the users of the exchange instruments.

As agricultural hedgers, the heart of the issue is:

- The financial well-being of our business is tied to futures contracts. Because these instruments have such a big impact on our bottom line, we think there should be safeguards in place to make sure these instruments are not changed on a whim.
- We deal in agricultural futures contracts that have NO competition. Unlike many users of the financial futures, we do not have a competing liquid market to use. We profoundly feel and must live with the financial consequence of an exchange's actions, for as agricultural hedgers we have no where else to go.

Proposal before the Commission
The Streamlined Procedure would permit exchanges to place new rules into effect the business day after the Commission receives the submission. The following would be included in the submission:

1. Give a brief explanation of the rule change.
2. Describe any substantive opposing views expressed by members of the exchange or others.
3. Certify that the rule does not violate current rules and is consistent with current regulations of the Commission.

We oppose the Streamlined Procedure for the following reasons:

I. **Inherent Conflict of Interest**

A. **Exchange Filters the Flow of Information**

The exchange controls the information that is contained in the submission to the Commission. It is not obliged to seek opinions from outside the exchange. It is not obliged to detail the unsolicited opinions given it by people who are not members of the exchange. Even if the exchange receives opinions that are contrary to what it wants to propose and includes an overview of the contrary opinion, the presentation will be tainted by the exchange's natural desire to minimize opposing views.

The exchange is acting as jury and advocate. It is unreasonable to assume the exchange will present both sides of the argument with the same zeal and intensity. In a criminal trial, could one attorney stand before a judge and represent both the State and the defendant and do so without being biased to either the State or the defendant? This is exactly what the Streamlined Procedure is proposing.

The exchange will filter the information submitted to the Commission to suit its own desires and purposes. The exchange will determine what opposing views warrant being categorized as "substantive." Might this be similar to having the fox watch the hen house?

B. **<u>Exchange is Under No Obligation to Seek Outside Contrary Opinions</u>**

Under the proposed amendment, the Exchange is not required to seek outside opinions; if it does seek outside opinions, it would naturally decide to seek opinions which are consistent with its own opinion. There is nothing Machiavellian in this; this is just human nature.

At the very least, there should be an independent review of the rule change from the industry associations that represents the largest number of hedgers. For example, in cattle, associations that could provide outside opinions to the CFTC could be the Texas Cattle Feeders Association, Kansas Livestock Association or the Nebraska Cattle Feeders Association.

It might be reasonable to assume that the Chicago Mercantile Exchange sought the opinion of all of the major users of the live cattle futures contract before making the major revisions it did commencing with the June 1995 and June 1998 contracts. As the largest cattle hedger in the country, ContiGroup Companies was never asked to review the CME's proposals or offer its opinions or suggestions. Why should things change in the future?

Can the Commission expect exchanges who have adversarial relations with users of their instruments to go and seek opinions? Could it be that the reason there are adversarial relationships between exchanges and hedgers is that users of the futures contracts do not feel they are being heard?

C. **<u>Exchange Members Have a Conflict of Interest</u>**

Members of the exchanges serve on the very committees that propose rule changes, e.g., the Live Cattle Committee at the Chicago Mercantile Exchange. And just who do those committee members represent? The members represent their brokerage customers. These customers are the ones who pay commissions that are the livelihood of the committee members.

If the exchange member's major customer wants rule ABC, but rule XYZ would actually be better for the cattle industry as a whole, the member is going to be a strong advocate for ABC because his livelihood is dependent on doing what the customer wants. The committee member will vote in his own self-interest. If he does not vote for ABC in committee votes, then his customer will go to another broker.

The exchange committees that give life to proposed rule changes are composed of members who are acting in their own self-interest; therefore, the committees will advocate changes that will benefit their members' largest customers. The needs and wants of these large customers may or may not be the same needs and wants of the hedgers.

Our experience has been that the interests of the exchanges and those of industry are not always the same. We have seen time and time again where the marketing committees of state and national cattle associations overwhelmingly voted on proposals for the CME to implement, only to have the CME Live Cattle Committee reject the proposals because the *status quo* benefited some of the customers of the Committee members.

D. <u>The Exchange May Have a Certain Philosophy Reflective in the Rules</u>

An exchange may have a philosophy of what the futures contract "should be." For example, the CME has stated time and time again that the futures prices should send "economic signals to producers" of cattle. Unfortunately, this is why the live cattle futures contract trades at an average of $1.20 / cwt over the average cash trade for steers -- the futures specifications identify an animal that is "premium" to the average steer.

The view of the CME is that the futures should lead the cash, rather than having the cash lead the futures. Our view is that the futures specifications ought to match the specifications of the majority of the cash trade. If they are basically the same, then the volatility and the absolute value of the basis will be small. The exchanges need to provide risk management instruments that are tightly linked with cash, rather than using the futures contracts as a way to effect change in the cash market.

When a contract describes what an exchange committee feels "should be," this causes three key problems for hedgers:

(1) there is no true convergence in price
(2) there is more volatility in the basis
(3) deliverable supplies are limited by contract specifications.

These three items above are every hedger's nightmare.
The fact that the Streamlined Procedure would allow exchanges much more latitude in following their own agendas, has us very worried.

II. No Requirement to Inform the Public

The proposed Streamlined Procedure does not require rule changes be published in the *Federal Register.* This would mean that only the members of the exchange would know of changes in the contracts. While we can assume that they would somehow publish rule changes, there is a chance that users of the contract will not know of the change and make incorrect trading decisions.

III. All Futures Contracts Are NOT Created Equal

The reason that an exchange would want to have a their proposed rules quickly approved is because of competition -- they want to have a competitive edge or they want to match the competitive edge that a competitor has.

A good example of this is the Eurex (formerly DTB Deutsche Terminborse). Considering what the Eurex did to the MATIF in France and to the LIFFE in Great Britain, the US exchanges would badly want the authority to quickly match or best Eurex market moves.

But all futures contracts are not equal. There is not the same intense competition in many of the commodities -- the exchanges have natural monopolies. For example, live cattle is traded on just 2 exchanges in the world. According the Futures Industry Association's December 1999 "Monthly Volume Report", these two contracts had the following January 1999 to December 1999 volume:

Beijing (China) Commodity Exchange	116,156 contracts
Chicago Mercantile Exchange	3,839,548 contracts

For contracts such as the CME live cattle contract, which is physically delivered and is the only "player" in the world, there is no need for speedy approvals for rule revisions like there would be for the CME Eurodollar contract. The CME has competition from all over the world in Euro's, so they must act quickly to keep themselves competitive. On the other hand, with live cattle, there is NO competition.

If the Streamlined Procedure is approved, then there may have to be a two-tiered system:

Streamlined Review	Traditional Review
Very competitive contracts	Contracts with little competition
Financial product contract	Agricultural product contracts

The more traditional review could allow for more public comment prior to approvals.

IV. Price Discovery and Basis Contracting

As a major cattle feeder and user of commodity futures, we have extensive cash market and futures market positions. In addition to normal hedging activity in live cattle, feeder cattle, and grain futures markets, we typically have extensive cash market forward contract positions that are priced off of futures market prices. These "basis contracts" are commonly have terms up to one year in the future and are dependent on contract rules, commodity definitions and contract specifications.

Basis contracting in the industry is a common practice that has a total volume greater than the actual hedging volume in the futures contracts. Over time, this adds significantly to direct use of the futures contracts. For example, it is not uncommon for ContiGroup Companies to own as many as 250,000 to 300,000 feeder cattle on a cash basis contract. Grain basis contracting is similarly a common practice in the industry. All of these contracts are dependent and based upon the specific contract rules, commodity definitions, and contract specifications.

If the exchanges have the ability to change contract rules

-- without sufficient input from the industry
-- without an unbiased review by the regulatory agency (CFTC)
-- without the industry having time to analyze and react to the changes

then our contractual risk in the cash markets would dramatically reduce our ability to forward contract commodities, and it would also reduce our related use of the futures markets. With fewer industry hedgers using the futures markets, the ability for those futures markets to act as a medium of price discovery would be greatly reduced. As it stands, the average daily total contract volume in live cattle has been flat the last four years. (See attachment) Making the contract less attractive to the hedging community will only lessen the volume.

As an example of this, consider the two significant changes to the live cattle contract during the last five years (the June 1995 and June 1998 contract changes). The change in the delivery process and par contract specifications resulted in a significant negative increase in basis and greater basis volatility. These rule changes almost completely eliminated our opportunities to contract fed cattle on a forward basis.

Subsequent to those rules changes, basis bids by packers reflect both the more negative basis and the higher variability in the basis. Packers are rational market participants. They have simply changed their bidding process to reflect the realities in the market. But this change in the bid structure has severely limited our ability to contract fed cattle on a forward basis because it is now a much less attractive option to the industry.

In addition, our use of live cattle options (long puts) as a hedging device has been substantially reduced. The reason for this is the added "basis" cost in addition to normal premium costs of buying options.

V. **Hedging Impact Study**

The Environmental Protection Agency requires "Environmental Impact Studies" to see what impacts there will be on the environment if this or that construction project is undertaken. These are independent reviews.

If the exchanges are given the authority in the Streamlined Procedure to propose and implement rule changes, then should they be required to independently assess the hedging impact of proposed rule changes? Since the primary justification for futures contracts is their use as a hedging vehicle, then hedgers would need to know what impact the changes will have on basis levels and the volatility of the basis. Hedgers want to know more than that the proposed rules are in compliance with the Commission's regulations -- they want to know how the proposed changes will affect their ability to hedge and manage their price risk.

Public comment periods allow hedgers the opportunity to judge the effectiveness of proposed rule changes and voice any concerns they might have to the Commission. If they do not have that ability in the future, then the exchanges should contract for a quantitative study to be done by an independent party. This would be a poor substitute for the free flow of information that public comment periods provide.

VI. **Outline the Economic Reasons for the Rule Change**

Finally, the exchanges should be required to include a statement of WHY the proposed rule changes are necessary and HOW they will be an improvement over the *status quo.*

In summary, we are opposed to the adoption of the Streamlined Procedure presently before the Commission.

We are not so concerned about commodities that have a high level of competition, because whatever rule changes exchanges propose must make the contract more competitive. Hedging is the main reason for futures contracts' use, and any rule changes in a truly competitive environment will be to make the contracts more useful to hedgers. If proposed changes do not make economic sense, then *The Wealth of Nations* author Adam Smith, and everyday experience would suggest that hedgers will quickly go to an equally liquid market that will allow them to maximize profits, while minimizing their price risk.

Commodities that have little competition are a different story entirely. Hedgers are locked-in and have no place else to vote with their hedges. They do not have a choice. In these cases, we would respectfully recommend a more traditional review method that allows for public comment, with the Commission judging what changes are appropriate. Only then can hedgers be assured of the best possible hedging instruments that will allow them to maximize profits, while minimizing their price risk.

We appreciate the opportunity to express our views with the Commission and would be willing to answer any questions you may have relative to the position of our Company.

Sincerely,

John Rakestraw

John Rakestraw, Vice President
General Manager, Cattle Feeding Division

Robert Dix

Robert Dix
Option Programs Manager

Tommy Beall

Tommy Beall
Marketing Manager

graph attachment: Average Daily Total Volume 1975 - 1999

Live Cattle: Average Daily Total Volume