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COMMENT



# National Grain and Feed Association

September 30, 1999

Commodity Futures Trading Commission  
Three Lafayette Centre  
1155 21<sup>st</sup> Street, N.W.  
Washington, D.C. 20581

Dear CFTC Secretary: **re: Agricultural Trade Options**

This statement is submitted on behalf of the National Grain and Feed Association (NGFA) and its members. The NGFA is comprised of 1,000 member companies owning and operating more than 5,000 facilities and locations throughout the U.S. NGFA member companies are involved in all aspects of the business, including country elevators, terminals, export facilities, feed mills, livestock integrators, grain processors, cash grain and feed merchants, brokers and futures commission merchants.

NGFA continues to have interest in agricultural trade options (ATOs), because they hold the promise of giving farmers and other commodity-related commercial businesses more flexible, wide-ranging and more comprehensive risk management tools. Additionally, ATOs offer the ability to manage more diverse risks than can be addressed using current exchange-based tools. All participants in agricultural markets stand to benefit by having access to ATOs. However, farmers, because they confront substantially more market risks under the 1996 FAIR Act, may stand to receive the greatest potential benefits.

The CFTC has made some revisions to the rule, which will remove some of the barriers to participation. While the changes are not insignificant, based upon industry feedback, we question whether the changes are adequate to obtain reasonable participation and a meaningful pilot program. We would ask the CFTC to make further modifications to this proposed rule to provide greater assurance that the ATO program is successful. It is not in the interest of U.S. agriculture to have another year's delay in obtaining access to modern risk management tools.

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## Positive Changes to the Rules

I. The CFTC's proposal to streamline registration, including the narrowing of the range of company principals that must certify that they are not disqualified, and the elimination of the dual certification (company and individual) of truthful applications is a positive change. This relaxation of the original requirement is most important to larger companies in lessening the burden of initial registration. (The issue of whether registration is the best approach for identifying, monitoring and regulating ATOMs remains a concern and is addressed later in this letter.)

II. Eliminating the delivery requirement and permitting cash settlement will make ATO contracts more valuable to the purchaser. It will also allow a wider range of ATO products to be offered. This feature of the proposed ATO pilot is necessary to have a successful program.

III. The elimination of specific contract terms to be included in ATOs will give the pilot program some needed flexibility. In our view, the disclosure statement information concerning terms that should normally be expected in an ATO contract, should provide useful guidance to both seller and buyer of the ATO.

IV. Changing reporting requirements of ATOMs to the CFTC to annual rather than quarterly is a welcome change. However, we continue to have serious concerns about the extensive record keeping and reporting requirements, and whether the information being requested will serve a useful commercial or regulatory purpose.

## Concerns with Proposed Rule; Recommendations for Change

I. The registration requirement that includes the requirement for reparations, thus restricting the freedom of commercial entities to reach pre-dispute agreement on adjudication venue, continues to be a major concern. It creates risks that serve no useful business purpose. NGFA is in strong agreement that CFTC, under defined circumstances, should have the clear authority to withdraw approval of a particular ATOM's right to continue under the program. However, this can be done in ways other than registration and the right to revoke such registration. One approach would be to state in the rules that the CFTC has the right to conduct unannounced audits and the ability to issue cease and desist orders, financial penalties, etc. for non-compliant companies, after a timely hearing.

The concerns with registration and reparations are: **1)** that ATO contracts will be offered in commercial channels, but will not generally be treated as commercial contracts with respect to dispute resolution (commercial contracts generally contain a reference to commercial arbitration or courts); **2)** that litigation risk and exposure of companies will be expanded greatly, not just to contracts "labeled" as ATOs, but to other cash contracts as well. Although some will argue that "legitimate" cash contracts have no such exposure, in the last three years, our industry has discovered that contracts can be

completely legal, but companies are still required to spend a lot of money proving it. Reparations represent one more forum, and one more litigation risk. This regulatory provision alone may stop a number of commercial companies from participating in the program. This risk and seemingly open-ended financial exposure will continue to be a major concern of companies as they assess the benefits vs. risks/costs of becoming an ATOM. We would urge the CFTC to seriously consider notification as an alternative to registration, and stipulate that CFTC has the right to conduct unannounced audits, administer timely hearings (if deemed necessary by the audit), and withdraw the rights of the company to continue participating in the pilot, under prescribed circumstances.

**II.** To be exempt from the regulations, the CFTC's proposed rule would maintain a \$10 million minimum net worth requirement for both buyer and seller of the option. We would urge the CFTC to reduce this exemption to a reasonable level. The \$10 million level is so extreme, it virtually eliminates all but the largest and wealthiest farmers (and companies) from having access to regulatory-exempt contracts. It is thus, highly discriminatory against small and moderate size companies as well as the vast majority of commercial and family farms. The exemption level is also excessive as related to: **1)** trade options for other non-agricultural commodities, which have been completely exempted, and effectively function with a zero net worth exemption level; and **2)** agricultural swaps, which are exempt from regulation if both buyer and seller have \$1 million in net worth. Arguably, agricultural swaps pose open-ended risk for both buyer and seller, while the ATO for the purchaser has risk limited to the premium plus the potential gains for the life of the contract. Thus, what is the CFTC's rationale for setting the net worth exemption for ATOs at ten times that set for swaps?

**III.** Record keeping requirements state that ATOMs must keep "full, complete and systematic books and records together with all pertinent data on ATO transactions," including solicitations, covering transactions, and make books available to the CFTC and Department of Justice.

-This requirement is all encompassing. We would recommend that the CFTC consider how the requirement could be narrowed to make the record keeping task more manageable and less threatening, while achieving its regulatory purpose.

-Maintaining records on solicitations in all forms is a substantial burden for ATOMs. Is this necessary under the pilot? If so, what constitutes a solicitation?

-Data on "covering transactions" may not be readily available from companies that have extensive hedging/risk management portfolios. Identifying one ATO contract and the transaction used to cover the futures risk portion of that contract simply may not exist on a one-to-one basis. CFTC needs to reconsider this requirement.

-Making books available to the CFTC and the Department of Justice could have a very chilling effect on ATOM participation. Is there any limitation on what CFTC or DOJ could audit under such circumstances? We would recommend CFTC consider how this authority of government to have complete access to internal company books could be

restricted to accomplish a specific, functional regulatory purpose while more reasonably limiting the audit exposure of companies. Extensive audits are time consuming and costly for the company involved.

IV. Reporting requirements to CFTC, as previously noted, have been changed from quarterly to annual. But the data requirements to complete such reports remain far-reaching. We would urge that CFTC re-examine these requirements to determine if such detail serves a necessary business or regulatory purpose. Is the CFTC staff really going to review this information and/or analyze it, and if so, to determine what? If the CFTC does not have specific use for such information, it represents only a factor of cost with no benefit to CFTC, the ATOM, or the customer. As potential ATOMs consider signing up under the program, reporting and record keeping burdens and the associated costs are a very large consideration. As now constructed, the pilot program has requirements that resemble, and in some cases exceed, the requirements of even futures brokers on regulated exchanges. CFTC needs to carefully review whether this regulatory approach is appropriate/necessary for cash markets, or simply creates an unwanted barrier to broader participation by ATOMs and ATOs being more widely offered to prospective customers.

### **Other Recommendations to Make ATO Program More Attractive**

Despite the CFTC's attempt to reduce the regulatory burden of this pilot program, there remains a significant up-front business cost to establish reporting, record keeping and other systems to comply with the regulations. Likewise, a number of questions are being raised by prospective ATOMs:

-Will CFTC registration always be required for ATOMs, thus creating a new permanent regulator of cash market companies?

-Will ATO contracts always be treated by law and regulation as a class of cash contracts distinct and different from other cash contracts, with exposure to CFTC reparations and specific record keeping, reporting requirements, etc.? Or is it possible that agricultural trade options eventually could be declared exempt from federal oversight, the same as all other trade options?

-How do companies know that CFTC and Department of Justice (DOJ) will not use access to books and records to harass companies, investigate non-ATO issues, and generally pursue "witch hunts"?

-What are the penalties for non-compliance? For example, if an audit turns up some deficiencies in internal controls, what is the exposure of the company? If the company is ordered to withdraw from offering ATOs, what happens to outstanding contracts?

-What are the limits of the regulatory reach of the National Futures Association (NFA)? Can NFA's regulatory authority (and its limits) be more specifically delineated?

-Under what regulatory violations would a company stand to risk losing registration rights? Would there be financial penalty exposure in addition to the lost business?

-What are the chances that, after the pilot program ends in two years, the CFTC decides to end the program, and the investment made by companies in designing and offering ATO contracts is lost?

-What are the chances that, after the pilot program ends in two years, the CFTC decides to permit ATOs under largely an exempt status (like non-ag commodities)? Such a change could have a significant impact on capital invested under the pilot program. (Note: This is a key issue that will affect company strategies on ATOs. Some companies, particularly smaller companies, might be willing to try ATOs with manual reporting/record keeping systems if there is a chance the extensive regulatory burden might be eliminated after a few years' experience with a successful pilot.)<sup>1</sup>

Farmers and other participants in agricultural markets can benefit from ATOs, but only if the long-term regulatory requirements/costs of compliance are less than the expected benefits, thus attracting some degree of participation. We would urge the CFTC

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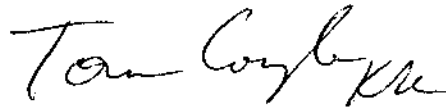
<sup>1</sup> Many companies in the grain industry, while understanding the potential benefits of ATOs, remain very apprehensive about the entrance of a new regulator in the form of CFTC and/or NFA and whether an ATO program becomes the "point of entry" for permanent federal oversight of cash commodity marketing. Attached to this letter is a matrix that compares the regulation of ATOs (under the current rules), other trade options, swaps and futures/options. While some of the ATO regulations will be reduced under this proposed rule, the amount of regulation being proposed in this rule remains extensive, particularly for cash market transactions, which generally are governed under long-standing state law and the UCC. The fear of a growing federal regulatory presence has led to varied ideas as to how such a pilot program should be approached by the CFTC. One NGFA member suggested the following:

*"What makes options (ATOs or other over-the-counter options) attractive to fraudulent operators has always been the collection of the premium up front. That is the only thing that would make an option riskier to a producer than a standard cash contract. It would seem that the CFTC could rationally eliminate most of its proposed regulatory oversight, if it would only address how the money (premium) is handled. There could be two types of ATOs. One category would be those contracts in which the option premium is only paid upon execution of the contract; these would be no riskier to the buyer of the option than a standard cash contract and require no special oversight. The other category would be those in which the buyer pays a premium up front. In this case, an escrow account could be established which could be managed by a third party. The premium could be authorized for disbursement to the seller upon proof of execution. CFTC's regulatory responsibility would be to see that sellers and the escrow agent complied with the procedures. This would seemingly protect buyers at a much lower expense to the industry, and be considerably less burdensome on the CFTC, which I understand is concerned about potential workload of CFTC staff and commissioners to administer the pilot program."*

This suggested alternative regulatory approach is clean and simple and serves to highlight some of the problems/commercial issues with the proposed ATO regulations. NGFA would generally agree that many forms of ATOs, in particular since the farmer-customer is restricted to purchase only, have a lower risk profile than many cash contracts that are statutorily exempt from CFTC jurisdiction (this is a point that NGFA made in its December 4, 1997, comments on the original proposed ATO rule). If the issue is financial protection of the customer, how is the current rule more protective than what this NGFA member proposes (paragraph in Italics above)? If the customer protection is equivalent, or nearly so, what does this suggest about how many redundancies may be contained in this proposed rule and how much needless costs may be imposed on the cash commodity industry? We would urge the CFTC to carefully evaluate this proposed rule and whether it is the best approach to achieve the CFTC's goals.

to consider whether its intent to protect customers through these regulations may ultimately result in unnecessary restrictions on customer access to needed risk management tools. The customer will always have the right to choose the risk management tool(s) that best serves his/her needs. If ATOs fail to succeed because the regulations quash commercial interest in making a market for ATOs, it is the customer that loses, as his/her market choices for marketing and risk management are more limited than they should be in a competitive marketplace.

Sincerely,

A handwritten signature in black ink, appearing to read "Tom Coyle". The signature is fluid and cursive, with a large initial "T" and a stylized "C".

Thomas Coyle  
Chairman  
Risk Management Committee

TC:br

Attachment

## COMPARISON OF CFTC REGULATION OF AGRICULTURAL TRADE OPTIONS (ATOs), TRADE OPTIONS (TOs), SWAPS AND EXCHANGE-TRADED FUTURES AND OPTIONS

Regulatory Requirement	ATOs	TOs	Swaps	Futures/ Options
1. NFA Registration Required	Yes <sup>1</sup>	No	No	Yes
2. CFTC Reparations Jurisdiction	Yes <sup>2</sup>	No	No	Yes
3. Restrictions on Eligible Vendors	Yes	No	Partial	No
4. Minimum Net Worth Required for Vendors	Yes	No	Yes	No
5. Minimum Net Worth Required for Exemption	Yes (\$10 mill. net worth)	No	Yes (\$1 mill. net worth or \$10 mill. assets)	N/A
6. Mandatory Written Contract Terms	Yes	No	No	N/A
7. Mandatory Risk Disclosure	Yes	No	No	Yes
8. Mandatory Transaction Specific Risk Disclosure	Yes	No	No	No
9. Restriction on Grant or Sale of Puts or Calls	Yes	No	No	No
10. Settlement by Delivery Required	Yes <sup>3</sup>	No	No	No
11. Mandatory Current Price Quotes and Notice of Expiration Date	Yes	No	No	N/A; No
12. Mandatory Training for Vendors	Yes	No	No	Yes
13. Mandatory Written Internal Controls	Yes	No	No	Yes
14. Recordkeeping Requirements	Yes	No	No	Yes
15. Reporting Requirements	Yes	No	No	Yes

<sup>1</sup> Section 8a of the CEA, 7 U.S.C. § 12a, does not expressly authorize the CFTC to create new categories of registrants. This may result, in part, in the CFTC exercising jurisdiction over excluded forward contracts. See Rule 32.13(a)(3).

<sup>2</sup> Conflicts with NGFA arbitration; CFTC will have jurisdiction to resolve disputes over ATOs settled by entry into forward contract. Rule 32.13(a)(3).

<sup>3</sup> Intended "to dissuade speculative use of the contracts." 63 Fed. Reg. at 18,823. However, speculation is not permitted with TOs, see 46 Fed. Reg. 23,469 at 23,476 (1981), yet TOs can be cash settled.