

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.  
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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.

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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 that 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 1974  
legislation that enacted the creation of 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 themselves.

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 Risk Management Agency here today represented at the commission, and they will provide an update on their activities as well as we'll have staff reporting on recent development by 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, 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 she will, I'm sure, provide her input as to what happened at the meeting.

Let's start then with introductions around the table. As tradition, we will have each member introduce himself and the organization they represent. So I'll start to my right with Trena. Trena, 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 on at one time, they don't work.

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

MS. GRABOWSKI: Thank you. I'm Trena 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 in time 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 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 it 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 repropose 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 repropsoed 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 down to 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 discussion as we get into the topic regarding 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 sheet like the chart sheet. That also attempts--put together by Don Heitman on my staff--attempts to outline what we just talked about in two or three pages. So for your members, it kind of outlines, lays it out, I think pretty simply how commodities are treated and how ag is treated compared to everybody else.

I also just want to note just 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 for a few minutes and have Ron Hobson, Senior Economist of Economic Analysis Division, come up and just outline for your 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 Neal Smith from Michigan, Congressman Nick Smith--excuse me--Nick Smith from Michigan, not Neal--Nick Smith, and it's section 4p of the act, and I've asked Ron Hobson to kind of 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, and we'd be at this time 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 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 provide to us today or in the future, not necessarily at a meeting, but just pick up the phone, give myself 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 other than, you know, 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 as to 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 CFTC was created in 1974, it was given expanded jurisdiction over futures and options and 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 was published in April 1998, but no firms took advantage of the ATO program.

In December 1999, the ATO rules were further implemented 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 transaction 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 a 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 very drastically or very importantly need your input--the 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 limited use and one can answer the question why? Is it due to market conditions? Is it due to the regulations and restrictions on the program as some have suggested? A combination of the two? Or 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 to the committee members and their experiences.

In addition to Jack, I've asked Bill Dodds, who is a member of this committee, to outline NGFA's views on ATOs and OTCs 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 Melissa 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 transaction 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 all committee members, and Melinda as well, and committee members, they 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. Look forward to your participation and further discussion with the committee members.

Next, I'd like to have Bill Dodds outline. As I mentioned earlier, NGFA has long been active in this arena dealing with this issue, and I'd like to have Bill kind of put forth in a few minutes, Bill, your

perspective as a committee member, but also as 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 the 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? Is 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 their 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 maybe 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 we'll try to, when we get into general discussion, I may ask Paul just to briefly--I don't think we can respond to all your questions in your testimony, but we can try to-- 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. Delaware, New Hampshire, Utah and Vermont only had one IB office in each in those states, and Hawaii and West Virginia had no offices at all registered that spring.

When IBs look for clearing arrangements with an FCM, they report that reputation of the firm is the number one reason for choosing that FCM. Rates, the clearing rates or the fees which are charged to do the transactions rank second in order of importance to the IB. And the category "other" ranked third. Other included such diverse things as who the management was, who owned the company, who were the main traders, and whether or not the FCM offered managed account programs.



Research was the most consistently ranked last in importance to the IB looking for a clearing arrangement. This is a change from just a very few years ago when research could only be gotten through your FCM. It's obviously a change that technology has helped to bring about.

A total of 211 FCMs were registered with the CFTC that spring and members of the NFA, but only 40 of those FCMs did business with guaranteed introducing brokers.

Since the NFA does not keep separate records about FCM relationships with IIBs, or independent introducing brokers, only firms with GIBs can be easily identified. 12 FCMs were guaranteeing about 750 IB offices of the total approximately 1,200 IB offices or GIB offices that were registered then.

An IB owner typically has at least three and one half years experience in the futures business before opening an IB office. The majority of IB owners I spoke to had between nine and 14 years experience in our industry and the IB office itself had been registered for six years or more. I spoke to an IB owner who had

actually been registered in some capacity in the industry for over 35 years.

Some of the IBs are also registered as CTAs. A few are farm management specialists or consultants and about 12 percent in the spring of 1999 were registered as security brokers or dealers. Some IB offices provided complete risk management services such as crop insurance, cash marketing or other producer related management services.

At the time of our survey, nearly 80 percent of the total volume of trading done in the 127 offices responding was done in futures rather than in options.

About 50 percent of the IBs told us they trade most heavily in grain and livestock markets. This is a significant change since the FIA survey of the early '90s found that about 80 percent of IBs were to be considered agricultural.

The next most heavily traded contracts were indices with the metals and the soft markets the least traded by IBs. IB offices reported in the spring of 1999 that no significant volume was being traded on markets outside the U.S. by their customers. Over 90 percent of the IBs placed orders in the E-mini S&P market at the CME

regularly, and a few IBs, and I think there were about ten of them all together, said that as much as 20 percent of their total business is done in the S&P contract. About 50 percent trade the Project A contracts at the Chicago Board of Trade.

A typical IB office has five to six APs, or associated persons, or sales persons, registered with it. Three of the offices responding reported that they had 25 or more APs working in their office.

Only one office responding to the survey was minority owned, and fewer than 15 percent of the offices responding had even one woman registered.

IB offices recruit APs among friends and former clients and from local newspaper advertising. Some also hire from the floor employees that they are using at their FCMs.

A typical IB office services 250 to 300 clients per year. Again, that's a big change in the last ten years, up from only 50 or 60 clients, most significantly due to technological advances. About two-thirds of the total number of clients in each office are what we would call active. The others are seasonal or occasional traders. Those also would include the bona fide hedgers.

A few offices which provide the specialized services along with futures and options such as foreign management consulting have only 30 to 50 clients on the books. And three IBs reported in 1990 that their offices were serving over 2000 active clients per year. When we asked the question what is the average length of time an account stays open with you, 80 percent of the IBs said they were still servicing some of the clients they opened when they first opened for business.

IB offices service a variety of clients, hedgers and speculators alike. Those which work primarily in the ag market areas tend to service small to medium size rancher and farmer. Because these offices are no longer servicing only local clients, they provide education and research to any size or type client who wants that information.

Virtually all IB offices use some form of electronic order entry. Generally, it's the system which their FCM has developed or purchased and requires all the offices in its system to use.

Nearly every IB uses the internet to solicit for customer leads. Some offices have their own web sites. Others are just links or addresses from the FCM.

Most of the IBs who have a web site post both news and education as well as information about the IB itself such as who are the principals, who does the trading, how long the IB has been in business, if the office has a specialty, and what other kinds of services the customer may find at the office.

Account forms or opening account documents can most often be downloaded from the sites. That background information is the long way around to addressing today's topics, specifically, the ag trade options, other ag derivatives and IB concerns related to the agricultural issues. The opinions that I'm expressing today are those of the IB members of the association. Some of the FCM members concur, others do not.

Number one, the agricultural trade options. Our membership is of the belief that the current ATO program has not been more utilized because none of the current large players in the grain trade want to open themselves to the type of regulation which registration with the CFTC and the NFA insists upon.

Most of the firms offering ATOs have so far been able to hide behind the forwards exclusion clause to do essentially full-blown futures business by what

appears to be a form of their own contrived ATO-like program without having licensed brokers and without having to disclose risks, strategies, fees and pitfalls, and without having to answer or account to their customers in the manner that the IBS and FCMS are required to do by the commission and the NFA.

Currently, unregistered ATO providers are not disclosing what the strategies are which are being utilized or what the risks involved may be. As the strategies have become more and more complicated over the past years, it's common to see providers who have no training in futures and options products diligently pitch the ATO program developed by their company without any better knowledge of the product than the producer to whom they are speaking.

The history of option and option-like products promoted by unregistered or minimally registered trained individuals to relatively unsophisticated participants is consistently negative, even when done with the best intentions. Just in the past few years, we've seen on several occasions that neither the seller or the buyer has the required familiarity with both the product and

its potential behavior during periods of volatility or sustained price movement.

Most often the smaller the end user, the less appropriate the ATO-like product becomes. Additionally, one IB pointed out that the tools and benefits that the grain trade argued that ATOs would offer apparently provide no marketing alternatives or benefits above and beyond what exchange traded futures and options currently allow.

So the need to offer ATOs at all would seem pretty limited. As much as most members of the NIBA would generally like to see less government regulation in every aspect of our business lives, most agree that no changes in the current ATO program should be made. Allowing unrestricted trading in ATOs or imposing some lesser level of deregulation would as the commission suggests in its questions to the three of us on this panel increase the potential for fraud against producers.

If the commission drops either the three-pronged approach or changes the minimum net worth requirement so that ATO users would find themselves trading in a less regulated environment, the result could

be that smaller producers will be disenfranchised, along with the IB community and small grain companies.

In addition, the probable result will be that larger provider consortiums will simply develop product which will allow all these smaller producers to be lumped together as one trading unit. No risk disclosure, no proper account identification, no segregation of consumer funds will take place. A customer will lose all current regulated protections.

We have only to look at the hog industry to see the consequences of corporatization in American agriculture and how quickly those consequences will occur. Likewise, the goal of some of the larger grain companies seems to be to use such products as ATOs to gain greater control over production, guarantee themselves a steady supply of crop upon demand, and not have to bid aggressively for production throughout the majority of the year.

The effect of the scenario will be that basis levels will suffer, the flat price will suffer, and farmers will become employees of these grain consortiums. While some changes in the ag segment of this industry are likely inevitable, dropping ATO registration and



regulation programs might very well create the environment above in as little as two to three years time. Just imagine one big grain company controlling all of American agriculture in the way Microsoft controls the software on virtually every PC in this country.

In response to the commission's questions regarding ATOs, one NIBA association member asked if comment on this issue was ever solicited from members of state grain and feed organizations as opposed to the large commercial agricultural concerns. Have those organizations seen an outcry from the people who would use them to make these products available?

In any case, the commission should recall that its mandate is not to provide product to consumers, but to make sure that those providing the product are adequately trained and regulated, and those using the product are adequately protected.

More specifically to your question as to whether producers should be able to write ATOs? While most NIBA members agree that farmers should have every benefit and advantage that big companies have, several members noted that as recently as just last week, they were hearing about companies which encouraged farmers to

enter a transaction which basically sold a call option limiting the farmers maximum selling price for a premium that was far substandard to current market prices.

In particular, this association member reports that the actual transaction was selling a call option for six cents that was currently trading on the Chicago Board of Trade for 12 cents, and being charged nearly \$300 in commissions for that transaction.

Since my first meeting in 1994 with then Chairperson Mary Shapiro, the NIBA has time and time again voiced the practical business concern that by allowing unrestricted trading in ATOs, registered and regulated members of the professional futures and options community are disadvantaged by being put on a less than level playing field with those people or entities who would offer such products without the need to answer to compliance and supervision arms of the CFTC, the NFA, and their exchanges.

We believe the atmosphere for fraud on the customer would definitely be increased. Effects suffered by the farming community will include mismanagement of pricing and marketing risk along with increased elevator failures.

We encourage the commission to look back to the hedge-to-arrive contracts of just a couple of years ago. Add to that the fact that many of the new contracts currently being offered are far more complicated. Throw in a little bit of desperation from the producer due to a tight economy and low prices, and you get a recipe ripe for disaster.

With regard to other agricultural derivative contracts, in this area, the NIBA is somewhat divided. Most members are not aware of any significant amount of bilateral agricultural commodity swaps currently going on. IB members and some FCMs believe that a platform which provides unified trading of cash and derivatives rather than the current versus-cash method is not an improvement at all and may even be impossible to construct due to the lack of a centralized cash marketplace.

One member commented that he couldn't see how these contracts would be constructed unless they were based on exchange traded regional basis contracts.

Another member said that unified platforms would mean to him more deregulation, greater complexity of the tools offered, and more opportunity for

unscrupulous, undertrained providers to sell complicated products to producers which neither party truly understands.

All NIBA IB members and many FCMS oppose parallel ag contracts or moving the ags to DTFs. The association believes this move would ultimately drive commercial volume to the less regulated market and would weaken contract markets by destroying their fundamental ability to allow transparent price discovery.

One IB member commented that the only way to provide producers more effective and attractive risk management strategies is to force all the participants to meet the same level of regulation. It appeared to him that the commission's intent with the CFMA was to construct a tiered market system that would fracture the agricultural markets into so many segments that only the largest commercial entities would be able to survive.

He along with several IB members of the NIBA was unable to see how allowing ag products on DTFs led to better price discovery, which is the absolute necessity for an efficient marketplace which continues to have value to its users.

And interestingly, many association members said they would be in favor of more versus less regulation as proposed in the current exchange versus DTF scenario, because in this time of HTA complications and other financial disasters, including the ones we've seen in the stock market frenzy and collapse, we've seen that the public's greed and willingness to accept unreasonable amounts of risk in the face of clear fundamental good business judgment indicates that these same people will not always self-manage and self-regulate risk.

And finally, to address the issue on introducing broker concerns, a few of the NIBA members noted that at the end of 1998, there were to their knowledge approximately 10,000 elevators and feedlots in the United States. We can't really tell how many were registered as IBs because, number one, the NFA doesn't keep records on the type of business done in the IB offices, and number two, many of the entities function as branch offices rather than as IBs because of the registration requirements.

But we do know that we have a few elevators and feedlots as members of our association.

The NIBA is generally opposed to reducing registration requirements for IBs. Our business entails utilizing highly leveraged financial products. Amateurs and part-timers bring with them problems such as unfamiliarity with the product, inability to assess the client's goals and risk capacity, and inattentiveness to both the markets and the clients. Diminished regulation requirements will attract operators seeking to take advantage of that lack of registration and regulation.

Our association members, IBs and FCMs alike, would like to see more registered IBs in the industry, but not at the expense of the investing public.

Neither the current registration or the Series 3 commodity exam is a significant impediment to registering or to engaging in the business. Therefore, the NIBA is of the belief that the rule changes would not substantially increase in number of registered introducing brokers.

However, we do believe that more firms would register if the CFTC more aggressively enforced their rules by forcing elevators that are currently trading futures and options and offering ATO programs and their

like to register and properly license their operators as APs.

Further, it's always seemed a bit peculiar to us that the commission cannot pursue action against entities which have not registered but which look to the public like CFTC registrants and offer products which purport to extend the benefits of exchange traded products. To mangle a phrase, if it quacks like a regulated futures or options product, it should be regulated as one.

In response to the commission posed question, what rule changes would allow registered IBs to offer more effective or more attractive risk management alternatives to their producer clients, the NIBA membership responds:

(1) The fact that IBs generally cannot sell commodity firms with a Series 3 license, but stockbrokers with a Series 7 can is totally unreasonable. This should be reexamined by the commission.

(2) The movement to streamline disclosure statements and options disclosure statements will be very beneficial to the IB attempting to solicit new business.

(3) Exchanges or other trading facilities should be encouraged to develop risk management tools in cooperation with such organizations as the USDA, farm bureaus and even local agribusinesses. Then we'll be able to offer and provide tools which the producer truly wants, which he truly needs, and which he truly understands how to use.

Before I close my prepared remarks, I want to address two of the other issues this committee is scheduled to take before it, and you'll be happy to know that it's only two more pages.

CHAIRMAN SPEARS: Melinda, if you could summarize that because we're already behind schedule by about 30 minutes now.

MS. SCHRAMM: Absolutely.

CHAIRMAN SPEARS: So if you would just take your two pages and summarize in a couple of sentences, I'd appreciate it because we do need to reserve some time for discussion on this topic.

MS. SCHRAMM: Absolutely. The two issues were that the NIBA is looking forward to a new day at the USDA. We're looking forward to a new day of working in cooperation in developing risk management product.



And secondly, with regard to the single stock futures, we are looking forward to what the commission has to offer. We're happy that the commission has been very strong in holding the line with regard to the selling requirements. However, we are disappointed in both the margining and a tax ramification of those requirements and would like to visit those issues with you all further.

That being said, we appreciate the opportunity to come before this panel, and I would be happy to take any other questions or expand. Thank you, Commissioner.

CHAIRMAN SPEARS: Thank you, Melinda. Well, where do we go from here is the question, I guess, that the commission is looking for input from this committee? As you can tell, there is a divergent--as the panel outlined, there are a number of different views out there in regard to what to do with bilateral transactions, what to do with ag trade options, and how it affects different people's lives and businesses.

I know this commission is very interested in this committee's input as to where do we go from here. We've heard from one--the only person so far--ATOM who's using the program with some success. I've heard today, I

think it's fair to say, that the reason why--now keep in mind there are two issues here. One is--and Paul, I may ask you to help outline these issues in a minute, but in my mind there are two issues.

One we've addressed is the ATO program. We're two years into the program. It's had limited use so far. Is that because of the design of the program, as some people suggested? Or is it due to the market conditions, as others have suggested? You know some folks have suggested, as Bill did, that it's the commercial people who will be utilizing, offering the program, and it's up to them to decide how to design the program as opposed to the ag producers.

The other issue before us, as Paul outlined in his introductory comments, is what to do with bilateral transactions on an undefined term of ag commodities? How do we treat ag swaps and ag commodities on that basis? Should they be exempt from regulation as other provisions? So, Paul, do you have any words of insight or thoughts to maybe put us on track to facilitate some discussion from the committee?

MR. ARCHITZEL: I guess I have a couple. One is the NGFA raised a number of questions with regard to

what kinds of contracts would be considered to be forward contracts and what would fall under the forward contract exclusion, and that's been an issue that has been a long-standing issue.

I think there are mechanisms to address that. For example, we have outstanding a Office of General Counsel interpretation that goes back many years to 1987 which had in it a discussion of various hypothetical type of contracts and gave an official view of the General Counsel's office on whether or not those were forward contracts, and I think that really is the most profitable way to get guidance in an official way on what kinds of contracting practices would flow within the forward contract exclusion, and then that it makes sense that if contracting practices are different and have grown since 1987 to revisit that in that kind of setting.

And that really would require a request from any of you around the table or anyone from the public that the commission consider certain types of contracts or the commission staff rather and give an opinion on those. So that would be one place to start.

As a general matter, responding to those contracting situations, however, I think we all know that

a forward contract which has run its time period both parties can go back and renegotiate a contract and not affect the nature of the fact that it's a forward contract.

So it's important to distinguish from the types of examples given between those contracts where both parties because of crop failure or some other type of situation renegotiate a contract after the contract has been entered into from a contract which provides for certain features at the time it's entered into. And that's an important distinction that I think we all are sensitive to and that in looking through the examples later, certainly that that's something that distinguishes many of the examples and should be looked at very carefully.

MR. GILLEN: Paul, one of the questions posed by Bill was rolling a contract forward, and in 1996, the commission issued I call it a derivative, but I don't know the status now, which precluded a producer in a contract from rolling forward past the last delivery month in that particular crop year. That, in effect, is the custom and usage of the cotton trade, and I was just

wondering if that edict is still in effect here at the commission?

MR. ARCHITZEL: I think what you're referring to is a staff advisory which was issued on the prudential nature of inter-crop year spreading, and that was not a commission pronouncement, and it did not discuss the legality and whether or not such a contract was a forward contract or not. What it discussed was the prudential nature of inter-crop year spreading. So from that perspective, it was an advisory statement of the staff.

To the extent that that contracting practice is one which you would like further clarification on, the appropriate mechanism is to provide the commission staff with a written description of it, and to provide us with an opportunity to consider it and respond in a considered way to it.

MR. GILLEN: Well, virtually all of our contracts preclude that practice because you're just begging trouble. That's why.

MR. ARCHITZEL: And that was the basis of the staff's advice, and again it was an advisory opinion that inter-crop year spreading is an imprudent practice. It doesn't say whether it's a legal practice or not.

CHAIRMAN SPEARS: Are there any comments or questions, other comments, questions, regarding where we go from here regarding the ATO program or bilateral transactions per ag commodities, whether they should be exempt or to what level exemption they should be? Neal?

MR. GILLEN: Yeah, I really appreciated Bill Dougherty's explanation of what they're doing, and in effect it's rather simple, and one could make the argument that why should such practices be regulated. You know that's just an opinion. Insofar as question number one, I think Mr. Dougherty answered that question insofar as whether or not low prices have any effect because he indicated, in effect, you could make the argument that these type of instruments are more valuable to a producer in times of low prices because a product can be offered way out when you can see light in the marketplace.

You know I just go down to number seven, and in effect--question number seven.

CHAIRMAN SPEARS: That was sent out in the advance packet.

MR. GILLEN: Yeah, in the packet you sent out. Go down, right down to question number seven, and give a

resounding yes. But there is something in process here at the commission that Paul may be able to comment on, and that is the Cargill Case. There is a decision by the ALJ. It's under appeal now, but ultimately the ruling in that case will be dispositive, could be dispositive of this issue.

MR. ARCHITZEL: Actually, that is under appeal so it's not appropriate for me to comment on it or for it to be a matter of discussion now. You are correct there has been a decision by an ALJ. It has been appealed by our Division of Enforcement to the commission. So it's currently pending with the commission. So it really isn't a matter that we can discuss now, other than you're also right to say that some of the issues in that case would have a bearing on the commission's policy ultimately on what it does with regulations regarding ATOs.

You did mention two things which I think are noteworthy. One is that the program that Kent Feeds outlined is rather simple and understandable and user friendly from what I was hearing, and that is what the commission's rules intended it to be.

You also asked why should such a simple program be regulated, and I think that the reason there is a history of the commission grappling with this issue of regulation of ATOs is because there had been in the past abusive practice with regard to trading options, particularly because, unlike futures, where there is the need for an individual to know his customer, in the case of futures where a premium may be paid fully up front, it has lent itself to abusive practices in the past.

So that the kinds of regulations we have segregating customer funds cover those kinds of provisions were intended to address the possible abuses we might see, and it becomes a policy question for the commission and for this committee to discuss is whether the cost of our regulations and how they work is so burdensome that it is too costly to prevent the kinds of harm that we envision might happen, and that's a judgment question that certainly this committee and the commission has grappled with.

MR. GILLEN: Well, I appreciate that, Paul, but you can make the argument that, as Bill said, the trade has rendered its judgment. It's of no value to producers unless some innovation can take place, and there is no



incentive for innovation with regulation. Thank you for considering it anyway.

CHAIRMAN SPEARS: I appreciate that, Neal. I think that it's fair to say that one reason why we're addressing this issue today, it is a new day and we're at this commission, myself and I believe other commissioners present, are open to addressing this issue in light of a new act and where we go from here to make a program workable. Bob, you wanted to say something?

MR. METZ: Yes, thank you, commissioner. I want to make clear I'm not speaking for the American Soybean Association but for myself personally. I am a production farmer. My wife and I are both full-time farmers. That is the only place we receive our income. We obviously use futures; we use options. But as was pointed out, the majority of production ag does use contracts to move their grain.

And this is basically because we not only need the futures, but we need to capture the basis, and we also need an orderly movement of our grain off our farms. We store all the grain at harvest. We need that orderly movement of grain off our farms through the winter

through the summer months. Up north, you can't move it during the spring because of road restrictions.

So we need an opportunity to move this grain. As far as production goes, ag production, most people would say that it's probably a good practice to have a third of your grain sold this time of the year, a third of your grain sold mid-summer, while there is still a lot of risk. Once the risk is out of it, generally the market is out of it, too. I'm strictly talking from the farmer's point of view.

So we normally would try to have two-thirds of our grain sold when the crop is about half grown. That, of course, gives us some risk. The 1988 drought, by mid-June, it was fairly obvious that we were not going to be able to fill our contracts. I don't know if it was legal, but I know I wrote a check to get out of those contracts, and I felt very good about writing that check even though it was fairly large because I had a huge risk hanging over my head.

So then I think anything that can be done -- and these ag trade options look like possibly a good opportunity for production ag as a way of limiting risk. I think the Crop Insurance Program has greatly helped

because you can also get an increase in the market when there is a drought. If this is the way out, ag trade options for the actual producers, I personally think it's probably a pretty good option. I do think we need some oversight on it. Just to have all kinds of contracts out there I think puts farmers at risk. Thank you.

CHAIRMAN SPEARS: Any other comments or questions? Richard, do you have something you want to add?

MR. GUPTON: Yeah, just a few things. The only thing I would recommend, I guess, is potentially with these questions that are pretty well presented do some type of survey for the different commodity groups and bankers on ATOs particularly, and as far as the banking perspective, there may be regulatory problems with ATOs, and you might want to consult the OCC or the FDIC. I don't know if you all have done that, but just would recommend that as well.

CHAIRMAN SPEARS: Thank you. Elizabeth, you wanted to comment?

MS. HAWS: Yeah. I do have a comment. This is a new day and I think it's a unique timing of opportunity for this committee because as we look at this, you know,

as potential for assisting producers, I mean we're all here, we're of the mind-set to find market-base alternatives to help producers out.

And as we, you know, listen to the farm policy debate going on down the street, I think this is a unique opportunity for us in this room that we could provide a tool to the farmers. So before we throw everything out, let's find what the farmers need. I mean we're sitting here and this is a tool that we can provide to them. So let's look at this carefully before we ditch this opportunity.

CHAIRMAN SPEARS: Thank you. Brian.

MR. DIERLAM: Thank you, commissioner. Specific to the Part 35 exemption--I know we had talked about this in the past--the Part 35 exemption requirements that were in place in the past, particularly on ag commodities, are in place today for eligible participants can engage in bilateral agricultural swaps; is that correct?

CHAIRMAN SPEARS: That's it?

[Laughter.]

MR. ARCHITZEL: That's an important question. Yes, the current Part 35 is in effect and ag swaps are

permitted. The only issue before us is whether the Part 35 requirements should be streamlined to be more reflective of the requirements for swaps that are in the act for other commodities.

CHAIRMAN SPEARS: Brian, I was just joking. I mean this committee always looks forward to your counsel and comments, and you are always very well read in your comments. So that's one thing, I guess, that is going to be helpful, I think for the commission to have a better grasp, understanding in what activity is out there in the ag swap.

I think that Melinda alluded to that, what level there is out there. There is some question--we know it exists, but there is no real foundation as to what the exact number or level of activity is regarding to bilateral transactions in that market. So that would be helpful, I think, if we had that information as well.

Brian?

MR. DIERLAM: To follow up a little bit on that, I think as we look at risk management and one of the things going into the regulations that was pulled back in the legislation that passed that you're currently in rulemaking on, as you look to manage systemic risk,

which was one of the main purposes of the bill and the legislation and the rulemaking, there are certain types of risks that a lot of folks in our industry have a very difficult time managing, and to the extent that we can address those issues, some can be addressed through a Part 35 exemption, some can be addressed through looking at issues surrounding legal certainty.

All of those types of things if we can look at them all play a role in reducing the systemic risk. As I've talked to different folks on the packing side, folks on the retailing side, people want, consumers want to know what is their beef going to cost down the road, and they want the packer to provide it.

The packer wants a way to lock up some supply so that they have some certainty, and one of the things that's important is the risk management system that facilitates all that. Now, the marketplace can provide it in terms of exchanges offering new types of contracts for different sizes or different volumes or different products, and certainly the more products you offer, the question always comes in about what's the liquidity going to be?

Are we going to drain liquidity? But there is a tradeoff and a balance between liquidity, between basis risk, between volatility, that folks out there are trying to find that balance. So to the extent that Part 35 exemption exists, to the extent that we can address some of these legal certainties, I think we can go a long way in providing the types of products that the marketplace needs to manage risk so that at the end of the day we've got risk covered and not creating, not holding an amount of risk that we can't hedge at the marketplace, because that in the end of the day is systemic risk, is risk that the marketplace can't manage.

So to the extent we can look at a number of these things, it will go a long way in providing the risk management tools that I think the beef industry needs.

CHAIRMAN SPEARS: Bill.

MR. DODDS: I don't know if this is relevant or not, but as it relates to ATOs, about eight percent--this is a personal statement now--about eight percent of our business is options versus futures on exchanges. I would just say those are hedges related to cash contracts and it also adds to the liquidity of the futures market, I think.

CHAIRMAN SPEARS: Other comments or questions from the committee members? Well, I'll come back--Jim, just a second. I just want to make a quick comment and I know that Jim wants to make a comment here. I'd like to note, as we talked about earlier, the transcript of this meeting will be put into the public comment file on the proposed new regulatory framework and our proposed rules.

If committee members would like to provide comments on this issue, and the other issues we talked about before, written comments, you know, before April 9 or even after April 9, that would be very helpful to the commission, I believe.

Again, the deadline is April 9, but I don't know that there has ever been a case where the commission has refused to accept a comment letter after the comment period is closed. We're always open to comments at any point in time.

These are issues that we're going to have to wrestle with as we go forward so if committee members would like to just maybe provide written answers to questions that we provided in the background memo, that would be helpful or any time, at any point in time. So with that, before we close this topic and go on to other



topics, I'd like to ask Jim if he had something he wanted to say?

ACTING CHAIRMAN NEWSOME: Thank you, Dave. I had just a couple of comments and then one question I wanted to ask. First, I wanted to thank Mr. Dodds and Kent Feeds for reaching out, for offering this product at least to a portion of your swine producers and showing that, at least under your situation, it can work and it can be successful.

I think Bill raises some legitimate issues. I think there are issues that have been discussed for a long, long time, and I think certainly issues that are worthy of more discussion and looking at by the commission. I think maybe an effective ag trade option could at least potentially solve some of those problems.

Melinda, in regard to your comments, you know, as sometimes happens, we agree to disagree on some things, and I think that's just an area, at least on a portion of what you said. I think that a few of your comments may be a little far-reaching or worst case scenario, at least, and one thing in particular I would disagree with your thoughts on, at least the needs for an ag trade option type program.

You know I come from a small family farm and fully recognize that as many risk management opportunities as we can develop and provide that are realistic, as Elizabeth said, I think have real value. I also realize that futures only provide one slice of the pie of the total risk management pie as we look at it, and there are lots of other opportunities.

Obviously, I think, as we look at ag trade options, at least there is the appearance that we have yet to get it right because of a lack of usage of the program, and I think it warrants the commission going back and revisiting the issue, but it's a difficult issue. I know that everyone would like for the commission at least to attempt to define these cash markets and the futures markets, but unfortunately the problem becomes that when you do that, there is always somebody who is looking after you defined it for a way around it. And it certainly becomes more simple to find that way around it.

And I think we have to look at the history in this business of at least farmers being taken advantage of, and, you know, our role is to protect the public good, and we take that responsibility very seriously and

are going to continue to try and take that responsibility very seriously. So when we get into an issue like this, it does become difficult. That doesn't mean that we are sensitive to everyone's desires and everyone's needs. But if it was simple to solve it, it would have been solved a long time ago, and obviously it's not.

The one question, Melinda, I wanted to ask, given your comments about the small and medium-size grain elevators and maybe the lack of desire, the lack of knowledge to offer an ag trade option type contract, has your organization or members that you've talked to discussed the idea of going to those elevators and at least attempting to serve as the agent for the elevator in providing these types of contracts to producers? It seems to me that would be a legitimate thing for you to do, and I just wondered.

MS. SCHRAMM: Our organization has attempted to provide educational programs for their customers or has attempted to partner up with them in terms of presentations to their customers. They haven't always been met with success. Sometimes they have though. And I wouldn't want to leave the impression that the introducing broker is stuck in the last millennium or is

stuck some place before the Modernization Act took effect.

He definitely has attempted to come forward. Mostly those types of programs that are being offered have actually been brought to his attention by the customer himself. The customer himself will come in and compare what he's doing in the futures and the options market with what he might be doing in a local scenario.

So the transaction and the action that's taking place locally is often brought to the attention of the IB by the customer who is a customer of both of the entities. I think that our association is very eager to partner, to have relationships with people who are offering all styles and all types of risk management. That includes some perhaps form of an ATO, some perhaps form of other risk management product, but we would not want to see it go either unregulated or unregistered in any way. Thank you.

CHAIRMAN SPEARS: Are there? Trena, go ahead.

MS. GRABOWSKI: Yes, thank you, commissioner. This would be in the nature of what Bob said, this would be my opinion as opposed to an official opinion of American Agri-Women, but I would reiterate Bob's comments

that any time we as farmers can have another risk management tool available, it certainly is beneficial to us.

Putting on my other hat, which is an accounting and CPA hat, I recall the dreadful misunderstanding and the ramifications from the hedge-to-arrive contracts. And I guess in the whole discussion of agricultural trade options, I think something very, very important to be said is that education and an understanding on the part of the folks who would be using any of these risk management tools is of paramount importance, and it's one thing to sit around a table and talk about it. It's another thing to get out into the country, and it's still another thing far removed when the discussion goes around the coffee shop table, as to what I did or what I heard that Henry Jones did, and therefore since it worked for him, then absolutely it will work for me.

And I think this is not in any way putting farmers down. It's just that this is another option-- pardon the word--but it's another possibility of something that can be utilized and utilized very effectively, but I think the education must be there so

that people who are going to be utilizing it will understand how to do it.

CHAIRMAN SPEARS: Thank you very much. Sure, Neal, go ahead.

MR. GILLEN: I ask Trena and Bob a question, whether or not the concept of marketing clubs has reached your production areas?

MR. METZ: Sure, we have marketing clubs in our area, and we use a lot of advisors, and I think that's part of the problem why things haven't taken off. There have been very few opportunities as far as farmers are concerned for forward contracting.

In soybeans in the last two years, probably a week in May last year, we've had--well, to be above loan rate, and normally you don't do any contracting unless you're above loan rate. We had some opportunities now in February on spring wheat and corn, but they were pretty short opportunities. So the markets themselves have probably stopped us from using some of these. We've had nice opportunities, but they've been short.

MS. GRABOWSKI: I would agree. Marketing clubs are a lot more fun to be a part of in a bull market, and there have been marketing clubs in our area, but frankly

over the last couple of years, folks have lost interest because it's not as fun, much fun to price on the way down.

MR. GILLEN: I just want to--Carl Anderson at Texas A&M oversees the marketing club concept in the state of Texas, which has been going now for about three years. I was at a meeting with him recently, and in the past, even in this past year, with mixed production producers, cotton and grains, throughout the state of Texas, the members of the marketing club averaged \$33,000 more in net income.

This program is funded by the state of Texas. I think they have a million dollars and the producers pay--and there is a waiting list to get into some of these clubs--\$300 fees. And he utilizes an ongoing education program.

CHAIRMAN SPEARS: Trena.

MS. GRABOWSKI: Oh, thank you. I think that might be one of the things that might be considered. The marketing clubs in our area have taken an unstructured approach, and possibly the structure backed by an institution such as Texas A&M and in my area maybe University of Illinois is something that would certainly

facilitate farmers get involved and would keep the ball rolling even during times when interest might seem to lag.

CHAIRMAN SPEARS: Okay. Any other comments or questions? Yeah, Bob.

MR. WHITE: One comment. I think that some hindrance to being concerned about marketing comes with the government program in that what do they tell a farmer? They say go to the insurance agency, manage your risk by covering your crop with insurance, here's a set price, and I sometimes think that farmers manage their risk that way more than being concerned about marketing.

I see that happening in my area even though, you know, they know there is marketing tools there. I think they've become involved with the government looking out for them, and so they're more apt to manage it by crop insurance than what the government is going to pay when fall comes.

CHAIRMAN SPEARS: Thank you, Bob. Well, we're way behind schedule, and I'll take the responsibility for that. I apologize for that. But I thought this issue was very important to get on the table in front of us. The input from the committee is very important, but



equally important, I believe, is to put the issue before you because it is a live issue that we're going to have to grapple with and wrestle with at the commission over the next few months. So any follow-up thoughts or comments that you have will be extremely helpful.

Again, I want to thank all the panel members for coming, Melinda and Jack. Jack, you were put in the spotlight as the only ATOM. You handled it very well. I appreciate it. Do you have any thoughts or closing comments you'd like to add before we move off the subject?

MR. DOUGHERTY: Well, I think that just the way that we've utilized the program in such a narrow scope to me says there is a lot of ways to use this program that's the benefit to, in our case, the livestock producer, but to the grain farmer also. It just needs a little bit of creativeness, and speaking from a company standpoint, so far we found not a lot of trouble meeting the regulations and segregating the system as it is required, and I just think that it does bring a lot to the table, and like some of them have mentioned around here, it's one more tool that a guy can use, a producer can use, to best

market his products and put profit to his bottom line and our concern is that he stays in business.

CHAIRMAN SPEARS: Thank you, Jack. As I mentioned, we are behind schedule. We're going to go ahead and instead of taking a break, we're going to go ahead and move in. We're going to have the next three or four topics shorten themselves down from 15 minutes each to about five minutes each. We're still about 20 minutes away from being done.

If folks would like to grab a cup of coffee and some cookies and some pop out there while we're moving forward, then go ahead and do so. Also, rest rooms are downstairs, but I think in the interest of--well, let's just take a five minute quick break, but we're going to start back in five minutes and people can bring their cookies and pop back to the table.

[Whereupon, a short break was taken.]

CHAIRMAN SPEARS: Let's go ahead and get started. We're going to bypass Fred Linse, who is the Chief of the Ag Commodity Units for EA. I believe there is some information in the packet that Fred put together that kind of outlines. Fred was going to kind of explain what the Warehouse Act was, and there is--okay--my crack

staff just pointed out that in Fred's document, dated March 9, that was in your packet, there is a typo, and the memo dated March 9 to me from Fred that was provided to you guys, the typo at the bottom of the page says 1994. It should say '95, 1995. So there is one typo. Thank you, Alan, for your contribution to the meeting.

With that, we're going to, like I said, this is Fred's memo. He was going to introduce the topic, but I think it's more important for us to hear from David Lehman with the Chicago Board of Trade as they are probably the primary exchange that has dealt with this issue in regard to the corn and soybean complex. So with that, David, I'd like to turn it over to you, and you'd outline the implications for this Warehouse Act as it deals with your exchange. Thank you.

MR. LEHMAN: Thank you, Commissioner Spears and I apologize, Fred, but really what I'm going to talk about today isn't really so much to do with the changes in the Warehouse Act, although if down the road the program that I'm going to give you just a brief overview of today will be expanded to warehouse receipt commodities.

The Board of Trade next month will be implementing an electronic delivery system for corn and soybean shipping certificates. This system dovetails in with the new Illinois River delivery system that was implemented in January of 2000, and obviously avoided the past restrictions in the Warehouse Act of requiring a paper or physical warehouse receipt to be in existence for warehouse receipts.

As I said, this Illinois River system uses shipping certificates, Board of Trade delivery instrument, and as a result, effective with the May 2001 deliveries, we will convert this system to totally electronic delivery system. The conversion process, and I might just point out, there are a couple of handouts out front, a notice from our Secretary's office that explains the implementation of the system, and conversion procedure, and also notices from our Board of Trading Clearing Corporation who will be operating the system and who developed the software for the system.

In this conversion process, later on in April here in a couple of weeks, holders of paper certificates will need to convert those into electronic certificates. If they choose not to convert them, they can continue to

carry that piece of paper, and it's still valid claim on the loading capacity of the issuing firm.

They could also cancel the paper and load out the grain that that paper certificate represents. The conversion process is really just a matter of the holder taking the paper certificate back to the agent, which is a clearing firm that represents the shipper or the regular firm and requesting an electronic version.

The agent then creates that electronic version and submits it to our registrar, which is also a part of the electronic system for registration, and at that point, the paper certificate will be canceled. The electronic certificates, once they're registered, then will be free transferred back to the clearing firm that holds or represents the customer who is holding or was holding the paper certificate.

The advantages of this system, I think, are pretty obvious of removing paper, in creating efficiency by going to an electronic system. One specific cost saving that the system will create is there will no longer be an expiration on certificates. So firms that issue certificates, delivery firms, won't have to reissue those every six months or every year. In the case of

corn and beans, it's every six months. That's about \$100,000 a year cost on firms.

The system is a dedicated network. It's the Board of Trade Clearing Corporation's customer network so only clearing firms will be able to access the system. It will increase the integrity and safety over the current system of manually carrying warehouse receipts and paper shipping certificates from one clearing firm to another and also manually handling the money transfer.

The invoicing also will be done by the electronic system and that will all be automated. As I mentioned, the payment for deliveries will be done via the system through the SWIFT banking system that is currently used for the daily pay collect margin transfers. The ownership of the certificate will occur electronically as well, facilitated by the clearing corporation, and another feature is its storage payments are automatically debited and credited on the 18th of every month so that will enhance the timeliness of storage payments.

These last two slides are just screen prints of what the system looks like. It's kind of hard to read, I think, but this is the main menu. This system is built

on top of the OTIS delivery system that the Board of Trade already has in place so it's something that our users are really already pretty familiar with.

And there is one last slide of once some electronic certificates are created just what the registered agent will see. As I said, the implementation this year is for corn and soybeans only. Our expectations are to move and expand that into warehouse receipt markets, wheat, oats, rice, once the Warehouse Act rules are in place to allow electronic warehouse receipts for those markets.

Soybean meal and soybean oil also can be implemented in the second stage. As we speak, I think in about two minutes ago, the first training session started, 2:30 this afternoon, in Chicago. We have half a dozen training sessions set up for clearing firms, for registered agents, and shippers themselves, regular firms if they want to come in and look at the system.

I think eventually also the next generation of the system will include a web application access for banks and also for entities that aren't currently customers of clearing firms. That's something that the Clearing Corporation has had some discussions with banks

on in the last few weeks. So that's the system. Any questions I'll be happy to answer them. Thank you.

MR. GILLEN: Do you anticipate beginning with electronic from the outset so you don't have a paper certificate?

MR. LEHMAN: Yes, we do. We will mandate participation or participation in this system is mandatory so that as of the May deliveries for corn and soybeans, in order to participate in the delivery system, you must use an electronic certificate.

MR. GILLEN: Maybe Bill Dodds, Bill, do you anticipate going electronic at the elevator level like we have in cotton at the gin level, warehouse level?

MR. DODDS: I think we will. As far as this is concerned, it's overdue and the quicker the better.

MR. LEHMAN: We've got about 2,000 corn certificates outstanding right now, and about 300 soybeans. I think there is about 4,000 wheat receipts out. So it would--and there are 10,000 oil receipts on the street. So we've got some much more large volume delivery contracts coming in the future for this system.

CHAIRMAN SPEARS: Any other questions for David? Again, David, I want to thank you for your coming



to the meeting. Your contribution as always is very much appreciated. You've been a contributor to this committee for a number of years, and it's greatly appreciated, as I said.

Also, before we move on, I want to acknowledge Fred Linse. Fred, thank you for--he's sitting over there--Fred, thank you for the memo, and I apologize for cutting you time, but so be it.

[Laughter.]

CHAIRMAN SPEARS: Got to have a little bit of fun. Our last topic, I'm going to ask Phyllis Honor, who is the Acting Administrator of the Risk Management Agency. These last two or three topics were primarily on the agenda for information purposes for the committee members, and I think it's important that this agency has an excellent relationship with RMA. As you know, they've been a member of the committee for a number of years, and have been ably represented by Ken Ackerman, who is in the audience as well. In previous years Ken has been a very valuable member to the committee.

I know Phyllis has done an excellent job in her role as acting administrator, the time that she's been acting. So she has graciously volunteered to shorten her

presentation from an hour and a half--no--down to roughly five, ten minutes. So Phyllis take as much time as you want because we're going to go ahead and not--you'll be the last topic on the--we're saving the best for last. You're going to be the last topic on the agenda.

John Bird who put together the information for the last topic, which was recent developments in electronic derivatives trading, has graciously said that all his information is in your packet. So there is no use in him getting up just repeating what's already there. You can read that at your leisure. And we'll save that topic for a later time, future meetings. I think it will be appropriate. It will be probably a more timely topic in the future as more exchanges come to the market dealing with ag contracts. So with that, I'll turn it over to you, Phyllis. Thank you.

MS. HONOR: You've already had some pretty weighty discussions here this afternoon, and we have a lot of food for thought. And I know that people want to move on. I am, as you have just said, the Acting Administrator, having been in the position since the change in administration in January, a little over two

months, and everything that I have touched has blown up on me.

[Laughter.]

MS. HONOR: And I do not intend to go easily into a new area of operation without lots of discussion and deliberation. Ken did a great job of being an administrator even though I was not always kind to him while he was there. My sins have come home to me.

[Laughter.]

MS. HONOR: I'm not a program expert. My background is accounting and business administration, and I was the chief financial officer. I was the bean counter and wondering how you were spending your money and now I have to deal with the bigger issues.

In June of the past year, we had an Agricultural Risk Protection Act passed, and it significantly changed the way in which we operate, and so what this act does is it provides us a great deal of money, money in the tune of \$8.2 billion to spend over five years to improve crop insurance. That's a lot of money and a big, big mission.

And what it does is it provides a number of incentives and things to farmers. It makes our buy-up

coverage more affordable and it offered a premium discount so they would buy more crop insurance, and I was pleased to hear the positive comments about our products that you have stated here, and that's only due to the efforts of people who are back at the office working on products now and also the leadership that Ken provided during the time that he was there. And I have every reason to believe that the incoming administration will do the same thing.

But what you want to know today is about our risk management education program, and also about a new initiative for livestock. The act that was passed did, in fact, provide--mandate a new pilot approach for livestock pilot program, and this has limited up to \$75 million over five years. That's a lot of money, and it is a new area for us.

It provides \$10 million in the current fiscal year and in the following, and so in 2001 and 2002, we have \$10 million to put into a livestock program. We have, of course, the dairy options pilot program that you may already know about and, of course, the risk management education, those kinds of things that you talked about today that are important that you want to

know about. And we would be pleased to come back and go into more detail about those programs with you.

But I think that what you want to know is what's up with livestock and the risk management agency. The act provided a definition for livestock and in the subsection, the term "livestock" includes but is not limited to cattle, sheep, swine, goats and poultry. So these are the areas that they identify as livestock.

And the program requires that the corporation shall conduct two or more pilot programs to evaluate the effectiveness of risk management tools for livestock producers including the use of futures and options, contracts and policies and plans of insurance that protect the interest of livestock producers.

So the act does, in fact, allow us to enter into that very, very dangerous area for us of futures and options, and I say for us because that's not our background. That's not what we normally do in this very technical area, and, you know, we've been in developing programs, and we've had some, some work in the options area with our options pilot program, but we are by no means the staff with the competence to do this.

And so what has happened is--and our pilot program is in Section 523, our livestock pilot program-- and it provides that livestock producers with reasonable protection that the financial risk of price or income fluctuation inherent in the production and marketing of livestock is what we're talking about, and the protection for production losses.

Now, the perils that have been identified as those that impact livestock that we're concerned about is financial risk of price or income fluctuations, production losses and poisoning and disease. And I'm telling you we didn't think about disease until the most recent things that are occurring to us now.

So I guess it's quite timely that it happened because that would be something that we would be covering, and we would not have thought about the advent of hoof and mouth and the other things, the mad cow, that other places have to consider at this time.

Where are we at this? At this time, the act was passed and we became aware of our new responsibilities. In the past, we developed our own. We did our own R&D, our own research and development on products, and we contracted out portions of that, and so

we have some very good technicians in developing programs in the old style programs that we have, but we're in the 21st century now and the needs of farmers have changed and they need more products and more tools.

And so the tools that we traditionally provided to them, while still good, we need to expand and provide some different types and we need to have a vehicle to do that. And so the Congress in its wisdom has said that we need to contract out, and so they provided us authority to contract out.

And so that's what we're doing, and this past year we spent a lot of time taking people who know how to do the job and teaching them out to be contractors out and overseeing the job. Now that's a struggle because, you know, people who know how to do things want to continue to do it. They don't necessarily want to help other people learn how to do it and watch others do it. So that's been an internal challenge for us to get our people to become the people who develop task orders and write programs and review others in their efforts to develop programs.

So we do have a proposal that did come in that we're consulting on now and developing, a livestock

proposal. It came in and we were not pleased with it, and so we're still working on it. We also have a task order out that will help us to understand what we have to address, and that task order will tell us what livestock producers need because we really don't know.

And it would also tell us what livestock producers are willing to pay for, what is feasible, and generally what we can do within the language of the new legislation. Now, we have many vehicles that we can use to accomplish our new responsibility in this area.

We can contract out for development. We can do what's 508(h) submissions which is private sector development of a program and bring to us and we put on line.

We also have and do receive unsolicited proposals. I'm sort of hoping that people here in the audience will know of others and will pass the word around that we do have this program and perhaps we will get more proposals in. And then we have partnerships through cooperative agreements, and those are the vehicles that we have available to us to use for our new livestock initiatives that we now have authority to do.



The bottom line in terms of that is that we're in the development stages of determining just what we will do and how we will do the things that will be necessary to help the producers meet their risk in the livestock area. It's an entirely new area, and actually as I was listening to some of the discussion here, it's really a very frightening area for the things that you have to consider, and I'm certainly hoping that I will not be so graced with this job long enough to make all the decisions on that program.

[Laughter.]

MS. HONOR: I hope I can pass that off to a wiser person. But that's where we are with it. Now you need to know that we are moving very, very cautiously in this area. Another thing that happened with the passage of the act that I'm pleased with--my colleagues are not-- is that we have an expanded role of our board. And the board has a greater role in the management of our corporation and they make lots of decisions that they were not involved in before.

And in 1938 when the Crop Insurance Act first came out, the board of directors was move involved in the management and decision-making process, and over the

years that has declined and it has changed. And the Congress decided that that needed to move back because a lot of the decisions that we're making are based upon our experience with the program that needs to be changed, and so we need a broader view.

And so the act says that our new board is made up of the Under Secretary of the Farm and Foreign Agriculture Section, an additional Under Secretary, which the Secretary will decide upon, the USDA Chief Economist--I think that's very important because we are fortunate to have Keith Collins as our economist, and he's a very intelligent and learned guy, and he asks a lot of questions, and he causes us to do a lot of thinking, and I'm very pleased to have him serving on our board, particularly while I'm serving in this role.

Also, the position that I hold acting is also a member of the board. It's a non-voting member now. Four farmers, at least one of which has crop insurance experience. So we, the board, has expanded and our board will be made up of farmers, and we're hoping to have farmers from across the United States to participate, and we need an individual who is knowledgeable in reinsurance or regulation on our board.

The reason that I'm bringing this up is that the legislation said that we had to have a new board by April 1, and that has been extended to the 13th.

[Laughter.]

MS. HONOR: But I know that you know a lot of people who could help us, and I know this is the place to bring this--April 13. At least it won't conflict with your tax day.

And so I have a handout that I'm going to give you and so if you know any individuals who would be interested in serving on our board, I'd be pleased to have more nominations of broad-based background and more experience, and it would be very, very important that we have that in our deliberative process because we have a lot of things to do, and we need as much support, as much information, as much background as we move into these new areas as we can, and so my biggest pitch today is to make sure that we get that out.

That's not an assignment that normally civil servants would do so I go very cautiously in that, but our time is short. So that's not normally what I would do. That's not normally my role, but our time is short, and I do need to get the message out, and I saw this is

an opportunity to do that. So I beg your forgiveness of me for imposing on you in this way.

That's generally where we are in this, and I would be more than pleased to come back at another time and go more extensively in exactly what we're doing, talk to you a little more about our DOT program, and also about our risk management education program, which Craig Witt runs, and we're available, we're down the street. I'm getting a lot more visitors from people who want to know what's going on, and want to come in and talk about how do we get new programs on line because now you bring the programs to us, we don't generate them anymore.

So those programs that people are interested in, they just prepare them, develop the proposals and submit them to us, and we take a look at them, and you can develop them, and then they have to be reviewed and then taken to our board.

So we have a whole new process, but we have an opportunity to try a lot of new things. I know I've gone very quickly. I'm from the South, but I do talk fast, and I hope that you are able to get something out of the discussion. Thank you.

MS. KEITH: Phyllis, Susan Keith with the National Corn Growers. I just wondered if you have any preliminary data on program participation this year with the higher subsidy rates? I've heard anecdotally sales are up, but I haven't--

MS. HONOR: Yes. The sales are up, and, no, I don't have the figures with me. I should have them because I was--you know, I still retained some of my CFO duties, and I was working on the budget presentation this morning, and we did have some numbers, but then I went to a very contentious meeting following that and I've forgotten our numbers.

[Laughter.]

MS. HONOR: I know that they are up because that's the first thing that we did was to get all the package out that we could to the producers, and we had adjusted our accounting systems to be able to account for that. But I know that it's up, I want to say maybe 25 percent, but I'm not sure. So if you'll give me your card and number, I can get that back to you.

Yeah, I know we've done a good job and it's up, but I don't know exactly what it is.

CHAIRMAN SPEARS: Bob.

MR. METZ: I'd like to thank you for the improvements in crop insurance. I was in Washington last week and I guarantee you the senators and congressmen that I visited with, I did thank them for the work they've done in crop insurance. I think as agriculture enters a new age, it just becomes more important everyday that we have good solid crop insurance. And I think it is going in the right direction, so thank you.

MS. HONOR: I needed that today after the meeting I had. I like to tell people--I don't know if Ken ever agreed with this because he never agreed with me when he was there--

[Laughter.]

MS. HONOR: --that crop insurance is the program for the 21st century because the government is involved in helping to subsidize it, the private industry delivers it, and the producer pays part of the cost. And that's really where we want to go. We want to get the government as much out of people's decision-making and sponsorship and get people more involved in what they do.

And it goes back to the questions that have been raised here and the discussion that we've had is that sometimes people don't know what they're getting

because they think the government is doing it all for them, and we have to get to the point where people are more involved in their decision-making and understand it more because our products that we have for them are products that they can understand.

MR. DIERLAM: Ms. Honor, I work with the National Cattlemen's Beef Association, and we just submitted a letter a few weeks ago to the Kansas City Risk Management Office that we'd like to participate and provide resources to the contractors that are developing the programs, particularly all pasture, range, and forage products, and then as we look specifically to the futures and options part of that, we definitely want to be able to consult.

We do have concerns on some implementation side, on some subsidy levels, and on federal money being used to go into the markets per se, but we'd like to sure be in a position to be able to discuss that, but we're definitely supportive, particularly on the pasture, range and forage side, working with Risk Management Agency and your contractors to develop programs that are going to work for calf producers out in the countryside.

MS. HONOR: That too is a new program that was introduced as of the act that we have just implemented and is moving alongside. I think it's going to be an improving program over the next year as we get out of the learning curve which is very high right now, but I thank you for hanging in there with us.

MR. DODDS: Phyllis, crop insurance is good. Like Bob, our producers like it. I haven't read the act, but I've heard that there is some language in there that might dictate that CFTC is exempt from regulation in this livestock risk management venture? Have you?

CHAIRMAN SPEARS: My understanding is that you're right, Bill, I think the--Ken, you're well aware of this language.

[Laughter.]

CHAIRMAN SPEARS: It is outside of purview regulation, this portion of the program. Ken. Come to the microphone so we can get you on tape.

MR. ACKERMAN: I'm kind of used to being a potted plant. It's very nice. There is a portion in the statute that says within the livestock pilot program, a new product that is, in fact, approved by FCIC for



reinsurance would not be considered a trade option for purposes of the FCIC trade option rules.

CHAIRMAN SPEARS: We talked about this once before at a prior advisory committee meeting, and it was an issue that came before us, and then now is now part of RMA purview.

MR. GILLEN: Mr. Chairman.

CHAIRMAN SPEARS: Yes.

MR. GILLEN: I don't want to rain on Ms. Honor's parade, but--

MS. HONOR: It's already been rained on today.

MR. GILLEN: --but it seems that Ken Ackerman might have done too good a job. The Delta Farm Press earlier this week had an article indicating that maybe the Crop Insurance Program was too good because production is up substantially in the mid-south region, and it may well be that not only crop insurance but the fact that cotton is the best thing to plant for producers in that particular region compared given the low price of beans.

CHAIRMAN SPEARS: Phyllis, you might, you mentioned that you're looking for nominations to your

board. Now is the name of the board the FCIC board or what?

MS. HONOR: Yes.

CHAIRMAN SPEARS: Okay. So there are a number of producer groups here and we would certainly appreciate your pitch. Maybe some of these producer groups have an opportunity here within the next two weeks to present some names to your board that would be knowledgeable from corn, soybeans, wheat, livestock, whatever. So do you have anything else, Phyllis?

MS. HONOR: No, that's all.

CHAIRMAN SPEARS: Okay. Again, thank you for coming, Phyllis. It's very timely as it's been quite evident, I think, that our lines with the different acts of Congress last year, the lines between our two agencies are somewhat blurred, and have somewhat come together, because we now have some education responsibility. You have some livestock programs to administer so. There are some tendencies to be some blurring of lines between our two separate agencies.

So I think it behooves us to continue communication as we have in the past, and I think it fuller demonstrates the need to have you guys as members

of this Ag Advisory Committee. So we thank you for your attendance and for your help and look forward to your assistance in the future. Go ahead.

MS. HONOR: Well, I thank you also, and I think that relationship has already been established in the fact that the administrator sits on this committee and that you also sit on our Risk Management Education Advisory Committee. So I think that the communication channels are already there for our agencies to know what's going on at both places, and we need to continue to keep those there.

CHAIRMAN SPEARS: Appreciate that. With that, what was just handed out to you guys a minute ago while Mrs. Honor was talking was John Bird's portion of the program. I misspoke earlier. I thought he said it was in your packets. It was not. It was on the table in our office. Again, thanks to my crack staff--I think what's on here is a list of the various internet based, electronic ag market internet sites that are out there today, as well as copies of the slides that he was going to present. So hopefully, that will be helpful to you guys if you have a chance to review that.

Well, are there any issues that need to come before this committee? Due to time management, we are now back almost on schedule. And we are set to adjourn at five o'clock, and it's almost five o'clock. Before I do adjourn, I wanted to have the opportunity once again to thank everyone for coming, for staying through the entire program.

I want to thank the panelists who came, Melinda and for Jack as well, to make their presentations to the group, and Bill as well, as he is a member of the committee. I think that we accomplished some things today. I recognize these are difficult issues. These are issues that are put before you on a relatively short basis, but they are issues that we're going to wrestle with, as I said before, and grapple with over the course of the next few months, and again I would stress the need for any future follow-up correspondence, comments, input, meetings, whatever it would take, to assist us in these matters, as we try to put together proposed rules on how to address ATOs and how to address bilateral ag transactions or bilateral transactions in ag commodities.

So with that, I want to thank you all for coming, for being patient, and for being flexible in your

schedules. I wanted to give Jim one last opportunity. Jim, did you have anything that you want to add before we close?

ACTING CHAIRMAN NEWSOME: No.

CHAIRMAN SPEARS: Okay. Wise chairman. Thank you again, and we look forward to working with you as always. Thank you.

[Whereupon, at 5:00 p.m., the meeting was adjourned.]