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NATIONAL GRAIN TRADE COUNCIL
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August 18, 2000

COMMENT

Ms. Jean A. Webb
Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, D.C. 20581

Re: Regulatory Reinvention

Dear Ms. Webb:

The National Grain Trade Council appreciates this opportunity to make its views known regarding the Commission's proposed overhaul of the regulatory structure for our Nation's futures markets.

Background. The Council is a national trade association whose regular, policy-making members are grain exchanges, contract markets, and national grain marketing organizations. The Council's associate members represent a broad cross-section of the grain industry and related businesses. These associate members include individual grain companies, milling and processing companies, transportation companies, futures commission merchants, and banks. (A complete list of the Council's membership is enclosed for your reference.) The Council was established in 1936 when it assumed the responsibilities of a predecessor organization, the Grain Committee on National Affairs. The Council's primary purpose has remained unchanged since that time: to advocate and defend, consistent with public interest, the principles and merits of open and competitive markets for the distribution of agricultural commodities. The Council, therefore, is vitally interested in ensuring that the Commission's proposal does not have the unintended effect of hampering the ability of its members to compete in the global markets for agricultural commodities.

At the outset, the Council would like to commend the Commission for its willingness to re- evaluate the regulatory structure that governs our Nation's futures markets. Recent years have brought changes that once would have been unthinkable – the evolution of electronic futures markets, some of which have displaced their well-entrenched open outcry competitors; the mergers of banks and brokerage firms and of exchanges and clearing houses; and the development of a broad range of synthetic, over-the-counter trading vehicle that replicate and, in many

cases, improve upon, the risk-management characteristics of exchange-traded futures and option contracts. The scope and breadth of the Commission's proposal is remarkable, and reflects a commendable willingness to consider new approaches to dynamically changing markets. The Council accordingly urges the Commission to adopt its Regulatory Reinvention proposals, but only after making the adjustments necessary to give participants in the agricultural markets the same tools and advantages that are being extended to participants in the interest rate, stock index and foreign currency markets.

The Enumerated Agricultural Commodities Must Be Allowed to Trade on Designated Transaction Facilities. Our foremost concern relates to the Commission's tentative decision to relegate agricultural products to the realm of regulated futures exchanges ("RFEs"), the most highly regulated of the multilateral transaction execution facilities, and not to permit the trading of the agricultural commodities enumerated in Section 1(a)(3) of the Commodity Exchange Act (the "Act") on less intensively regulated derivatives transaction execution facilities ("DTFs").[1] As we understand it, an RFE would be required to establish and maintain a framework, program, policies and procedures in all of the following areas from which a DTF would be exempt: market surveillance, compliance, and enforcement for the prevention of market manipulation; disciplinary mechanisms for violations of the RFE's rules; arrangements to obtain information necessary to fulfill the foregoing functions and the terms of the International Information Sharing Agreement and Memorandum of Understanding developed by the Futures Industry Association; and a mechanism to provide ready access to the RFE's rules and regulations.

These requirements are supplemented by fifteen core principles for RFEs, as opposed to seven core principles for DTFs. Although the increased number of core principles applicable to RFEs is indicative, it dramatically understates the degree of regulation that would be imposed on an RFE relative to the DTFs. For example, the "Application Guidance" provided by the Commission for DTFs is less than a third the length of that provided for RFEs. More significantly, the Commission's expectations and standards for RFEs clearly are intended to be more strict and burdensome. For example, both DTFs and RFEs are required by their respective Core Principle #1 ("Enforcement") to monitor and enforce their rules. A DTF, however, would effectively be required only to have arrangements for the effective enforcement of its rules and the authority

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1/ We are aware that the Commission has left the door open to the trading of the enumerated commodities on a DTF, at least in theory. Proposed Commission Regulation 37.2(a)(1) would permit a multilateral transaction execution facility to operate as a DTF only if it restricted access to "eligible commercial participants" (as defined) and did not permit the trading of the enumerated commodities. Proposed Commission Regulation 37.2(a)(2), however, would permit a multilateral transaction execution facility to operate as a DTF in <u>any</u> commodity if the Commission were to determine, on a case-by-case basis, that the commodity in question had a sufficiently liquid and deep cash market and surveillance history sufficient to assure that the contract in question was highly unlikely to be manipulated.

and ability to discipline members. An RFE, by comparison, would be expected to have arrangements for effective trade practice surveillance (including maintenance of data reflecting the details of every trade, electronic analysis of this information, and investigation of apparent trading rule violations), monitoring of members' books and records, direct supervision of the markets, effective enforcement of its rules, and the authority and ability to discipline members.

We think it is inevitable that the RFEs are destined to become the markets of last resort, the place for the trading of products that cannot qualify for trading on a DTF. The RFEs will be saddled with compliance costs and legal obligations that have no counterpart in the world of DTFs. For example, RFEs are subject to the requirements of Core Principles ## 8 and 9 (Trading Systems and Audit Trail); DTFs have no such obligation. This disparate burden will inevitably result in extra costs to market participants, whether in the form of increased exchange or National Futures Association fees, or higher rates for commissions and floor brokerage.

The argument has been made in response that futures contracts involving the enumerated commodities must be traded on an RFE and, therefore, that hedgers and other commercial participants are not as a practical matter disadvantaged. This argument overlooks two key facts: First, all else being equal, the exchanges will inevitably devote less time and resources to those products that are more intensively regulated and, therefore, more expensive to sponsor. (This is particularly likely to be the case as the exchanges demutualize. Unlike the member-owned exchanges, a demutualized marketplace will almost certainly place greater importance on profits, even if that means diminished opportunities for certain of its members.) Second, and perhaps more importantly, this argument ignores the fact that agribusiness enterprises can and do avail themselves of non-exchange trading alternatives, such as swaps, that permit them to bypass the exchange markets altogether. These alternatives to the exchange markets will become even more attractive if the cost of exchange trading goes up and liquidity in the exchange markets consequently declines.

Thus, while we feel strongly that the enumerated commodities should be permitted to trade on DTFs, we would support an arrangement whereby any such DTF was required additionally to establish a framework, and to adopt and enforce rules and procedures, that ensure that the markets for the enumerated commodities are not subject to manipulation. In effect, we are proposing – and we urge the Commission carefully to consider – allowing the enumerated commodities to be traded on a DTF subject to enhanced market surveillance requirements (such as those in RFE Core Principle #3), position limits (RFE Core Principle #4), and such other narrowly targeted additional requirements as the Commission concludes are essential to the preserve the integrity of the agricultural futures markets.

The Net Capital Requirement for DTF Clearing Members is Unnecessary and Unsound. The Commission has proposed to amend its net capital requirements so that only those futures commission merchants ("FCMs") who maintain adjusted net capital of no less than $20 million

will be permitted to act on behalf of non-institutional customers on a DTF. The Commission has stated that it is proposing to permit non-institutional customers to have access to a DTF only "through FCMs that are more capable of properly maintaining such accounts and handling the associated risk." 65 Fed. Reg. 39008, 39013 (June 22, 2000). We respectfully submit that the Commission's reasoning is fallacious.

First, we are unaware of any correlation between a firm's adjusted net capital requirement and its ability to properly maintain customer accounts. Only 81 of 203 (or less than 40%) of registered FCMs would have satisfied this standard as of March 30, 2000. As the Commission is well aware, virtually all of the largest FCMs are also securities broker-dealers, for whom regulated futures activity constitutes only an incidental part of their business.[2] One could just as readily argue that smaller, boutique firms that specialize in serving the cash grain trade are far more committed to this business and will be more willing to do what is necessary to "properly [to] maintain such accounts."

Second, while it is true that a firm that is better-capitalized may better be able to withstand risk, it does not follow that this is a necessary attribute for participation in a DTF. Among other things, the Commission has separately proposed to require that all transactions on made on a DTF be submitted to a registered derivatives clearing organization. Thus, the greatest risk that is associated with trading in any market – the risk of counterparty non-performance – is substantially ameliorated, if not eliminated, by the interpositioning of the clearinghouses. This risk reduction or elimination will take place as a result of the clearing process, without regard to the capitalization of the FCM. It would be one thing for the Commission to propose a minimum net capital requirement for the clearing members of a DTF (an objective it presumably has sought to address through the financial integrity requirements set forth in proposed Regulations 37.3(a)(3)). It is quite another thing for the Commission to impose an arbitrary and needless barrier to participation in these markets by FCMs that seek to do nothing more than maintain omnibus accounts for their customers with a DTF clearing member.

In any event, we submit that this minimum capital requirement is unnecessary in light of the far more important qualification established by proposed Regulation 1.17(a)(1)(ii) – the re-

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2/ This point is amply illustrated by the Selected FCM Financial Data that is published as of the end of each calendar quarter by the Division of Trading and Markets. In virtually every case, those FCMs whose net capital significantly exceeds their required net capital are also broker-dealers. Indeed, of the 81 registered FCMs with adjusted net capital in excess of $20 million on March 31, 2000, fully 65 of them were broker-dealers. In other words, four out of five FCMs who would satisfy the Commission's $20 million test would do so because they are subject to Securities and Exchange Commission ("SEC") net capital requirements. Needless to say, the SEC's net capital requirements have nothing whatever to do with a futures clearing firm's ability to "maintain [the] accounts" of its non-institutional customers.

quirement that any person acting on behalf of a non-institutional customer on a DTF be a clearing member of a designated contract market or a recognized futures exchange. As the Commission is aware, the clearing organizations monitor their members' activity on a continuous basis and act as necessary (through increases in margin, security deposits and/or capital, restrictions on trading activity, etc.) to ensure their members' ability to perform all of their obligations, timely and in full. Nor is this monitoring process narrowly confined to the markets cleared by a particular clearinghouse; rather, the clearinghouses collect and apply data and information across markets to better allow them to assess their members' ability to withstand risk. The fact that an FCM must also be a clearing member of a designated contract market or a recognized futures exchange is, therefore, far more meaningful than any arbitrary minimum capital requirement.

Moreover, we believe that the Commission cannot rationally defend its choice of $20 million as the threshold for access to this market. Under Regulation 1.17(a)(1)(i), an FCM can do business for customers on the futures markets with as little as $250,000 in adjusted net capital. Under Regulation 3.13(d)(1)(i), an agricultural trade option merchant can issue options – certainly, a far more risky endeavor – with a net worth of as little as $50,000. We simply cannot accept the premise that merely acting as a customer's agent on a DTF is 80 times as risky as acting as an FCM or 400 times as risky as acting as the grantor of (*i.e.*, principal and obligor in respect of) off-exchange agricultural options.

Taken together, we believe that these factors demonstrate conclusively that proposed Regulation 1.17(a)(1)(ii) is needlessly anticompetitive and, therefore, inconsistent with the Commission's mandate, as set forth in Section 15 of the Act, to "endeavor to take the least anticompetitive means of achieving the objectives of this Act, as well as the policies and purposes of this Act, in issuing any order or in adopting any Commission rule or regulation[.]" We accordingly urge the Commission to modify proposed Regulation 1.17(a)(1)(ii) to eliminate the requirement that clearing members maintain adjusted net capital in excess of $20 million if they are to serve non-institutional customers seeking to trade through a DTF.

We appreciate the opportunity to make our views known on this important subject. The National Grain Trade Council would be pleased to have the opportunity to discuss these subjects in greater detail or to answer any questions that you may have. The Commission and its staff should feel free to contact the undersigned (at 612 742 4547) if we can be of any further assistance.

Very truly yours,

Daniel P. Dye
Chairman

Enclosure

NATIONAL GRAIN TRADE COUNCIL MEMBERSHIP

REGULAR MEMBERS

Chicago Board of Trade
Kansas City Board of Trade
Lincoln Grain Exchange
Minneapolis Grain Exchange
Transportation, Elevator, and Grain Merchants Association

ASSOCIATE MEMBERS

ABN-AMRO Chicago Corporation
Ag Processing, Inc.
Agricore
American Commercial Barge Line Co.
The Andersons
Archer Daniels Midland Co.
Banque National de Paris
Bunge Corporation
Burlington Northern Santa Fe Railway
Canadian National Railway
Canadian Pacific Railway
Cargill, Incorporated
Cenex Harvest States Cooperatives
CGB Enterprises
CoBank, ACB
ConAgra Grain Companies
ConAgra Grain Processing Companies
E . D. & F. Mann Conmpany
Farmers Commodities Corp.
Farmland Industries -- Grain Division
Garnac Grain Compnay
Iowa Grain Company
James Richardson International
J.G. Boswell Company
Kansas City Southern Railway
Koch Nutrient Services
LayMac, Inc.
Louis Dreyfus Corporation
Maloney Commodity Services
Macquarie, Inc.
Mid-America Commodity Exchange
Miller Milling company
Nabisco, Inc.
Nidera, Inc.
Prairie Pools, Inc.
Quaker Oats Company
Rabobank International
Sparks Companies, Inc.
TENCO, Inc.
Trinity Industries, Inc.
Union Pacific Railroad
Wolcott & Lincoln-Div of E.D. & F. Mann