

Risk Management

Selecting and Working with a Broker

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During the early stages of developing your marketing plan, think about the types of pricing tools you want to use to market your crops. If you plan to use futures or options contracts, you will need a broker who can execute those trades for you. You cannot trade these products unless you are a member of the exchange or go through a company that is a member of the exchange.

Selecting a Brokerage Company

Brokerage companies are generally classified as full-service or discount operations, depending on the types of services they provide and the amount of commission they charge per trade.

A full-service brokerage company may charge a commission of \$60 to \$100 or more per trade, but will also provide free services such as newsletters, fundamental and technical analysis, advice from market specialists, chart services, trading recommendations, weather information, access to Internet or computer bulletin board sites, etc.

Discount brokerage companies may charge only \$12 to \$35 per trade, but offer customers few other services. When the discount brokerage concept was first introduced to futures trading in the late 1970s, discount companies provided very little service beyond simply

executing the orders customers gave them. In recent years, the discount brokerage business has become so competitive that some companies offer almost as many services as full-service brokerage companies.

Broker Location

When selecting a brokerage company, decide whether you want a local company or would prefer to deal with someone only by telephone or computer. When you deal with a local broker you have the opportunity to stop by to check prices and discuss your marketing plan, price objectives and the market outlook in person. Dealing with someone in a local office also might help build a more trusting professional relationship. However, even if the company is a discount brokerage you will likely pay something closer to full-service commissions because of the cost of operating a local office.

You'll also want to consider how orders are entered, how quickly they get to the trading floor, and how quickly trade confirmation gets back to you. Having a broker who is actually located on the exchange floor means transactions will be executed and reported to you more quickly. Speed of execution and reporting may seem more important if you are a speculator than if you are a hedger. But even as a hedger, it can be frustrating if you are attempting to make



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a trade in a market that is moving quickly and your broker cannot confirm information about your order in a timely manner.

Trading over the Internet can be faster when everything is going well, but there could be occasional problems with power disturbances, network congestion or other technology breakdowns.

Financial Strength of the Company

Whether you are dealing with a small, independent firm that clears trades through a larger company, or with a large brokerage company, you should ask for the company's financial statements to get an understanding of the firm's financial integrity. Keep in mind, however, that this is a very fast-moving industry, and even if a firm's annual report shows a strong financial position, a series of mistakes could quickly put the firm in financial trouble. If your brokerage company goes broke, you could find yourself involved in a long, drawn-out legal process. While brokerage companies are not allowed to use the money in your trading account to meet their obligations (customer accounts must remain segregated), if they get into financial difficulties or go out of business, the funds in your account could be tied up during the legal process.

Reputation of the Brokerage Company/Broker

One quick way to judge how reputable a brokerage company or a particular broker is would be to talk to clients. A reputable company or broker should be willing to provide you with names of customers you could contact. If you are dealing with a company that has a local office, you may also want to check with the Chamber of Commerce, local lenders, Better Business Bureau, etc.

The Commodity Futures Trading Commission (CFTC), the government regulatory agency, and the National Futures Association (NFA), the industry self-regulatory organization, are the main entities responsible for regulating the

futures industry. If you have questions concerning the reputation of a brokerage company or a specific broker, you can contact one or both of these agencies. They will be able to tell you if a complaint has been filed against a company or if any disciplinary action has been taken against a broker you are considering. This information may help you avoid problems. The mailing address, phone numbers and Internet addresses are listed below.

U.S. Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, NW
Washington, D.C. 20581
(202) 418-5000
www.cftc.gov

National Futures Association
300 S. Riverside Plaza, #1800
Chicago, IL 60606-6615
(312) 781-1300
www.nfa.futures.org

Account Requirements

Different brokerage companies will have different requirements for opening an account. To some extent this may be a function of the amount of risk the brokerage company wants to bear with respect to having you as a client. While all firms are required by law to collect and provide certain kinds of information and to warn potential clients that there are risks involved in futures and options trading, some firms are inclined to collect more information than others. A brokerage company with a local office may not ask for as much information, assuming that your local broker will find out who he or she is dealing with and make sure that you are a good risk as a client. Large regional or national firms that do not have a local office where you live may ask for more information because they do not know you personally and want to find out if you will be a good client. One of the risks brokerage companies face is clients incurring losses in their trading accounts and refusing or not being able to pay. The brokerage company must cover those losses. As a result, brokers and brokerage companies must always

be careful about whom they are doing business with. You may be asked for the following when you open an account.

- Social Security number
- Financial statement
- Banks and accounts
- Commodities to be hedged
- Information about your investment knowledge and experience
- A check to open the account

Some firms will require a substantial deposit to open an account (\$5,000 to \$10,000). Some firms pay interest on money in your account when it is not being used for margin. You may want to avoid brokerage companies that require a large initial deposit to open the account and do not pay interest on that money when it is not being used for trading purposes. However, if they provide good services you may think it is worth forgoing interest.

Margin

As you investigate different companies, you will likely see differences in the way they handle margins. While the exchanges set minimum margin requirements for each commodity, brokerage companies are allowed to set their margins at that exchange minimum or at some higher level. Some companies may also have different margin requirements for hedgers than for speculators.

There may be considerable differences in the ways companies handle margin calls—how quickly they must be met, and how quickly the brokerage company will send money back to you from your account. Some companies/brokers may suggest that when you get a margin call, you must bring or wire-transfer the funds the next day. Other companies/brokers may say that it is okay if you put the check in the mail the next day. Either way, the important thing is that you know and are willing to abide by the policies of the company you are working with. You should expect a company to follow the same schedule for sending out payouts as they require for sending in margin money.

Commissions

The amount of commission you pay per contract can vary substantially among companies, and may even vary from client to client within a company if there are discounts for more active trading or a reduced level of services. As mentioned earlier, full-service companies and brokers usually charge higher commissions but offer more services; discount companies/brokers charge lower commissions but offer fewer services. Make sure you understand exactly how the company charges commissions.

Experience and Knowledge

When selecting a broker, consider your knowledge of the markets and the amount of trading experience you have. If you need information about the commodity you are hedging, ask brokers about their backgrounds, educational training, years of experience, the types of analysis they specialize in, whether they provide trading recommendations, whether they trade for their own accounts, whether they specialize in a particular market(s), the types of accounts they handle (hedging vs. speculative), whether they have local basis information, whether they will work with you to develop a marketing plan, whether they will work with your lender to use three-way agreements for hedge accounts, and other special services offered.

Communication

It is extremely important that you be able to talk to your broker, that you understand what he or she is telling you, and that your broker has a clear understanding of your investment objectives. This profession, like many others, is full of its own special jargon, which may make little sense to a new trader. A good broker can help you work through this maze of new terminology.

You may want to ask some questions, such as: “Can you explain the current market situation to me?” or “Can you explain how to use a certain market strategy?” See if the broker can relate the information to you in a way you can understand.

Reputation

This industry is full of opportunity. As a result, it attracts some really good, honest, conscientious, hard-working individuals. It also attracts its share, or maybe more than its share, of people of somewhat dubious honor. Because you need to be able to depend on and trust your broker, it is very important to select an honest person. Some people say to look for the busiest broker in the office, assuming that a busy broker is a good one. It is true that a good broker is probably going to be a busy broker. If a broker provides good service and has a good reputation, he or she will tend to build and retain a sizeable client list and, as a result, could appear to be very busy any time you walk in the door or call on the telephone. However, you cannot assume that a busy broker is necessarily a good broker.

Most companies in the futures industry make money by charging clients commissions each time they make a trade. Most brokers are paid a percentage of the commissions they generate each month. The more clients trade, the more their brokerage companies and brokers earn. If your intent is to put a hedge on and wait until it is time to offset it when you make the cash sale or purchase, you need to find a broker who is not going to be too pushy about getting you to trade more often.

Overall, you should strive to build a long-term relationship with a broker with whom you feel comfortable and whom you trust. Thorough and thoughtful consideration should be given to the broker's personality, experience, knowledge and level of service so that you can build a close working relationship with that person and achieve your financial goals.

What Not to Expect from Your Broker

A good broker will be someone you can trust to get your orders executed quickly, efficiently

and accurately. You might also expect a full service broker to provide you with accurate and timely market information. However, if you have unrealistic expectations about what your broker could or should do, you may be disappointed.

Don't assume your broker will:

- have a crystal ball and be able to provide perfect forecasts;
- know your cost of production;
- know and help you with your cash marketing alternatives;
- make your decisions for you;
- know when the market will move against you and get you out of a bad trade; or
- break rules/laws to take care of you.

While your broker may be willing to do one or all of these for you, you shouldn't expect it. Your broker is a sales person who is trained to sign up clients and efficiently execute orders. Most are not trained as analysts, trading experts or business managers. Asking them to perform these functions usually causes problems.

Your Broker's Expectations

There are certain things that your broker will expect from you. If you are going to have a long, trusting business relationship with your broker:

- be responsible for your decisions;
- don't ask him/her to break rules or laws;
- be honest and stand behind your words and actions;
- don't dodge his or her phone calls;
- meet your margin calls in a timely manner; and
- don't waste his or her time by engaging in idle conversation during trading hours or entering orders you will cancel when the market gets close.

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