HEDGE-TO-ARRIVE CONTRACTS*

David C. Barrett, Jr.*

I. Background
II. Hedge-to-Arrive Contracts ....
A. Basic Hedge-to-Arrive Contracts ....
B. HTA Contract (with rolling of the futures month and/or the shipment period on the contract permitted)...
C. HTA Contract (using a futures month for pricing other than the intended cash delivery period) ....
D. HTA Contract Allowing the Customer to Price/Unprice (final cash .. price is adjusted for gain/losses on the unpricing/repricing) ....
E. HTA Contracts with Walk-Away Provisions.......................................
III. Legal Risk/Enforceability of HTA Contracts ....
A. Legal Risk versus Risk of Dispute ....
B. General Contract Law Applicable..
C. Special State Statutes ....
D. Cash and Forward Contracts versus Trade Options versus Futures Contracts ....
E. Prohibited Transactions...
F. The Regulatory Environment/Role of CFTC Staff ....
G. Legal Consequences of Offering Prohibited Off-Exchange Trade ..... Options or Futures Contracts ....
IV. The Future
A. Proposed Exemption ....
B. Rationale for the CFTC to Act Now ....

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* David C. Barrett, Jr. is counsel for Public Affairs/Secretary-Treasurer, National Grain and Feed Association, Washington, D.C. He is a member of the Ohio and District of Columbia bars. Mr. Barrett received a B.S. in Agriculture from Ohio State University in 1978 and a J.D. from the University of Toledo in 1981. The author wishes to acknowledge and thank Tom Coyle, vice president, Continental Grain Company, Chicago, Ill., for his substantial work in preparing the examples taken from the NGFA White Paper. Mr. Coyle served as chairman of the NFGA Risk Evaluation Task Force, whose members contributed the professional expertise for the project.

I. BACKGROUND

Numerous forward contracts are offered in the cash grain market today. Many are traditional cash contracts with well known obligations. Increasingly, however, more sophisticated contract forms intended to increase flexibility for the user are being offered. Hedge-to-arrive contracts are simply one of the variations of newer hybrid cash contracts that have seen increased use.

While hedge-to-arrive (HTA) and other hybrid cash contracts currently represent a relatively small percentage of overall contracting volume in the cash marketplace, their use has increased significantly over the past five years. Generally, these contracts are intended to allow farmer-customers more pricing flexibility by using a pricing formula that focuses on the futures portion of the cash price.

The change in farm support programs in the 1996 farm bill[1] and continuing expansion in global trade suggest increased risk and a greater need for these contracts. Nevertheless, expanded use of hybrid cash contracts has created concern at many levels in the industry. The consequences have included numerous media articles, lawsuits, arbitrations, regulatory investigations,[2] and congressional hearings.

The Commodity Futures Trading Commission (CFTC) on November 13, 1996, filed three separate administrative complaints[3] related to grain contracts that are alleged to have violated the Commodity Exchange Act (CEA). As the CFTC noted, the complaints were "based on information presented by the CFTC's Division of Enforcement . . . . The filing of these complaints does not represent a

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1. Federal Agriculture Improvement and Reform Act of 1996, Pub. L. No. 104-127, 110 Stat. 888 (1996).

2. The Commodity Futures Trading Commission (CFTC) by mid-1996 had publicly acknowledged that its Division of Economic Analysis and Division of Enforcement were investigating several situations involving hedge-to-arrive contracts including: "(1) whether some of these contracts may be illegal off-exchange futures or agricultural trade options; (2) whether certain participants are required to be registered [with the CFTC]; and (3) whether some persons may have committed fraud in the marketing or sales of HTA contracts." Joseph B. Dial, The CFTC and Hedge-To-Arrive Contracts, Address Before the Commodity Futures Trading Comm'n at the 58th Annual Summer Conference (July 30, 1996), *printed in* FDCH FED. DEP'T. & AGENCY DOCUMENTS, July 30, 1996, *available in* LEXIS, News Library, Curnws File.

3. All three of the complaints involved allegations that cooperative grain elevators had violated the prohibition against the offering of off-exchange agricultural options and/or futures contracts. See In re Grain Land Co-op., No. 97-1 (CFTC Nov. 13, 1996 (on file with the DRAKE J. AGRIC. L.); In re Wright, No. 97-2 (CFTC Nov. 13, 1996) (on file with the DRAKE J. AGRIC. L.); In re Southern Thumb, Co-op., Inc., No. 97-3 (CFTC Nov. 13, 1996) (on file with the DRAKE J. AGRIC. L.). One of the complaints also asserted various violations of the Commodity Exchange Act involving fraud in connection with marketing and promotion of, and illegal entry into, illegal, off-exchange futures and options contracts against an agricultural marketing consultant. *In re* Wright, No. 97-2 (1996). The CFTC also charged a registered futures commission merchant and one of its associated persons with aiding and abetting . . . unregistered activities and with trading without proper authorization. *See id.* at 22.

determination by the CFTC that there has been a violation of the CEA, nor that any sanctions or other remedies are warranted."[4] Additionally, the CFTC was careful to point out that "[t]he CFTC recognizes that there is widespread use in the grain industry of various grain contracts, some of which are termed hedge-to-arrive contracts or options. The decision to bring these actions is based solely on the facts relating to the specific contracts involved in these three cases."[5]

At the forefront of the current forward contract controversies are farm customers who entered into hedge-to-arrive or other minimum/maximum price forward contracts during the 1995/96 grain marketing year. These contracts, as with any forward cash sale contract, were affected negatively by record price escalation during the 1995/96 marketing year. Grain elevators and other grain merchants also were impacted heavily by the record price movements as they struggled to meet unprecedented margin calls as to their hedged positions on the regulated futures markets.[6] These hedged positions were used as part of a risk-management program for much larger forward contracting programs.

It is important to understand what typically happens when a grain elevator purchases grain, whether for immediate delivery or for delivery at some point in the future. The grain elevator (the buyer) enters into a contract for the purchase of grain from a producer (the seller). In addition to quality and other factors, a grain contract generally can provide for a flat price or a pricing formula based on factors agreed upon by the buyer and seller. Hedge-to-arrive and other hybrid cash contracts ordinarily use a pricing formula that references price movements on a federally regulated futures market such as the Chicago Board of Trade (CBOT). While the grain buyer ordinarily will take action to hedge the obligations arising from the cash contract by using that referenced futures market, the grain buyer is under no contractual or other obligation to do so. Indeed, the grain buyer could in some cases deal with its risk by using a different futures market to hedge its contractual risks or enter into forward contracts with processors, feeders, or others as the means of managing its contractual commitments. In other words, the hedge-to-arrive or other forward contract represents the deal between the grain buyer and the producer-seller.

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4. Commodity Futures Trading Commission, CFTC FILES THREE SEPARATE ADMINISTRATIVE COMPLAINTS RELATED TO GRAIN CONTRACTS, ALLEGING VIOLATIONS OF THE COMMODITY EXCHANGE ACT, (Press Release #3965-96) Nov. 13, 1996 at 2. (This release may be obtained from the U.S. Commodity Futures Trading Commission, Office of Public Affairs).

5. *See id.*

6. Grain buyers, upon entering into spot or forward contracts to purchase grain, typically take positions in the futures market to reduce the risk of subsequent price movements. In its simplest terms, hedging involves taking a futures position that is equal and opposite from one's position in the cash market. Congress expressly recognized this fact in its legislative findings codified in the Commodity Exchange Act: "Such transactions [futures] are utilized by shippers, dealers, millers, and others engaged in handling commodities and the products and byproducts thereof in interstate commerce as a means of hedging themselves against possible loss through fluctuations in price." 7 U.S.C. § 5 (1994). Other risks also may be addressed through hedging, and a pending Senate bill would delete the phrase through fluctuations in price from 7 U.S.C. § 5. S. 257, The Commodity Exchange Act Amendments of 1996, 143d. Cong. § 2 (1996).

Any contracts entered into by the grain buyer on a regulated futures exchange or with other third parties are separate and distinct contractual obligation(s) to which the producer-seller is *not* a party.

Early in 1996, a special multi-discipline National Grain and Feed Association (NGFA) task force issued a white paper[7]on hybrid cash contracts. This white paper provides a comprehensive overview of the various types of hybrid contracts, identifies the key issues, and establishes recommendations to help the industry effectively address and manage the potential growth of these contracts. Portions of the NGFA white paper addressing hedge-to-arrive contracts have been adapted for this presentation.

II. HEDGE-TO-ARRIVE CONTRACTS

Hedge-to-arrive contracts have evolved from the basic forward cash contract. HTA's are sometimes known in the cash marketplace as "futures first" or "futures only" contracts. In their simplest form, these contracts are the opposite of a basis contract,[8] permitting the user to price the futures level before the basis. To the buyer, the futures hedging requirements in the basic HTA are the same as with a forward cash purchase. Sometimes elevators and merchants add features to the basic HTA to increase flexibility for customers (farmers/country elevators) using this pricing mechanism. The flexibility generally provides the opportunity to adjust (roll) a previous pricing decision or to price futures in a period different than the intended cash shipment period. The manner in which flexibility is offered varies by contract. These added features require special attention because of their potential to create increased costs, risks, and confusion.

Some HTA contracts used or considered for use in the cash marketplace include:[9] basic Hedge-to-Arrive (HTA) contract, HTA Contract (with rolling of futures month permitted), HTA Contract (using a futures month for pricing other than the intended cash delivery period), HTA Contract (allowing customer to price/unprice), and HTA Contract (with walk-way provision)

A. Basic Hedge-to-Arrive Contract

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7. National Grain & Feed Ass'n., Hybrid Cash Contracts-Assessing, Mananging and Controlling Risk (April 1996) (On file with DRAKE J. AGRIC. L.) (this paper may be obtained by purchase at the National Grain & Feed Association, 1201 New York Avenue, N.W., Suite 830, Washington, DC 20005-3917).

8. In the cash grain market "basis" refers to the difference between the cash grain price at a specific location and a futures price for a given month. This difference may be the result of time period differences including the time value of money, geographic location, quantity differences, and other factors.

9. The HTA examples are intended to be illustrative of possible marketing strategies. Whether the strategies are appropriate in given situations or legally acceptable off-exchange transactions is a separate issue.

This type of contract transfers the futures risk and opportunity from the seller (farmer) to the buyer (elevator, consumer, or merchant) on the contract date.

Example: On July 1, a farmer agrees to sell a specified quantity for November delivery on a HTA (futures only) contract. The HTA (futures) price is set at $2.50., which is the December future. The farmer maintains the basis risk until a later date, usually no later than the date of shipment.

<u>Calculation</u>:	July 1	Nov. 1	Nov. 1 Scenario A	Nov. 1 Scenario B
CBOT Dec. Futures	$2.50	$2.50	$2.25	$3.00
Basis level	NA	-.25	-.25	-.25
Cash Price	NA	$2.25	$2.00	$2.75

The farmers' decision to lock in the futures portion of the cash price on July 1, improved the price by $.25 versus scenario A, but $.50 worse than scenario B.

Risk to the seller: The seller's futures risk ended on the date and at the price of the HTA, but the seller retained the basis risk.

Risk to the buyer: The buyer accepted the futures risk at $2.50 on the date of the HTA. To eliminate this risk, the buyer will hedge this in the same manner as with a forward cash purchase by selling futures or a similar amount of cash corn versus $2.50 futures.

B. HTA Contract (with rolling of the futures month and/or the shipment period on the contract permitted)

Example: On July 1, a farmer sells corn for delivery in November on a HTA based on December futures at $2.50, as in the previous example. However, in this case the buyer permits the seller to shift (roll) the futures month. On September 1, the seller requests to change the HTA to March future at the prevailing spread of a $.15 carry. Then on October 1, the seller requests to roll the HTA back to December futures at the prevailing spread of $.05 carry. On November 1, the farmer elects to establish the final price by setting the basis.

Calculation:

	Seller HTA	Buyer's Hedge CBOT Dec.	CBOT March
July 1 HTA (Dec. Futures)	$2.50	($2.50) Sold	
Sept. 1 Roll HTA to March	+.15	$2.45 Bot	($2.60) Sold
Sept. 1 HTA (March Futures)	$2.65		
Oct. 1 Roll HTA to Dec.	-.05	(2.55) Sold	$2.60 BOT
Oct. 1 HTA (Dec. Futures)	$2.60 Cash Bot	($2.60) Futures Sold	

The net result of this activity is a $.10 improvement in the seller's HTA futures value less any fees. On November 1, the seller completes pricing of the cash contract by setting the basis at -$.25. *An important point is that the $.10 improvement in the HTA was the result of the seller taking a new risk -- a spread risk.*

Comparison:	July 1 HTA	Nov. 1 Adjusted HTA	Nov. 1 Scenario A	Nov. 1 Scenario B
Futures	$2.50	$2.60	$2.25	$3.00
Basis level	NA	-.25	-.25	-.25
Cash Price	NA	$2.35	$2.00	$2.75

C. HTA Contract (using a futures month for pricing other than the intended cash delivery period)

The primary difference between this type of HTA and the previous example is the intended use of the contract. The previous example demonstrated a HTA that is intended to offer flexibility for the seller to respond to market changes. In this example, the intention from the start is for the seller to assume the risk on the direction of spreads. The amount of risk is directly correlated to the time spread between the intended cash delivery period and the futures month chosen for the HTA.

October '96 Delivery v. December '96 Futures = No Spread Risk
October '96 Delivery v. March '97 Futures = Minor Spread Risk
October '96 Delivery v. July '96 Futures = High Spread Risk

Example 1: HTA in futures month other than the intended cash delivery period, *but within the same crop year.*

On July 1, a farmer sells a specified quantity for November delivery on a HTA contract using the Chicago Board of Trade (CBOT) September futures. The buyer (elevator/merchant) hedges this cash purchase by selling September futures. On September 1, the seller requests to roll the HTA to December futures, and on

November 1, the seller requests to establish the cash basis to complete the pricing of this contract.

<u>Calculation</u>:	Seller HTA	Buyer's Hedge CBOT Sept.	CBOT Dec.
July 1 HTA (Sept. Futures)	$2.60	($2.60) Sold	
Sept. 1 Roll HTA to Dec.	-.20	$2.65 BOT	($2.45)
Sept. 1 HTA (Dec. Futures)	$2.40 Cash Bot $.05 + ($2.45)=($2.40)		
			Net Futures Sold

The buyer's hedge equals $2.40 ($2.45 Dec. less loss of $.05 on Sept.) compared with Seller's HTA of $2.40.

<u>Comparison</u>:	July 1 Dec. HTA	Nov. 1 Adjusted HTA	Nov. 1 Scenario A	Nov. 1 Scenario B
Futures	$2.50	$2.40	$2.25	$3.00
Nov. 1 Basis level	NA	-.25	-.25	-.25
Cash Price	NA	$2.15	$2.00	$2.75

The seller could have established a basic HTA on July 1, with December futures at $2.50, but the loss of $.10 on the Sept./Dec. spread resulted in a final HTA of $2.40. This is an example of a relatively minor futures spread risk associated with establishing a HTA in a futures month different than the futures month that corresponds to the intended cash delivery period.

The next example expands the risk.

<u>Example 2</u>: HTA in futures month that is not only different than the intended cash delivery period, but *in another crop year.*

On April 1, a farmer sells a specified quantity of cash bushels for delivery in November on a HTA using old crop July futures. The buyer hedges this purchase by selling an equal amount of July futures. On or before July 1, the farmer will be required to roll the HTA out of July futures forward to September or December futures. If the farmer chooses to roll the HTA from July to September future, the farmer will be required to roll again from a September future to a December future on or before September 1. The final price will be established when the basis is priced -- in this case the basis on November 1.

<u>Calculation</u>:

	Seller	Buyer's Hedge		
	HTA	CBOT	CBOT	CBOT
		July	Sept.	Dec.
Apr. 1/July 96 Futures	$2.80	($2.80) Sold	--	--
July 1 Roll to DEC.	-.40	$2.90 BOT	--	($2.50)Sold
July 1/Dec. 96 Futures	$2.40 Cash Bot	$.10	+	($2.50)=($2.40)
				Net Futures Sold

Alternatively, on July 1, the farmer could have selected to roll the HTA only to September and then roll from September to December on or before September 1. This calculation is as follows:

<u>Calculation</u>:

	Seller	Buyer's Hedge		
	HTA	CBOT	CBOT	CBOT
		July	Sept.	Dec.
Apr. 1/July 96 Futures	$2.80	($2.80) Sold	--	--
July 1 Roll to Sept.	-.30	$2.90 BOT	($2.60) Sold	--
July 1/Sept. Futures	$2.50			
Sept. 1 Roll to Dec.	-.20	--	$2.65 BOT	($2.45) Sold
Sept. 1/Sept. Futures	$2.30 Cash Bot	$ .10 +	$ .05 +	($2.45)=($2.30)
				Net Futures Sold

The seller could have established a basic HTA on April 1, and locked in the futures portion of the cash contract with December futures at $2.50. But the loss incurred in the July/December spread (or the July/Sept. and Sept./Dec. spreads) reduced the HTA to $2.40 or $2.30 depending on which rolling strategy the seller chose. Of course, the opposite could have occurred if the prevailing CBOT spreads would have weakened. The key point is that this type of HTA contract provides substantial *risks* as well as opportunity from futures spreads fluctuations.

<u>Example 3</u>: HTA in a futures month of one crop year to establish the futures price for multiple crop years.

The basic features of this type of contract resemble Example 2. But, instead of crossing one crop year the HTA crosses multiple crop years. In such cases, the seller will be required to roll the initial HTA futures value until the expected delivery period in the appropriate crop year. Using this market strategy requires a thorough understanding by the buyer and the seller of how futures spreads function.

<u>Risks to the seller</u>: The seller is accepting a "futures spread risk" *each time* the futures month of the HTA does not correspond to the intended delivery period. The longer the time between the HTA futures month and the intended delivery period, the greater the risk. Counterparty risk increases with these types of contracts.

Failure of the buyer to properly hedge the HTA contract could lead to deterioration in the financial condition of the buyer.

Risks to the buyer: If hedged properly, there is no additional price risk to the buyer. The biggest risk is the potential margin calls on hedge positions maintained over a longer time. Counterparty risk increases with these types of contracts for buyer and seller, particularly with multi-year contracts. While the seller is assuming the futures spread risk on these contracts, the potential for significant decreases in the seller's final contract price also increases the possibility of contract disputes or defaults on these contracts.

D. HTA Contract Allowing the Customer to Price/Unprice (final cash price is adjusted for gain/losses on the unpricing/repricing)

Example: On April 1, a farmer sells a specified quantity for September shipment on a HTA contract with September futures at $2.70. On July 1, the farmer requests to "unprice" the HTA established on July 1, at the prevailing market of $2.60. On September 1, the seller requests to "reprice" at the current market of $2.65 and completes the cash pricing by locking in the current basis of $.20 under the September futures.

Calculation:		Seller HTA		Buyer's Hedge CBOT Sept.
Apr. 1 HTA (Sept. Futures)		$2.70		($2.70) Sold
July 1 HTA (unprice)		($2.60)	$2.60 Bot	
Gain on HTA		$ .10		($ .10) Gain
Sept. 1 "reprice" HTA	$2.65		($2.65) Sold	
Sept. 1 HTA (Sept. Futures)		$2.75 Cash Bot	($2.75)Net Futures Sold	
Sept. 1 fix basis	-.20			
Final Cash Price		$2.55		

This strategy allowed the seller to improve the cash sales price by improving the futures portion of the pricing equation. The HTA is $.05 better than if the farmer maintained the original HTA and $.10 per bushel better than if the farmer waited until September 1, to establish the futures level.

Risks to the seller: The risks relate to the "futures portion" of the cash price. Each time the seller unprices a sale, he assumes the futures price risk again.

Risks to the buyer: There is no additional price risk as long as the transaction is hedged. However, there are other risks. The primary risk relates to whether the transaction is a legal off-exchange forward cash contract as defined by the Commodity Exchange Act. Permitting the seller to *repeatedly* price/unprice a HTA may undermine the integrity of the forward cash contract status of the HTA. As discussed later, agricultural options and futures contracts generally are transactions that must be conducted on a regulated futures exchange.

E. HTA Contracts with Walk-Away Provisions

The term "walk-away" refers to the practice of permitting a customer to cancel a cash contract or reduce the delivered volume and settle the market difference with some sort of cash payment.

Cash forward contracts which permit the producer-seller to simply walk-away from their contractual obligations raise serious regulatory concerns under the Commodity Exchange Act. Is the contract a legitimate forward cash contract or a futures contract in the form of a cash contract? A regulatory review is strongly recommended prior to offering contracts with this feature.

III. LEGAL RISK/ENFORCEABILITY OF HTA CONTRACTS

A. Legal Risk versus *Risk of Dispute*

Most hedge-to-arrive and other forward contracts are legally enforceable contracts. As with all contracts, if one of the contracting parties has a different expectation of what the deal is, then there is a clear risk of developing a dispute with that other party. Thus, both parties to the contract need to understand their rights, obligations, risks, and expectations.[10] This will help eliminate and minimize the risk of disputes. A grain buyer or seller does not want to spend time and money fighting with the companies and people with whom they do business, regardless of the legal risks accompanying litigation or arbitration.

B. General Contract Law Applicable

The commercial grain and feed business is based on entering into and performing thousands of contracts every day. While a written contract signed by both parties is the ideal, most of the contracts entered into in the domestic trading of grain and feed are made orally over the telephone with confirmations of some type

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10. The NGFA already has implemented a number of actions to provide grain buyers and sellers with educational materials about hedge-to-arrive contracts and other risk management and marketing alternatives. The NGFA made a public commitment at the October 2, 1996, meeting of the CFTC's Agricultural Advisory Committee (AAC) to cooperate fully with any organization that wants to work together on such educational efforts. The central theme of the AAC's meeting on October 2, was "the need for, and importance of, risk management education programs for U.S. agricultural producers." The AAC, chaired by CFTC Commissioner Joseph Dial, "was created for the purpose of giving advice to the Commission concerning agricultural issues." "CFTC's Agricultural Advisory Committee to Meet" (Press Release #3941-96) Sept. 24, 1996 (For more information about the AAC meeting, contact the U.S. Commodity Futures Trading Commission, Office of Public Affairs, Kimberly Harter at (202) 418-5050).

sent later to the other party or parties. These confirmations finalize the oral agreements previously reached. Often, a single copy of a contract signed by both parties does not exist, yet valid contracts are formed and performed.

> In the grain and feed industry, an enforceable contract is an agreement that a court or arbitration committee will enforce.[11] The rules on when a valid contract or agreement exist are extremely important. A commonly accepted definition of contract is: "An agreement between two or more persons which creates an obligation to do or not do a particular thing. Its essentials are competent parties, subject matter, a legal consideration, mutuality of agreement and mutuality of obligation."[12]

In the case of hybrid cash contracts and other grain contracts, the normal rules of contract law apply. State law generally provides the rules on the formal requirements of legally enforceable contracts. Apart from that, each contract must cover the rights and obligations that each party to the contract is undertaking. The sample hedge-to-arrive contract attached to this paper can be used as a general checklist for developing contracts. Likewise, NGFA Grain Trade Rule 1 contains a checklist applicable to contracts subject to the NGFA Grain Trade Rules.[13] Because business practices vary considerably between commercial grain firms, the contract terms appropriate to particular transactions also will vary.

One of the most fundamental rules of contract law is the statute of frauds provision embodied in state-enacted versions of the Uniform Commercial Code (U.C.C). The general rule set forth in U.C.C. section 2-201(1) is that contracts involving the sale or purchase of goods for a price of $500 or more must be in writing and signed by the party against whom enforcement is sought.[14] However, there are important exceptions to the general rule. The one commonly applicable to

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11. NGFA arbitration of disputes between NGFA Active and/or Allied members is compulsory under the NGFA Bylaws and NGFA Arbitration Rules. Additionally, many NGFA members now include arbitration clauses in their contracts with non-member commercial firms (including producers). *See also,* David C. Barrett, Jr., *Arbitrating Agricultural Disputes: The National Grain and Feed Association's Experience,* 68 N. D. L. REV. 539 (1992). At least three federal courts have found that disputes arising from hedge-to-arrive contracts are subject to NGFA arbitration because of contractual provisions incorporating the NGFA rules. *See* Hodge Bros., Inc., v. DeLong Co., Inc., 942 F. Supp. 412 (W.D. Wis. 1996); Lowell E. Harter v. Iowa Grain Co., 1996 WL 556734 (N.D. Ill. 1996); and Andersons, Inc. v. Horton Farms, Inc., No. 1:96-CV-171 (W.D. Mich. Aug. 26, 1996).

12. BLACK'S LAW DICTIONARY 322 (6th ed. 1990).

13. While the NGFA Trade Rules were developed initially for use on transactions between commercial grain firms, many contracts between producers and grain buyers also expressly incorporate the NGFA Trade Rules. The NGFA Trade Rules provide for arbitration of disputes arising from such transactions.

Some contracts merely reference the NGFA Arbitration Rules. The NGFA Arbitration System provides a cost-effective and accepted method to resolve disputes when at least one of the contracting parties is a NGFA member. Thus, the sample hedge-to-arrive contract attached to this paper provides that all disputes will be resolved by NGFA arbitration.

14. *See* U.C.C. § 2-201(1)(1996).

commercial grain and feed transactions is the merchant rule embodied in U.C.C. section 2-201(2), which provides as follows:

> Between merchants if within a reasonable time a writing in confirmation of the contract and sufficient against the sender is received and the party receiving it has reason to know its contents, it satisfies the requirements of subsection (1) against such party *unless written notice of objection to its contents is given within ten days after it is received* [emphasis added].[15]

In most cases, therefore, a farmer-customer's failure to object to a written confirmation of trade amounts to acceptance that the confirmation accurately states the oral agreement previously entered into between the parties. Several potential problems, however, still remain. The farmer-customer may object when he receives the written confirmation. Further, whether a person is a merchant depends upon how individual states apply the definition of merchant contained in section 2-104(1) of that state's version of the U.C.C.[16]

Regular commercial firms are almost always considered merchants. Producers usually are merchants, but some state courts have concluded that farmers are not merchants.[17] However, the trend of recent cases has been to find that farmers are merchants just like other businessmen.[18] Additionally, the merchant rule may take on new importance given the rise of "farmer-advisors" often cited as being involved in advising farmers on new forms of forward contracting. The farmer who hires a farmer-advisor to advise him or negotiate with the local grain elevator substantially increases the likelihood that he will fit into the definition of merchant set forth in U.C.C. section 2-104(1) even in those states that have otherwise found farmers not to be merchants. Note that all section 2-104(1) requires is that the agent or other intermediary (the farmer-advisor) "holds himself out as having such knowledge or skill,"[19] which would be "peculiar to the practices or goods involved."[20]

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15. U.C.C. § 2-201(2)(1996).

16. *See* U.C.C. §2-104(1)(1996). "'Merchant' means a person who deals in goods of the kind or otherwise by his occupation holds himself out as having knowledge or skill peculiar to the practices or goods involved in the transaction *or to whom such knowledge or skill may be attributed by his employment of an agent or broker or other intermediary who by his occupation holds himself out as having such knowledge or skill*." The judicial interpretations of this definition of merchant vary from state to state and by courts within a particular state.

17. *See* Dickson v. Delhi Seed Co., 760 S.W.2d 382, 388 (Ark. Ct. App. 1988) (finding that under Arkansas law, farmer is not a merchant).

18. For cases finding farmers to be merchants, *see* Colorado-Kansas Grain v. Reifenschneider, 817 P.2d 637 (Colo. App. 1991); Busby Inc. v. Smokey Valley Bean, Inc., 767 F. Supp. 235 (D. Kan. 1991); Agrex, Inc. v. Schrant, 379 N.W.2d 751, 754 (Neb. 1986); and Thunderbird Farms, Inc. v. Abney, 343 S.E.2d 127, 128 (Ga. Ct. App. 1986).

19. U.C.C. § 2-104(1)(1996).

20. *Id.* This is in accord with long-standing legal rules on the responsibility of a principal for the acts of its agents.

Another problem encountered is the less-than-perfect contract (i.e. the grain buyer's new employee drafted the contract terms without the benefit of counsel). While there is no substitute for doing it right the first time, counsel is all too often faced with salvaging these situations. In some cases, the solution might be the so-called gap fillers contained in state-enacted versions of the Uniform Commercial Code.[21]

> For the reasons pointed out later, delivery terms are a controversial issue with hedge-to-arrive contracts. What if the grain buyer's mistake involves a failure to mention a time for delivery in the contractual documents? Since legitimate cash forward contracts obviously contemplate actual delivery of the underlying commodity, there is a U.C.C. gap filler for this situation. Specifically, U.C.C. section 2-309(1) provides that, "The time for shipment or delivery of any other action under a contract if not provided in this Article or agreed upon *shall be a reasonable time* [emphasis added]."[22]

What is a reasonable time for delivery in the case of a contract involving 1996 corn? U.C.C. section 1-204 provides, among other things, that "[w]hat is a reasonable time for taking any action depends on the nature, purpose and circumstances of such action."[23] One could certainly argue that a reasonable time for delivery of 1996 crop corn is the ordinary time for harvest in that locale. So, if corn in Iowa is ordinarily harvested in October or November, then a reasonable time for delivery on a 1996 crop corn contract between an Iowa elevator and an Iowa farmer would be in October or November of 1996.

The U.C.C. also contains statutory gap fillers where the contract fails to specify the place for delivery[24] and where payment terms are left open.[25] There are even U.C.C. gap fillers for such issues as price and quantity terms.[26] Gap fillers only apply if the parties have otherwise intended to form a contract. U.C.C. section 2-204 reads,

> (1) A contract for sale of goods may be made in any manner sufficient to show agreement, including conduct by both parties which recognizes the existence of such a contract.
> (2) An agreement sufficient to constitute a contract for sale may be found even though the moment of its making is undetermined.

21. This is what I call the Contract Repair Kit.
22. U.C.C. § 2-309(1)(1996).
23. U.C.C. § 1-204(2)(1996).
24. *See* U.C.C. § 2-308(1996).
25. *See* U.C.C. § 2-310(1996).
26. *See, e.g.,* U.C.C. § 2-305(1996).

> (3) Even though one or more terms are left open a contract for sale does not fail for indefiniteness if the parties have intended to make a contract and there is a reasonably certain basis for giving an appropriate remedy.[27]

C. Special State Statutes

This is an area where those dealing with producers must be especially careful on particular types of contracts. A number of states have specific statutory requirements for deferred payment or deferred price contracts between grain dealers and producers.[28] The current controversy over hedge-to-arrive contracts has led to calls by some for additional state legislation governing grain contracts.[29] Some state laws require that arbitration or mediation clauses be included in agricultural contracts under certain circumstances.[30]

D. Cash and Forward Contracts versus *Trade Options* versus *Futures Contracts*

The legality and enforcement of cash and forward contracts generally are governed by state law even though many federal laws affect the sale and purchase of grain.[31] However, the Commodity Futures Trading Commission (CFTC) and federal law determine whether a contract has crossed the line from being a legal cash/forward contract to an illegal off-exchange trade option or futures contract under the Commodity Exchange Act (CEA).[32]

A complete discussion of the CEA is beyond the scope of this paper. Suffice it to say that the CEA vests the CFTC with broad jurisdiction over commodity and commodity-related futures contracts and options. The bottom line is that the CFTC has jurisdiction over commodity contracts except where Congress has said otherwise. Agreements or transactions involving cash forward contracts generally are excluded from CFTC oversight because the CEA contains a self-executing exception which provides that "[t]he term `future delivery' does not include any sale of any cash commodity for deferred shipment or delivery."[33]

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27. U.C.C. § 2-204(1996).

28. *See, e.g.,* Wis. Stat. Ann. § 127.10(5) (West 1989).

29. *See* Lyle Niedens, *Bills Regulating Hybrid Grain Contracts Move Forward in Iowa,* BRIDGE NEWS, March 5, 1997 *available in* Westlaw, FINEWS Database. (reporting that "[t]he Senate Agriculture Committee of Iowa's General Assembly has approved two proposals that would regulate and even ban some multi-year hybrid grain contracts in Iowa.")

30. *See, e.g.,* Minn. Stat. Ann. §§ 17.90-.91 (West 1981); Idaho Code § 22-436 (1995); and Ark. Code Ann. §§ 2-23-101-110 (Michie 1996).

31. *See, e.g.,* Federal Food, Drug, and Cosmetic Act, 21 U.S.C. § 301, 346 (1994); Protection for Purchasers of Farm Products, Section 1324 of the Food Security Act of 1985, 7 U.S.C. § 1631(1994); United States Grain Standards Act, 7 U.S.C. § 71(1994).

32. 7 U.S.C. § 1(1994).

33. 7 U.S.C. § 1a(11)(1994). This self-executing statutory exception to the agency's jurisdiction should be distinguished from those situations where the agency has jurisdiction, but has granted or has the power to grant regulatory exemptions on a broad or case-by-case basis.

Contracts involving agricultural commodities can be broken down as follows:

GRAIN TRANSACTIONS

Cash/Forward Contracts[34]	Agricultural Trade Options	Agricultural Futures Contract
No CFTC Jurisdiction to regulate	CFTC Jurisdiction Current ban on off-exchange ag trade options	CFTC Jurisdiction Ban on off-exchange futures contracts

While the preceding chart is helpful to illustrate that only cash or forward agricultural commodity[35] contracts presently are legal off-exchange transactions, determining the line between a cash/forward contract and a prohibited off-exchange trade option or futures contract is considerably more difficult. There are many gray areas because the contract as a whole must examined to determine whether it has crossed the legal boundaries between permissible off-exchange transactions not covered by the CEA and transactions that must be transacted on a CFTC-regulated exchange. Additionally, even a seemingly safely worded contract can become something else if the practices between buyer and seller are different than the contract's terms.

In 1985, the CFTC published an interpretive opinion to guide the public on how the CFTC Office of General Counsel views aspects of the CFTC's jurisdiction and the exceptions.[36] That interpretive opinion provides firms with examples of prohibited off-exchange transactions and examples amounting to safe harbors. A transaction that does not fit within the examples does not necessarily violate the CEA.

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34. The focus here is on the sale of an actual commodity for immediate or deferred delivery, as distinguished from futures or options contracts where the contract may be satisfied by delivery *or* offset. While not necessarily legally determinative, it is helpful to understand how the CFTC has tried to explain these terms in a CFTC publication, Commodity Futures Trading Commission, THE CFTC GLOSSARY: A LAYMAN'S GUIDE TO THE LANGUAGE OF THE FUTURES INDUSTRY, (March 1993) at 105.

35. *See* 7 U.S.C. §1(a)(3)(1994). The Commodity Exchange Act expressly defines the term commodity for purposes of the Act. The primary bulk agricultural commodities such as wheat, cotton, rice, corn, oats, barley, rye, flaxseed, grain sorghums, mill feed and all fats and oils such as soybean oil are included in the statutory definition. However, some specialty crops such as canola (in its unprocessed state) do *not* appear to be included in the definition.

36. *See* Commodity Futures Trading Commission, 50 Fed. Reg. 39,656-61 (1985). For the rule and regulation of the Commodity Futures Trading Commission, *see* 17 C.F.R. pts. 1-199 (1996). It is important to recognize that the 1985 opinion was issued under the auspices of the CFTC Office of General Counsel rather than the Commission itself. While the interpretative opinion is a reliable indicator of the CFTC's regulatory views at that point in time, it does not have the legal effect of an official vote or action taken by the CFTC commissioners.

E. Prohibited Transactions

Off-exchange trade options[37] involving agricultural commodities are *not* currently permitted by the CFTC (although off-exchange trade options on non-agricultural commodities generally are permitted). Because the CEA does not expressly define what a trade option is, the courts and the CFTC have developed guidelines. Generally, the buyer of an option including a trade option, can choose to walk away from the delivery aspect of the contract. The right to make delivery is different than the obligation to make delivery. With that in mind, the courts and the CFTC have stated that an option has these characteristics:

1) An option gives the purchaser the right, but not the obligation, to make or take delivery of the physical commodity;
2) The initial charge for an option is normally a non-refundable premium covering the grantor's commissions, costs and profits; and
3) The purchaser's maximum potential losses on an option normally are limited to the premium.[38]

The CFTC Office of General Counsel has described a prohibited off-exchange trade option as being, for example, the following:

> The contract establishes a minimum contract price determined when the contract is written, and a premium is collected, either at the initiation of the contract, during the life of the contract or, together with interest accumulated over the life of the contract, at the time of the settlement. In return for premium, the producer has the right to require the merchant to accept delivery of and pay a minimum contract price for the crop. However, the producer may forfeit the premium and seek a higher price for, and deliver, the crop elsewhere.[39]

Because the contract in the aforementioned example does not *require* delivery, it is not a cash forward contract. Rather, the elements of this instrument make it a trade option, which, according to the 1985 interpretation, is *not* the type of off-exchange contract currently permitted under CFTC regulations. CFTC does,

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37. While the CFTC has authority to lift the ban on off-exchange agricultural trade options, it also has authority to issue regulatory exemptions on a case-by-case basis. However, the Commission often sets forth specific conditions when granting such relief. *See, e.g.,* CFTC Advisory 32-91 (June 4, 1991) (no-action letter issued to registered futures commission merchant permitting off-exchange options on agricultural commodities to certain commercial purchasers).

38. Commodity Futures Trading Commission, 50 Fed. Reg. 39,656-61 (1985).

39. Commodity Futures Trade Commission, 50 Fed. Reg. 39,660 (1985).

however, have the authority to lift the regulatory ban on trade options through new rulemaking procedures.

F. Some Examples of Non-Regulated Transactions

The CFTC staff has, in the past, focused primarily on whether an agreement requires delivery in setting forth its examples of off-exchange, non-regulated transactions meeting the Commodity Exchange Act's forward contract exclusion. The following types of forward contracts illustrate permissible off-exchange transactions provided that the seller has an obligation, not merely a right, to deliver the commodity:

> 1) A contract involving delivery in the future and a so-called minimum-price guarantee where the contract fails to establish a final price payable for the commodity, but rather the method for determining the final price. The CFTC example includes basis contracts referring to a particular futures contract for the base price as coming within the example of a permitted forward contract. However, it should be noted that the CFTC also said as to this example that the contract mandates delivery, absent events beyond the parties' control, and a primary purpose of the contract is to market agricultural commodities in the normal channels of commerce. To the extent that this contract includes characteristics of an option, those terms cannot be severed or marketed separately from that contract's requirement of delivery [emphasis added].[40]
>
> 2) A delayed-price or deferred-payment contract involving immediate delivery, but providing that the price is fixed later. Title to the commodity passes to the buyer, and the contract may involve a minimum price guarantee. In the CFTC example, the buyer may even offer the minimum price guarantee to the selling farmer in exchange for a premium. The final price is determined later based on a formula set forth in the contract. The CFTC example said that this type of arrangement is a spot contract which generally falls outside the regulatory scheme of the Act. Importantly, the CFTC said that "the option component [in this contract] is inseparable from the actual delivery of the commodity between participants in normal marketing channels."[41]

What are the lessons to be gleaned from the CFTC General Counsel's 1985 opinion? For the creative-minded, the good news is that mere inclusion of option-like pricing features such as a minimum price provision in a bona fide forward

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[40]. *Id.*
[41]. *Id.*

contract does not turn the contract into a prohibited trade option or futures contract.[42] The down-side, however, is that an area of uncertainty remains. When does the contract's option-like or futures-like terms turn the contract into an off-exchange options or futures contract? In other words when do the scales tilt too far away from the contract being a bona-fide forward contract not subject to the CFTC's regulatory jurisdiction? There is a large area of uncertainty between the clearly prohibited and safe transactions outlined in the CFTC General Counsel's 1985 opinion.

In the past, the CFTC staff has issued guidance letters on particular agricultural contracts and fact situations in response to requests by individual companies. Two recent such guidance letters are CFTC 95-104 and 96-23.[43] Guidance Letter 96-23 should be reviewed by those firms offering contracts with options-related features. In the example discussed in the letter, if the farmer-customer decides to terminate the option component of the contract, the farmer-customer is *not* permitted to reestablish the option component and the options positions may *not* be rolled from one expiration month to another. In that situation, the CFTC staff concluded the contract was a cash forward contract and not a prohibited off-exchange trade option or futures contract.

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42. This was reaffirmed, by Paul Architzel, CFTC Chief Counsel, Division of Economic Analysis, Remarks at the CFTC Chairman's Roundtable on the Prohibition of Agricultural Trade Options 11-12. (Dec. 19, 1995).

43. There are several factors to keep in mind before requesting such a letter. First, it is better to seek such CFTC guidance, if at all, before offering the contract to customers. An unfavorable guidance letter on contracts already in use could subject the requester to CFTC enforcement action and could be used by customers as leverage to escape from or alter existing contractual obligations. Further, guidance letters are not legally binding upon the CFTC or the courts because they do not reflect the official views of the Commission. While guidance letters may be reliable indicators of the CFTC staffs' current opinions, such letters do *not* prevent later action by the CFTC and/or private parties once the contracts are used.

G. The Regulatory Environment/Role of CFTC Staff

On May 15, 1996, the CFTC Division of Economic Analysis issued a Statement of Policy and a Statement of Guidance[44] addressing hedge-to-arrive contracts. While the CFTC documents contained express language stating they were *not* intended to represent a legal interpretation of risk management strategies or hedge-to-arrive contracts, the CFTC's disclaimer did not prevent further controversy.[45]

CFTC Statement of Policy: The effect of the statement of policy issued by the CFTC Division of Economic Analysis has been to merely clarify that it was permissible for producers and grain buyers to separately negotiate and enter into settlements involving cash payments on contracts entered into prior to May 15, 1996, without running afoul of earlier CFTC guidance, which focused on actual delivery as a condition of meeting the Commodity Exchange Act's forward contract exclusion. In other words, cash payments to settle an existing contract did not turn it into a prohibited off-exchange option or futures contract.[46]

CFTC Statement of Guidance: The guidance statement proved more controversial because the CFTC Division of Economic Analysis took the unprecedented step of providing its opinion of what the staff considers to be prudent risk-reduction for "any contract, account or agreement which is of the character of, or is commonly known to the trade as, a hedge-to-arrive or flexible hedge-to-arrive contract for the future delivery of grain."[47]

The following are some common questions about the CFTC's statements in the guidance letter and the NGFA's analysis:

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44. *See* U.S. Commodity Futures Trading Commission, Division of Economic Analysis Issues Statements of Policy and Guidance Relating to "Hedge-to-Arrive" Contracts, (Press Release # 3911-96") May 15, 1996, at 1,2. (on file with the DRAKE J. AGRIC. L.) (This report may be obtained from the U.S. Commodity Futures Trading Commission, Office of Public Affairs)

45. *See, e.g.,* Policy Statement and Guidance on Hedge-to-Arrive Contracts Issued by CFTC Division of Economic Analysis. NGFA Newsletter, Vol. 48, No. 11 May 23, 1996 at 1. (including a discussion of statements by Iowa Attorney General Thomas J. Miller).

46. "Based upon earlier court and staff guidance, persons who have experienced losses on these contracts and who may, for financial reasons, wish to restructure their arrangements, may have concluded that failure to deliver on a particular agricultural contract was what determined, among other things, whether a transaction in question is, or was at the time of its inception, subject to the forward contract exclusion of the Commodity Exchange Act. . . . Under this Policy, the Division will not determine the status of any HTA contracts existing as of May 15, 1996, under the forward contract exclusion of the Commodity Exchange Act based on the fact that the parties mutually agree by a separately negotiated settlement, entered into subsequent to entry into the original contract, to unwind, arrange a work-out, or restructure the original transaction through cash payments, wholly or in part." Division of Economic Analysis Issues Statement of Policy and Guidance Relating to "Hedge-to-Arrive" Contracts, *supra* note 44 the May 15th letter at 1.

47. *Id.* at 3.

1. **Q:** The Statement of Guidance Regarding Certain Contracting Practices uses the phrase prudent risk-reduction and then describes the Division of Economic Analysis' view of what prudent risk reduction requires on Hedge-to-Arrive or Flexible Hedge-to-Arrive contracts. Does that mean that contracts not meeting the guidelines set forth by the CFTC Division of Economic Analysis do not fit within the statutory exclusion found in section 1a(11) of the Commodity Exchange Act?[48]

   *NGFA Analysis***:** No. The statement of guidance does not make any judgment as to whether the statutory forward contract exclusion applies to contracts with provisions different from those set forth in the statement. Indeed, the CFTC document expressly provides that: '*In providing this Statement of Policy and this Statement of Guidance, the Division is not thereby taking a position on the validity or legality of any individual contract. To the contrary, such determinations must be based on the specific contracts to be analyzed, and made within their specific factual context*.'[49]

2. **Q:** The explanatory material (footnote 12) accompanying the statements refers to concerns expressed by the CFTC over the additional risk associated with pricing across crop-years and the reluctance of the agency to grant 'spread exemptions from speculative position limits.' While the CFTC has considerable discretion in deciding whether to grant regulatory exemptions for matters within its jurisdiction (*e.g. futures* and options contracts required to be traded on regulated exchanges), isn't it true that the CFTC lacks jurisdiction over forward contracts meeting the statutory definition of a forward contract set forth in section 1a(11) of the Commodity Exchange Act?[50]

   *NGFA Analysis***:** Yes, that is true. If a forward contract fits within the statutory exclusion, then the CFTC does *not* have jurisdiction over the contract. In interpreting the statutory exclusion for cash forward contracts, CFTC staff has focused on the statutory criteria of whether a transaction involves the sale of an actual commodity for immediate or deferred delivery, as distinguished from futures contracts where the contract provides that it can be satisfied by delivery *or* offset; or options contracts where the holder does

48. Policy Statement and Guidance on Hedge-to-Arrive Contracts issued by CFTC Division of Economic Analysis, *supra* note 46 at 5.

49. *Id.*

50. *Id.*

not incur obligations, but merely purchases unilateral rights to sell or buy a commodity.[51]

3. **Q:** What, then, is the effect of the CFTC's 'Statement of Guidance Regarding Certain Contracting Practices?'[52]

NGFA Analysis: First, the statement was issued by the CFTC Division of Economic Analysis. According to the CFTC release accompanying the statement, '[t]he Division has also explained its views on the application of the principles of prudent risk-reduction to the structure of HTA contracts by providing a Statement of Guidance.' The CFTC did *not* describe the statement as a legal interpretation of the Commodity Exchange Act's forward contract exclusion. Second, since the CFTC does not have regulatory jurisdiction over cash forward contracts excluded from coverage by the Commodity Exchange Act, the statement may simply reflect a conservative example of the types of contracts not within the CFTC's jurisdiction. The statement does not resolve the issue of whether a particular contracting strategy meets the forward contract exclusion. Indeed, the statutory criteria set forth in the Commodity Exchange Act are not based on whether a particular strategy is deemed prudent by the CFTC or a court.[53]

4. **Q:** What if my company (a grain buyer) wishes to enter into contracts with producers that are outside the parameters set forth in the CFTC's 'Statement of Guidance Regarding Certain Contracting Practices?'[54]

*NGFA Analysis***:** As is always the case, your contracts and contracting practices should be reviewed by competent legal counsel. In addition, as has been done in the past, the CFTC said in its May 15 announcement that 'with regard to particular factual situations, the staff will continue to provide guidance on a case-by-case basis as to the applicability of the forward contract exclusion or other exclusions or exemptions from the Commodity Exchange Act and (CFTC) rules, as appropriate.'[55]

5. **Q:** "There have been reports in the media and even statements by at least one state attorney general that some hedge-to-arrive contracts could be 'off-

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51. *Id.*
52. *Id.*
53. *Id.*
54. *Id.*
55. *Id.*

exchange' contracts and 'unenforceable.'"[56] What can be done to respond to individuals or firms who are now wondering about their contracts?[57]

NGFA Analysis: Hedge-to-arrive and other forward contracts have existed for years. The major difference this year is the significant price movements caused by weather, and supply and demand factors (due in part to the federal government's implementation of a 7.5% acreage reduction program for corn in 1995). The fact is that cash forward contracts fitting within the Commodity Exchange Act's forward contract exclusion are legitimate off-exchange transactions, provided they comply with general state and federal law.[58]

Contractual terms and practices on hybrid cash contracts can vary widely from one firm to another, where "work-out" plans for addressing problem situations are developed, plans need to be based on what may be the unique needs and abilities of both buyer and seller.[59]

As part of the process leading to the preparation of NGFA's white paper in early 1996, the NGFA met with various CFTC staff members regarding the CFTC's views on hybrid contracts. While the ultimate official interpretation of the Commodity Exchange Act is made by the courts and the CFTC commissioners,[60] the CFTC staff do influence the day-to-day actions taken by the CFTC. Therefore, their views are extremely important. Following are some points to consider:[61]

1. When analyzing whether a proposed or actual transaction involves a cash forward contract or a prohibited off-exchange transaction, the staff looks at the whole picture.[62] It is not just what is on paper, but also how the parties

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56. *Id.*

57. *See id.*

58. *Id.*

59. *Id.*

60. Two new commissioners, Chairperson Brooksley Born and Commissioner David Spears, joined the CFTC as the result of their confirmation by the Senate on August 2, 1996. The CFTC is now at its full level of five voting commissioners. David D. Spears Sworn in as CFTC Commissioner (September 4, 1996), *reprinted in* FDCH FED. DEP'T & AGENCY DOCUMENTS, September 4, 1996, *available in* LEXIS, News Library, Curnws File.

61. This analysis represents NGFA's interpretation of the views expressed by various CFTC staff members. Those CFTC staff members did not review or endorse NGFA's interpretation.

62. *Futures Trading Commission House Agriculture Risk Management and Specialty Crops Hedge-to-Arrive Contracts* (July 24, 1996) (testimony of John E. Tull Jr., acting chairman of the CFTC) *reprinted in* FDCH CONG. TESTIMONY, July 24, 1996 *available in* LEXIS, Legis Library, Cngtst File.

actually conduct business.[63] Does the final result have any relationship to the initial merchandising intent of the written contract?

2. CFTC legal professionals and economists are involved in analyzing particular fact situations. For example, the May 15, 1996, Statement of Guidance Regarding Certain Contracting Practices reflects the CFTC Division of Economic Analysis' hindsight view of whether given strategies were prudent as opposed to a legal analysis of the forward contract exclusion.

3. Walk-away features in cash forward contracts are likely to be viewed by CFTC staff as turning the contract into a prohibited off-exchange option.[64] Legitimate force majeure (Act of God) clauses are not considered a problem.

4. While a firm delivery obligation on a cash forward contract is necessary to avoid being classified as a prohibited off-exchange trade option or futures contract, delivery is *not* the only factor the CFTC staff considers important.

5. The CFTC staff has reservations about merchandising strategies that reference a futures month or year different from the actual delivery period set forth in the contract. Does the futures month or year referenced in the contract have a legitimate merchandising purpose? Are rollovers from one crop year to another for a purpose inconsistent with a legitimate cash forward contract?

6. The so-called rolling of the futures month on a bushel-for-bushel basis is not necessarily improper. The May 15, 1996 statement of guidance reflects the CFTC Division of Economic Analysis' strong views against rolling between crop years.[65]

7. Contracts that involve routine and repeated unpricing/repricing moves are not looked upon favorably. However, CFTC staff understands that uncontemplated situations might arise subsequent to contracting that result in further negotiation between a buyer and seller.

8. Contractual provisions requiring farmer-sellers to provide cash performance guarantees to protect a buyer's financial exposure on hybrid cash contracts do not seem to cause the CFTC staff a great deal of concern.

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63. *See id.*

64. *See* Roger McEowen, *Marketing Agricultural Commodities Through Use of Hedge-to-Arrive Contracts May Violate CFTC Rules,* AGRIC. L. UPDATE, May 1996, at 4, 4.

65. Division of Economic Analysis Issues Statements of Policy and Guidance Relating to "Hedge-to-Arrive" Contracts, *supra* note 44 the May letter at 8-10.

9. If the CFTC decides to lift the ban[66] on off-exchange agricultural trade options, the CFTC staff is likely to construe any conditions the CFTC sets for off-exchange trade options transactions as applying to a wide variety of hybrid contracts.

10. For the foreseeable future, it is unlikely that the CFTC will issue formal no-action letters approving[67] specific cash forward contracts and fact patterns. This appears due in part to the fact that no decision on whether to lift the ban on off-exchange agricultural trade options has yet been made. However, the CFTC staff has continued to issue the less authoritative guidance letters in response to specific requests as to proposed contracts.[68]

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66. In 1991, the CFTC proposed amending its trade option exemption rules to permit the off-exchange use of trade options on agricultural commodities to the same extent as on other commodities. The proposal, however, was never adopted by the Commission. Proposed Amendments Concerning Trade Options and Other Exempt Commodity Options, 56 Fed. Reg. 43,560 (1991).

67. The word "approval" is used here as indicating that the CFTC is being asked to certify that the proposed contract is a cash forward contract not subject to CFTC regulation. A cash forward contract not subject to CFTC regulation must still comply with other federal and state laws applicable to such contracts.

68. Such requests can be made by writing to: Division of Economic Analysis, U.S. Commodity Futures Trading Commission, Paul M. Architzel, Esq., Chief Counsel, 1155 21st St., N.W., Washington, DC 20581.

H. Legal Consequences of Offering Prohibited Off-Exchange Trade Options or Futures Contracts

In addition to the CFTC's broad injunctive and enforcement power, the CFTC may seek both civil and criminal penalties against individuals or firms violating the provisions of the Commodity Exchange Act. Of particular concern to most firms should be the power of the CFTC to seek civil penalties for any violation in the amount of not more than *the higher of* $100,000 or *triple the monetary gain to the person for each violation*.[69] Firms should realize that violations of the Commodity Exchange Act, even if unintentional, can subject them to possible civil liability under the Act. Indeed, in two of the recent pending administrative cases brought by the CFTC against cooperative grain elevators, the agency seeks civil penalties under 7 U.S.C. section 9 even though no allegations of fraud or misrepresentation are made by the agency against the grain elevators.[70]

Moreover, it is a general rule of contract law that agreements involving promises that are otherwise illegal or immoral are not enforceable.[71] A contract involving an off-exchange trade option or futures contract prohibited by the Commodity Exchange Act[72] runs the risk of being found wholly or partially unenforceable by state and federal courts.[73]

As the 1985 interpretative statement issued by the CFTC Office of General Counsel demonstrates, a cash forward contract does not become a prohibited off-exchange options or futures contract merely because it contains some options-like features.[74] Because an off-exchange cash forward contract contemplating actual delivery of grain ordinarily is a legal transaction, a contract might still be enforced if it is found in hindsight to contain only some impermissible provisions. However, even if the primary purpose of the contract is legally permissible, both parties risk substantial uncertainty as to the final result by leaving it to a court or arbitration committee to reform the contract.

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69. *See* 7 U.S.C.S. § 13a-1 (1996).

70. *See, e.g.,* In re Grain Land Co-op., No. 97-1 (CFTC Nov. 13, 1996) (on file with the DRAKE J. AGRIC. L.) (CFTC alleged that the cooperative violated the prohibition contained in 7 U.S.C. § 6(a) against offering off-exchange futures contracts); In re Wright, No. 97-2 (CFTC Nov. 13, 1996) (on file with the DRAKE J. of AGRIC. L.) (CFTC alleges that grain elevator involved in case violated Act and regulations by entering into illegal, off-exchange futures and options contracts).

71. *See* E. ALLEN FARNSWORTH, CONTRACTS, § 5.1 n.10 (2d ed. 1990) (citing Crichfield v. Bermudez Paving Co., 51 N.E. 552 (Ill. 1898)).

72. The Commodity Exchange Act, among other things, specifically restricts futures trading to CFTC-designated contract markets by or through members of such contract markets. The CFTC has the power to grant regulatory exemptions when it "determines that the exemption would be consistent with the public interest." 7 U.S.C. § 6(c)(1) (1994).

73. Obviously, an arbitration committee could reach the same conclusion. Many grain buyers incorporate contractual provisions providing for NGFA arbitration of disputes in their contracts with other commercial firms and producers.

74. Commodity Futures Trading Commission, 50 Fed. Reg. 39,656, 39,658, (1985) (citing Interpretive Statement of the Office of the General Counsel).

IV. THE FUTURE

While CFTC regulations permit off-exchange trade options on non-agricultural commodities, off-exchange trade options involving agricultural commodities remain subject to the regulatory ban contained in existing regulations. The National Grain and Feed Association (NGFA) on January 30, 1997, petitioned the CFTC to complete a rulemaking[75] started in 1991 that would permit trade options, and other options determined by the agency not to be contrary to the public interest, on agricultural commodities to the same extent as other commodities.[76] The NGFA asked the CFTC to adopt the amendments to 17 C.F.R. part 32 previously proposed by the agency.

Extending the current trade options exemption on non-agricultural commodities to agricultural commodities would, for example, authorize the following off-exchange transaction between a producer and a grain buyer:

> The contract establishes a minimum contract price determined when the contract is written, and a premium is collected, either at the initiation of the contract, during the life of the contract or, together with the interest accumulated over the life of the contract, at the time of settlement. In return for the premium, the producer has the right to require the merchant to accept delivery of and pay a minimum contract price for the crop. However, the producer may forfeit the premium and seek a higher price for, and deliver, the crop elsewhere.[77]

It also has been suggested that extending the trade options exemption to agricultural commodities would clarify that so-called revenue assurance contracts can be utilized by producers and grain buyers in the cash marketplace. The NGFA urged the Commission, if it agrees to lifting the current ban on agricultural trade options, to clarify that such revenue-based contracts would be permitted under the amended regulations.

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75. Commodity Futures Trading Commission, 56 Fed. Reg. 43560-65 (1991).

76. (Petition for Amendment of Commission Rules Concerning Trade Options to Permit Trade Options in Agricultural Commodities, National Grain and Feed Association)(filed Jan. 30, 1997)(proposed amendments to 17 C.F.R. part 32).

77. *See, e.g.,* Characteristics Distinguishing Cash and Forward Contracts and "Trade" Options, 50 Fed. Reg. 39,656, 39,660, (1985).

A. Proposed Exemption

The NGFA requested that the following amendments proposed by the Commission in 1991 be adopted (new material underlined; deleted material struck-through):

1. It is proposed that 17 C.F.R. section 32.1 be revised as follows:

§ 32.1 Scope of part 32; definitions.

* * * *

(b) *Definitions.* As used in this part:

(1) *Commodity option transaction* and *commodity option* each means any transaction or agreement in interstate commerce which is or is held out to be of the character of, or is commonly known to the trade as, an "option", "privilege", "indemnity", "bid", "offer", "put", "call", "advance guaranty", or "decline guaranty" involving any commodity regulated under the Act ~~other than wheat, cotton, rice, corn, oats, barley, rye, flaxseed, grain sorghums, mill feeds, butter, eggs, onions, Solanum tuberosum (Irish potatoes), wool, wool tops, fats and oils (including lard, tallow, cottonseed oil, peanut oil, soybean oil, and all other fats and oils), cottonseed meal, peanuts, soybeans, soybean meal, livestock, livestock products and frozen concentrated orange juice~~;

2. It is proposed that 17 C.F.R. section 32.2 be removed in its entirety and reserved. The amended and deleted provision is as follows:

§ 32.2 ~~Prohibited transactions.~~ [Removed and reserved]

~~No person may offer to enter into, enter into, confirm the execution of, or maintain a position in, any transaction in interstate commerce involving wheat, cotton, rice, corn, oats, barley, rye, flaxseed, grain sorghums, mill feeds, butter, eggs, onions, solanum tuberosum (Irish potatoes), wool, wool tops, fats and oils (including lard, tallow, cottonseed oil, peanut oil, soybean oil and all other fats and oils), cottonseed meal, livestock, livestock products and frozen concentrated orange juice if the transaction is or is held out to be of the character of, or is commonly known to the trade as, an "option", "privilege", "indemnity", "bid", "offer", "put", "call", "advance guarantee", or "decline guarantee".~~

3. It is proposed that 17 C.F.R. section 32.4 be revised as follows:

> § 32.4 Exemptions.
>
> (a) Except for the provisions of §§ ~~32.2,~~ 32.8 and 32.9, which shall in any event apply to all commodity option transactions, the provisions of this part shall not apply to a commodity option offered by a person which has a reasonable basis to believe that the option is offered to a producer, processor, or commercial user of, or a merchant handling, the commodity which is the subject of the commodity option transaction, or the products or by-products thereof, and that such producer, processor, commercial user or merchant is offered or enters into the commodity option transaction solely for purposes related to its business as such.
>
> (b) The Commission may, by order, upon written request or upon its own motion, exempt any other person, either unconditionally or on a temporary or other conditional basis, from any provisions of this part, other than §§ ~~32.2,~~ 32.8 and 32.9, if it finds, in its discretion, that it would not be contrary to the public interest to grant such exemption.

B. Rationale for CFTC To Act Now

Agriculture truly has entered a new era. With changes enacted in the 1996 farm act now being implemented, today's producers need flexibility and a wide range of alternatives to manage risk and market their production. The NGFA believes that today's producers are increasingly sophisticated with regard to using an array of marketing and risk management vehicles, ranging from crop insurance to cash grain contracts to exchange-traded futures and options. In this changed farm policy environment, producers need to seek a greater share of income from the marketplace while managing the risks arising from price volatility. Lifting the agricultural trade options ban would facilitate these goals. That necessity also has been recognized by various producer groups[78] that have supported lifting the agricultural trade options ban.

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78. Many producer representatives are supportive of lifting the ban on agricultural trade options. For example, National Corn Growers Association Chairman Rod Gangwish said that "[a]llowing agricultural trade options would be a natural fit under our free-market and risk-management policies, and it would run parallel with and complement crop insurance, revenue insurance and revenue assurance." CFTC Chairman's Roundtable on the Prohibition of Agricultural Trade Options *supra* note 42 at 19. In accord was the National Cattlemen's Association representative, John Ferguson, who stated that his association "favors the lifting of the prohibition of trade options on ag

Further, lifting the ban would put agriculture on equivalent footing with other commodities that have been exempt from such a ban for years -- currently, agriculture is the only industry subject to such a ban. The NGFA believes that a ban only on agriculture puts producers and other market participants at a disadvantage when seeking means to manage risk. U.S. agriculture has many competitive advantages, not the least of which is its highly efficient risk management system. While there is considerable creativity in the marketplace today, even with a trade options ban in place, unfettering agriculture from governmental restraints undoubtedly would enhance potential gains in marketing efficiency.

There is another element to the agricultural trade options debate that has surfaced recently. Crop insurance companies and the Federal Crop Insurance Commission have designed hybrid insurance products designed to protect producers against volatility in commodity prices and yields. Such vehicles essentially guarantee a certain level of revenue to the producer. These products generally are underwritten or reinsured by the U.S. government at substantial expense to the U.S. taxpayer.

Many cash grain market participants would like to offer products in the private marketplace with similar revenue assurance coverage at no cost to government. However, under current regulation, they are precluded from doing so by the agricultural trade options ban. The NGFA believes that, in the interest of fairness, the Commission should allow offerors of cash grain contracts to offer producers similar risk management strategies in the private marketplace. The issue of federal subsidization of revenue assurance instruments issued by crop insurance companies or agents competing against private, unsubsidized products is an issue that will need to be addressed but is beyond the scope of this discussion.

Some have argued that existing cash grain contracts or revenue assurance instruments that might be offered if the ban is lifted would compete against or serve as a substitute for exchange-traded instruments. The NGFA believes this is an incorrect and short-sighted objection to lifting the ban. Without a doubt, those offering hybrid cash grain contracts today, and potentially offering revenue assurance products if the ban is lifted, must hedge their own (sometimes substantially increased) risk. The NGFA believes that greater flexibility will increase the need for exchange-traded instruments, thereby increasing volume on commodity exchanges.

Further, the NGFA disagrees with those who would argue against lifting the ban for fear that agricultural producers lack the sophistication to deal with such instruments and need protection. Today's producers are increasingly sophisticated businessmen and women. In addition, this exemption, if granted, would do nothing to diminish the CFTC's ability to investigate and enforce its regulations in those rare cases where fraud or unlawful representations may occur. The Commission would retain its authority over those matters as set forth in 17 C.F.R. sections 32.8 and 32.9.

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commodities because this prohibition is inhibiting the development of new risk-management tools for the ag producer." *Id.* at 74-75.

Likewise, the Commission would retain authority to determine whether a particular transaction fits within the exemption.

In the entire area of risk management, the NGFA consistently has maintained that education of producers, grain elevators, market advisors, lenders, extension economists, and all market participants is a critically important element. The availability of more sophisticated risk management and marketing strategies will serve little useful purpose if such strategies are not well understood by all parties. NGFA will continue to provide education to the industry as new developments occur in this area.

The Commission has gathered extensive information and testimony on an agricultural trade options ban. In addition to the 1991 proposed rule, a Chairman's Roundtable on the Prohibition of Agricultural Trade Options was conducted by the Commission on December 19, 1995, during which extensive testimony was given. The NGFA is hopeful that, given the substantial record already compiled on lifting the ban, the proceeding can move ahead and be implemented quickly. Lifting the agricultural trade options ban would enhance the ability of the cash grain industry to offer producers additional pricing and risk management tools.

HEDGE-TO-ARRIVE CONTRACTS[79]

1. NGFA's Sample HEDGE-TO-ARRIVE PURCHASE CONTRACT.

2. NGFA's Sample "MINIMUM PRICE" PURCHASE CONTRACT.

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[79] (On file with the Drake J. Agric. L.)