AGRICULTURAL TRADE OPTIONS - WHAT AGRICULTURAL PRODUCERS NEED TO KNOW

Prepared by

Commodity Futures Trading Commission
Division of Economic Analysis

December 1998

AGRICULTURAL TRADE OPTIONS - WHAT AGRICULTURAL PRODUCERS NEED TO KNOW

About the CFTC

The Commodity Futures Trading Commission (CFTC) was created by Congress in 1974 as an independent agency with the mandate to regulate commodity futures and option markets in the United States. The agency protects market participants against manipulation, abusive trade practices and fraud. Through effective oversight and regulation, the CFTC enables the markets to serve better their important functions in the nation's economy--providing a mechanism for price discovery and a means of offsetting price risk.

About this Pamphlet

In June 1998, the Commodity Futures Trading Commission (CFTC or Commission) began a three-year pilot program to permit the purchase and sale of agricultural trade options. This pamphlet provides an overview of agricultural trade options and the rules for trading them. It is not intended to offer specific financial or legal advice. You may be able to obtain additional information from your agricultural extension agent and various agricultural associations. You may also wish to consult with your own financial or legal advisors before entering into an agricultural trade option. Agricultural trade options entail financial risk. You should understand that risk, how agricultural trade options operate and their potential uses before entering into an agricultural trade option.

A glossary defining technical terms is included at the end of this pamphlet. The terms defined in the glossary appear in **bold** type throughout the pamphlet.

Contents

Questions

Questions

What is an agricultural trade option?

An agricultural trade option is an agreement giving the producer the right to deliver his or her commodity in the future for a set price (the option's **strike price**). However, the producer is not obligated to deliver and may simply choose to "walk away" from the option contract. In return for this right, the producer pays a fee, usually called the option **premium**. Agricultural trade options are not traded on a commodity futures exchange. Rather, they are traded directly between commercial parties.

What is the CFTC pilot program for agricultural trade options?

After much study and consultation with agricultural interests, the Commission adopted rules to permit the offer and sale of agricultural trade options. Agricultural trade options may not be offered or sold in the United States on the commodities listed below except in compliance with these rules. The pilot program for agricultural trade options is a three-year trial period and is modeled after the earlier pilot program for the reintroduction of exchange-traded agricultural options. After the three years are over, the CFTC will consider whether the rules should be made permanent.

What commodities are covered by the pilot program rules?

The commodities are: wheat, cotton, rice, corn, oats, barley, rye, flaxseed, grain sorghums, mill feeds, butter, eggs, Irish potatoes, wool, wool tops, fats and oils, cottonseed meal, cottonseed, peanuts, soybeans, soybean meal, livestock, livestock products and frozen concentrated orange juice.

How can a producer use agricultural trade options?

A producer can purchase an agricultural trade option as a means of locking in a minimum price for his or her commodity, while maintaining the flexibility to sell the commodity at higher prices later on. Here's one example of how it could work. A producer purchases an agricultural trade option for fall delivery. The option specifies the price, the "**strike price**," that the producer will be paid if he chooses to deliver the commodity. He pays a fee to the option seller for the option. If spot prices are below the option contract's **strike price** when the farmer goes to deliver the commodity, he or she gets the highest price agreed upon in the option contract. If at the time of delivery spot prices are higher than the option's strike price, he or she lets the option **expire** and is free to deliver the commodity to any buyer at the higher spot price.

In either case, if the producer has a shortfall in yield, he or she can simply walk away from the option for the amount of the shortfall, letting that portion of the option **expire**.

What does an agricultural trade option cost?

The cost of an option is the **premium**. Generally, the buyer of the option pays this up front. The **premium** must be paid whether you, the producer, deliver under the option contract or let the option **expire**. By knowing the cost of the **premium** and any sales commissions or other fees, you can determine the total cost of the option to you. If, at a later date, you decide to amend the option contract, for example by **rolling** forward the delivery date, it is likely that additional **premium**(s) and fees will be charged. CFTC rules require that these charges be disclosed to you.

What are the risks of agricultural trade options?

In general, the risk of loss to the producer is limited to the cost of the option (the **premium** plus any commission or other fees that you paid). As with any contract, there is the risk that one of the parties will default. If the option seller defaults on the option contract when you try to **exercise** the option, you would be forced to find a different buyer and sell the commodity at the prevailing, lower spot price. This might result in a loss of the profit you expected to make by delivering your commodity at the more favorable **strike price** , in addition to the cost of the option (the **premium** plus any commissions or other fees that you paid).

Several of the pilot program rules offer some protection against defaults by agricultural trade option merchants (ATOMs). These include a requirement that to be registered, ATOMs have and maintain

$50,000 in net worth. In addition, the ATOM is required to hold its customers' money separate from its own operating funds, except if used by the ATOM to obtain an exchange-traded contract to cover the risk of the agricultural trade option.

Does an agricultural trade option require the producer to deliver commodity?

Unlike a traditional forward contract, an agricultural trade option gives the producer the right to make delivery if he or she chooses, but does not obligate him or her to deliver. If the producer can get a better price for the commodity on the spot market, does not have the commodity to deliver, or simply does not wish to market his or her commodity at the time, the producer can simply let the option contract **expire**. However, if the producer wants to get the price stated in the option contract, he or she must deliver the commodity to do so.

Can the producer terminate the option contract other than by exercising it (or allowing it to expire unexercised)?

Unlike an exchange-traded option, agricultural trade options cannot be terminated before expiration through offset. Although the producer cannot terminate an agricultural trade option, the option can be amended by substituting a forward contract for the option. By doing this, the producer is converting his or her option to deliver into a binding obligation to deliver. The price of the commodity at which the producer is now obligated to deliver can be adjusted to include any remaining value on the option which is being amended. You, the producer, and the option seller, may also agree to amend an option contract by **rolling** it forward to a later **expiration date**. If an option is amended, it should continue to reflect your production expectations or the cost of storing the commodity. When you **roll** the option forward, you will likely have to pay an additional **premium**. However, any remaining value on the old option can be credited against this amount. These are the only two ways permitted to terminate an agricultural trade option other than by **exercising** it by delivering the commodity. Agricultural trade options may not be offset or cash-settled with the ATOM, nor may they be transferred or resold to another producer as a means of early termination.

How do I purchase an agricultural trade option?

Only an ATOM who is registered with the CFTC can legally offer to sell you an agricultural trade option. Generally, an ATOM firm will be a grain elevator or other first-handler. The individual selling you the agricultural trade option must also be registered as the associated person (AP) of an ATOM. You can check on the registration status of an ATOM or its APs by calling the National Futures Association Information Center at (312) 781-1410 (or toll free (800) 621-3570; if within Illinois, (800) 572-9400).

Are agricultural trade options traded on an exchange?

No. An agricultural trade option, like a forward contract, is simply a contract between you and the party

who sold you the option. As with a forward contract, the party selling you the option may use exchange-traded futures or option contracts to hedge and to price the agricultural trade option. Ultimately, however, the terms and conditions of the contract are determined in negotiations between you and the ATOM and are not governed by the rules of a commodity exchange.

Are ATOMS required to meet minimum standards in order to become registered with the CFTC?

Yes. In order to become registered, ATOMS are required to maintain a net worth of $50,000, and the ATOM's owners and its sales agents must not have been convicted of a felony or have committed a similar type of violation. In addition, the ATOM's owners and sales agents must be trained in the use of these instruments and the rules governing their offer.

What requirements apply to the agricultural trade option contract?

All agricultural trade option contracts are required to be in writing. If you decide to buy an agricultural trade option, the ATOM must give you a signed copy of the option contract. The option contract must state the amount and grade of the commodity, where delivery would be made, the option's **strike price**, and a breakdown of the purchase price. The option contract should also include instructions telling you how to **exercise** the option. This includes the latest date by which you must notify the ATOM that you wish to **exercise** the option. In addition, the ATOM is required to notify you in writing during the month before the option's **expiration date** that the option is due to expire.

Will I be given any other information?

Yes. The CFTC requires that the ATOM disclose to you information about the general risks of agricultural trade options and information about the specific option contract, including its terms and cost, before you enter into that contract.

You should read and understand these disclosures before purchasing an agricultural trade option.

As a producer, are there limitations on the types of agricultural trade options I can enter into?

You may only purchase an option. You may not **sell** ("**short**," "**write**," or "**grant**") an agricultural trade option, unless the short option is in combination with a purchased trade option on the same commodity. Some people refer to this combination option as a "fence," "window," or "spread" option. The amount of the option that you sell cannot be more than the amount that you buy.

Are there any size limitations restricting the amount of options I can enter into?

The CFTC's rules require that agricultural trade options be entered into for purposes related to the purchaser's business. Thus, generally, you should not purchase options covering more than the amount of

commodity you expect to produce or have in storage.

What happens if I have a dispute with the ATOM?

If you believe that your ATOM has violated CFTC rules and thereby caused you to suffer a loss on your agricultural trade option, and you are unable to resolve the dispute with the ATOM, you may file a reparations claim with the CFTC. For more information on the CFTC's reparations program, call the CFTC's Office of Proceedings at (202) 418-5250 or contact the CFTC's website at http://www.cftc.gov/proc/reparations.html. In addition, the agricultural trade option contract itself may provide for arbitration or for other forms of dispute resolution. You may also be able to bring your dispute to court.

Where can I obtain information on whether someone is registered as an ATOM or as a sales agent for an ATOM?

Call the National Futures Association Information Center at (312) 718-1410 (or toll free (800) 621-3570; if within Illinois, (800) 572-9400).

Where can I obtain more information about using options to hedge?

Information may be available from the United States Department of Agriculture, your local extension service, state land-grant universities, your state department of agriculture, and various agricultural associations.

Where can I obtain more information about the CFTC's rules on agricultural trade options?

Additional information on the CFTC's pilot program for agricultural trade options can be obtained by contacting the CFTC's Division of Economic Analysis at (202) 418-5260.

Glossary of Terms [(1)]

Exercise - The act of electing to sell or purchase a commodity at the strike price stated in an option contract. For agricultural trade options, the **exercise** of an option must result in the delivery of the commodity.

Expiration Date - The date on which an option contract automatically expires; the last day an option can be exercised.

Premium - The price paid for an option. The total cost of the option will equal the **premium** plus sales

fees, commissions, and similar charges.

Roll, Rolling - The process of moving forward the delivery date of an option contract. Rolling typically results in an adjustment to the ultimate price received for the commodity to reflect the adjustment of the delivery period.

Sell, Short, Write, or Grant - Terms used to indicate the sale of an option. The seller, writer, or grantor of an option is required to purchase (in the case of put options) or sell (in the case of call options) the commodity at the agreed-upon strike price if the option is exercised. In return for selling the option, the seller receives the option premium.

Strike Price - The price specified in an option contract at which the buyer of the option has the right, but not the obligation, to sell or purchase a commodity.

1 Because the definitions of the terms included in this glossary are not readily available in standard references, this glossary is intended to assist readers in understanding the specialized words that are used in this pamphlet. It does not contain all of the specialized terms that may be used in connection with agricultural trade options. Nor is it intended to state or suggest the views of the Commission concerning the legal significance or meaning of any word or term.