Hybrid Cash Grain Contracts
Assessing, Managing and Controlling Risk

A White Paper
by the
Risk Evaluation Task Force on Hybrid Cash Contracts

National Grain and Feed Association

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National Grain and Feed Association
1201 New York Ave., N.W., Suite 830, Washington, D.C., 20005-3917

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Editor: Todd E. Kemp
Director of Legislative Affairs
National Grain and Feed Association

Desktop Publishing, Layout, Design: Alison J. Bawek
Publications/Graphic Design Specialist
National Grain and Feed Association

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Contributing Authors

Tom Coyle, Vice President, Continental Grain Company, Chicago, Ill.
Frank Beurskens, President, Frank Beurskens Consulting, Inc., Bloomington, Ill.
John Sen Chu, Director, Financial Risk Strategy, KPMG Peat Marwick LLP, New York, N.Y.
Rod Gangwish, Chairman, National Corn Growers Association, Shelton, Neb.
Tim Regan, Vice President/Treasurer, The Scoular Company, Omaha, Neb.
Martha Carpenter Smith, Senior Vice President, Boatmen's First National Bank, Kansas City, Mo.
David C. Barrett, Counsel for Public Affairs, National Grain and Feed Association, Washington, D.C.

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Risk Evaluation Task Force:

Tom Coyle, *Chair*, Vice President, Continental Grain Company, Chicago, Ill.
Frank Beurskens, President, Frank Beurskens Consulting, Inc., Bloomington, Ill.
John Sen Chu, Director, Financial Risk Strategy, KPMG Peat Marwick LLP, New York, N.Y.
Rod Gangwish, Chairman, National Corn Growers Association, Shelton, Neb.
Tim Regan, Vice President/Treasurer, The Scoular Company, Omaha, Neb.
Martha Carpenter Smith, Senior Vice President, Boatmen's First National Bank, Kansas City, Mo.

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Education Task Force:

Diana Klemme *Chair*, Vice President, Grain Service Corporation, Atlanta, Ga.
Terry Beard, Manager, Koch Agri Services, Imperial, Neb.
JoAnn Brouillette, Vice President, Demeter, Inc., Fowler, Ind.
Les Busboom, General Manager, United Feeds, Inc., Royal, Ill.
Joe Christopher, Broker/Analyst, LFG LLC, Kansas City, Mo.
Robert Gast, President, R.J. Gast & Associates, St. Paul, Minn.
Larry Hammond, General Manager, Auglaize Farmers Co-op, Inc., Wapakoneta, Ohio
Neill McKinstray, Marketing and Sales Manager-Grain, The Andersons, Maumee, Ohio
Greg Noble, Assistant Vice President, Marketing/Origination Services, Countrymark Cooperative, Inc., Indianapolis, Ind.
David Reiff, President, Reiff Grain and Feed, Inc., Fairfield, Iowa

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Purpose of White Paper

In the last several years, hybrid cash contracts -- such as hedge-to-arrive, minimum price, and so-called "flex" contracts -- have come into wider use. This has been driven by market forces as companies seek to increase the basket of services they offer customers. Further, changes in government support programs will increase the importance of managing price risk and, in the process, expand the development of flexible risk-management tools.

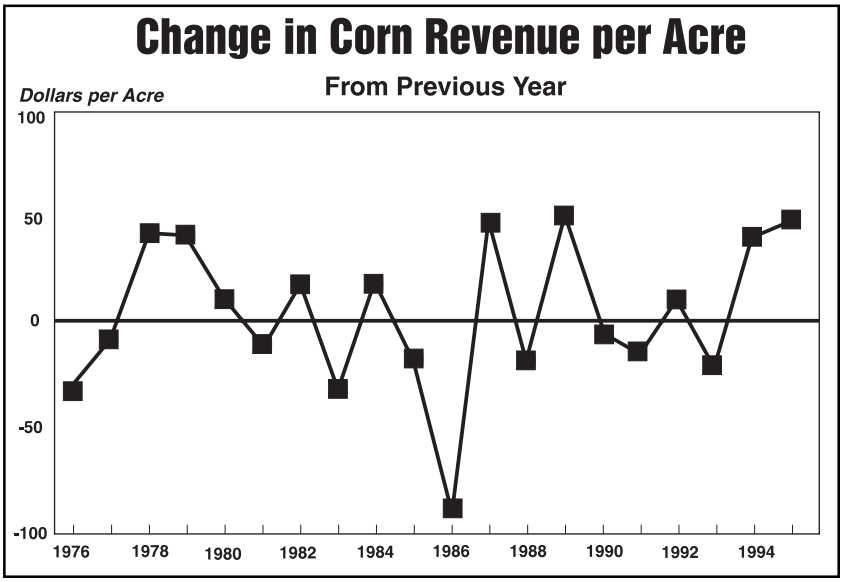
Price escalation in 1995 created genuine concern about the appropriateness, level of understanding and ability of the industry to manage the risk of the wide range of cash contracts being utilized. To address these concerns, the National Grain and Feed Association (NGFA) initiated a multi-discipline task force to develop a white paper on the topic of hybrid cash contracts. The goal was to create a document that would provide an overview of the situation, identify the key issues, and establish recommendations to help the industry effectively address and manage the potential growth of these contracts.

Disclaimer

This white paper has been reviewed carefully by numerous individuals. However, because of the complexity of the subject matter and the wide variety of contracts that are being or could be utilized, there can be no assurance that this white paper covers all situations or presents complete information. The NGFA and authors of this white paper make no warranties, express or implied, concerning the use of the information contained in this document. The NGFA disclaims any responsibility whatsoever for the use of the information contained in this white paper. Readers should consult competent legal, accounting and financial professionals to evaluate and advise them as to their particular rights and obligations with respect to the issues discussed herein.

Situation Overview

Although hybrid cash contracts currently represent a relatively small percentage of overall contracting volume today, the use of these flexible cash contracts and their inclusion in more complex marketing strategies has increased significantly over the past five years. These contracts generally are intended to allow the customer more pricing flexibility and to better focus on the *futures* portion of the cash price. The increased use of these contracts largely has been driven by the commercial trade (elevators/merchants) offering a wider range of cash contracts. The industry has offered these new contracts to respond to a perceived interest from the farm community.



Farmers have demonstrated their interest through increased use of market information services, market advisory services, attendance at marketing meetings, and participation in marketing clubs. All of these activities are intended to enhance the effectiveness of marketing and pricing decisions. In addition to the perception that customers want greater access to a broader range of marketing tools, historical price volatility (see chart) demonstrates the need for contracts and strategies that can maximize pricing decisions within a crop year and stabilize revenue-per-acre over time.

The change in farm support programs in the Freedom to Farm-inspired 1996 farm bill and continuing expansion in global trade suggest increased risk and a greater need for these contracts. At the same time, the yield contract offered by the Chicago Board of Trade, as well as Crop Revenue Coverage and Income Protection pilot programs recently approved by the Federal Crop Insurance Corp., provide additional tools to serve this potential demand. Increased demand and new vehicles suggest that the nature of risk management is changing and that a continuing trend toward more creative cash contracts probably will continue. However, many companies are reviewing their strategy for offering hybrid cash contracts in light of the sharp price movements during the 1995 crop year.

While a long-term demand for creative risk management solutions may exist, the expanded use of hybrid cash contracts has created concern at many levels in the industry. At the forefront are farm customers who have utilized forward cash instruments in the form of hedge-to-arrive contracts or various forms of minimum price or maximum-price contracts. These contracts, like any forward cash sale contract, have been negatively affected by record price escalation during the 1995/96 marketing year. On the other side are grain elevators or merchants struggling to secure bank financing to service margins on hedge accounts for much larger forward contracting programs.

At the same time, companies are struggling to develop effective systems to administer hybrid cash contracts and to manage risk. Elevator operators are increasingly asking: "Do we have the credit lines, the systems, and the margin or fees to justify continuing or expanding the offering of hybrid cash contracts?" In the middle is the regulatory community, concerned about the *futures-like or options-like features* of hybrid cash contracts.

The critical issues concerning hybrid cash contracts are as follows:

1. Contract clarity: Do buyer and seller clearly understand the terms and conditions?

2. Risk disclosure: Does the customer understand when the futures pricing risk is transferred to the buyer/seller and which risks are retained by the customer (futures, spread, volatility)?

3. Risk assessment and management: Is the elevator operator or merchant equipped to identify and manage all contract risks?

4. Regulatory: At what point does a forward cash contract with "futures-like features" become more like a futures contract and less like a forward cash contract?

This document identifies the types of contracts being offered in the trade today, discusses the key issues of concern, and provides suggestions on how to address the growth of hybrid cash contract usage. To accomplish this goal, a wide range of contracts was reviewed and categorized by feature to allow for comparison of risk profiles and critical issues. In addition, an elevator survey and a farmer survey were conducted to establish current contracting practices.

The **elevator survey** demonstrated a very strong response rate, with approximately 45 percent of the 800 companies surveyed responding. The highlights of the elevator survey are as follows:

1. Of those facilities responding:

   - ➢ 45 percent offer hedge-to-arrive contracts, but only 6 percent of grain is purchased in this manner.

   - ➢ 76 percent offer minimum price contracts, but such contracts represent only 5 percent of purchase volume.

   - ➢ Only 20 percent are requiring margins on selected cash contracts.

   - ➢ 78 percent state that they offer hybrid cash contracts only to selected customers.

2. When asked if offsetting or cancelling contracts is permitted:

   ➢ Yes = 3 percent

   ➢ Sometimes = 40 percent

   ➢ Never = 57 percent

3. A ranking of "the driving force behind your growth in hybrid cash contracts" concluded that growth was driven primarily by:

   ➢ producer requests and farm advisers; and

   ➢ competitive businesses.

4. When asked about their experience with hybrid cash contracts:

   ➢ Positive = 35 percent
   ➢ Negative = 13 percent
   ➢ Mixed/Don't Know = 51 percent

The **farmer survey** received a lower response rate, but a few conclusions can be derived from those received:

1. Of farmers responding, 60 percent are aware of most of the hybrid cash contract types identified in the survey. But only 20 percent used any of the contracts.

2. Of farmers responding, 80 percent identified an interest in participating in seminars on the topic of hybrid cash contracts.

3. When asked what they liked most about hybrid cash contracts, the overwhelming response was "flexibility."

4. When asked what they disliked, the general theme was confusion or uncertainty about the contracts.

Contract Classification and Examples

Numerous contracts are offered in the market today, ranging from very traditional cash contracts with well known obligations to more sophisticated contract forms intended to increase flexibility for the user. These new contracts, generally referred to as "hybrid cash contracts," take many forms. But they share a common purpose -- to change the timing of the pricing decision and risk transfer between the buyer and seller of cash grain.

In this section, various contracts are classified by "type," with a brief description and supporting example. It is important to note that many variations of these contracts exist, and names vary by market and geographic area. Users are advised to compare contracts by their pricing features rather than by contract name. Contract types are compared in a matrix at the end of this section.

In this document, the various contracts are classified in four broad categories:

I. Traditional Cash Contracts:

- A. Fixed Price Contract
- B. Basis Contract
- C. Deferred Price Contract

II. "Futures Based" Hybrid Cash Contracts:

- A. Basic Hedge-to-Arrive (HTA) Contract
- B. HTA Contract (with rolling of futures month permitted)
- C. HTA Contract (allowing user to hedge in futures month other than intended shipment period)
- D. HTA Contract (allowing customer to price/unprice)
- E. HTA Contract (with walkaway provision)

III. "Options Based" Hybrid Cash Contracts:

- A. Minimum Price Contract (for sellers)
- B. Maximum Price Contract (for buyers)
- C. Minimum/Maximum Contracts
- D. Ratio Minimum/Maximum Contracts
- E. Maximum Price Contract (for sellers)

IV. Derivative Contracts:

- A. Grain Swap Contract
- B. Revenue Contracts

Situation for All Contract Examples:

Market Values	April 1	July 1	Aug. 1	Sept. 1	Oct. 1	Nov. 1A	Nov. 1B	Jan. 1A	Jan. 1B
CBOT July Futures	$2.80	$2.90		--	--	--	--	--	--
CBOT Sept. Futures	$2.70	$2.60		$2.65	$2.65	--	--	--	--
CBOT Dec. Futures	$2.50	$2.50	$3.00	$2.45	$2.55	$2.25	$3.00	--	--
CBOT March Futures	$2.55	$2.60		$2.60	$2.60	$2.30	$2.95	$2.10	$3.00
Basis Nov. Delivery	-.20	-.20		-.20	-.20	-.25	-.25	--	--
Nov. Cash Bid	$2.30	$2.30		$2.25	$2.35	$2.00	$2.75	--	--
Basis Jan. Delivery	--	--		--	--	-.25	-.25	-.20	-.20
Jan. Cash Bid						$2.05	$2.70	$1.90	$2.80
$2.50 Dec. Call	$ .15	$ .12	$ .52	$ .07	$ .10	$ .00	$ .50	--	--
$2.50 Dec. Put	$ .15	$ .12	--	$ .12	$ .05	$ .25	$ .00	--	--
$3.00 Dec. Call	$ .05	$ .025	$ .22	$ .005	$ .005	$ .00	$ .06	--	--

The information and examples contained in this section are for educational and informational purposes only. The information has been obtained from qualified sources and is believed to be correct.

Futures and options trading is governed by federal law, the rules and regulations of regulated commodity exchanges and the CFTC, and judicial interpretations. Whether a particular marketing strategy should be used depends upon many factors involving risk evaluation for both buyer and seller, as well as other legal and business considerations.

I. Traditional Cash Contracts

These contracts generally provide no flexibility on shipment period and require only one "futures" pricing decision for the seller.

Contract types include:

A. Fixed Price Contract...also known as "Flat Price."
B. Basis Contract...also known as "Fix Price Later" or "FPL."
C. Deferred Price Contract... also known as "No Price Established" or "NPE."

A. Fixed Price: This type of contract transfers all price risk and opportunity from the seller to the buyer on the date of the trade.

Example: On July 1, a farmer sells for November delivery and establishes a flat price of $2.30.

Calculation	Jul 1	Nov 1 Scenario A	Nov 1 Scenario B
CBOT Dec Futures	$2.50	$2.25	$3.00
Basis level	-.20	-.25	-.25
Cash Price	$2.30	$2.00	$2.75

The farmer sold at $.30 better than if waiting until harvest to sell in scenario A, but $.45 worse than in scenario B.

Risk to the seller: None; all price risk ended on the date of the sale.

Risk to the buyer: At the time of the purchase, the buyer accepted two price risks; the CBOT futures level and the basis.

B. Basis Contract: This type of contract transfers the basis risk and opportunity from the seller to the buyer on the date of the contract.

Example: On July 1, a farmer sells a specified quantity for November delivery at -.20 Dec. The farmer (seller) retains the "futures" risk until the final flat price is established on or before November 1.

Calculation:	Jul 1	Nov 1 Scenario A	Nov 1 Scenario B
CBOT Dec Futures	NA	$2.25	$3.00
Basis level (fixed)	-.20	-.20	-.20
Cash Price	NA	$2.05	$2.80

The farmer's decision to "lock-in" the basis for November delivery in July improved the price by $.05 (-.20 Dec compared to -.25 Dec if farmer waited until November to price).

B. Basis Contract Cont'd:

Risk to the seller: The farmer has eliminated the "basis" part of the price risk, but retained the CBOT futures risk.

Risk to the buyer: The buyer (elevator/consumer/merchant) accepted the "basis risk" at the time of the contract.

C. Deferred Price: This contract provides the seller the opportunity to deliver and transfer ownership of cash bushels, but without setting a sales price. The buyer generally charges an up front or a monthly fee. The farmer retains the basis and futures price risk and opportunity in this contract until the contract is priced.

Example: On November 1, a farmer delivers a truckload of corn to the local elevator and enters into a deferred price contract. On January 1, the farmer prices the contract at the current elevator bid, less the DP (Delayed Price) charge. A $.10 per bushel DP charge is assumed for November 1 through January 1.

Calculation:

	Nov 1	Jan 1 Scenario A	Jan 1 Scenario B
CBOT Mch Futures	NA	$2.10	$3.00
Basis level	NA	-.20	-.20
DP Charge	NA	-.10	-.10
Cash Price	$2.30	$1.80	$2.70

The November cash price is important only for comparison. Delaying the pricing decision cost the seller $.50 in scenario A, but improved the price by $.40 in scenario B.

Risk to the seller: The seller retained the risk of futures *and* basis until the pricing date.

Risk to the buyer: If the buyer maintains ownership, there is no risk. However, if the buyer (elevator) chooses to sell these "unpriced" bushels to a third party, then the elevator takes on at least a basis risk and potentially a futures and a spread risk.

Example: Risk and hedging requirements for an elevator that *sells DP bushels before farmer prices* cash contract.

Calculation:

	Cash		Futures Hedge		Elevator
	Nov 1 Scenario A	Jan 1 Scenario B	Nov 1 Scenario A	Jan 1 Scenario B	Gain/Loss
CBOT Dec Futures	$2.25	--	--	--	--
CBOT Mch Futures	$2.30	$3.00	$2.30 Bot	($3.00) Sold	$.70 Futures
Basis level	-.25 Dec/-.30 Mch	-.20 Mch	--	--	($.10) Basis
DP Charge	--	-.10	--	--	$.10 DP Charge
Cash Price	($2.00) Sold	$2.70 Bot	--	--	($.70) Cash
				Net Elevator Gain (Loss) =	$ .00

By selling the bushels before the farmer price was established, the elevator took a basis and a futures risk. In this example, the elevator broke even on the transaction. The basis loss of $.10 was offset by the DP charge of $.10. The loss on the cash sale was offset by the gain in the futures.

II. "Futures Based" Hybrid Cash Contracts

These contracts have evolved from the hedge-to-arrive (HTA) contract also known as a "futures first" or "futures only" contract. In their simplest forms, these contracts are the opposite of a basis contract, 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.

Contract types include:

A. Basic Hedge-to-Arrive (HTA) Contract
B. HTA Contract (with rolling of futures month permitted)
C. HTA Contract (allowing user to hedge in futures month other than intended shipment period)
D. HTA Contract (allowing customer to price/unprice)
E. HTA Contract (with walkaway provision)

A. Basic Hedge-to-Arrive Contract: This type of HTA contract transfers the "futures" risk and opportunity from the seller (farmer) to the buyer (elevator/consumer/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 Dec. The farmer maintains the basis risk until a later date, usually no later than the date of shipment.

Calculation:	Jul 1	Nov 1	Nov 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 farmer's 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 vs. $2.50 futures.

B. HTA Contract: This type of HTA contract permits rolling of the futures month and/or the shipment period.

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 futures at the prevailing spread of $.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 establishes the final price by setting the basis.

Calculation:	Seller HTA	Buyer's Hedge CBOT Dec	CBOT Mch
Jul 1 HTA (Dec Futures)	$2.50	($2.50) Sold	
Sep 1 Roll HTA to Mch	+.15	$2.45 Bot	($2.60) Sold
Sep 1 HTA (Mch 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:	Jul 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: This type of HTA contract allows the user to hedge in a futures month other than the intended cash delivery period.

The primary difference between this type of HTA and examples 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 speculate on the direction of spreads. The amount of risk is directly correlated to the time spread between the intended shipment period and the futures month chosen for the HTA.

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

C. HTA Contract Cont'd:

Example 1: HTA in futures month other than the intended shipment 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 CBOT Sep futures. The buyer (elevator/merchant) hedges this cash purchase by selling Sep futures. On September 1, the seller (farmer) requests to roll the HTA to Dec futures, and on November 1 the seller requests to establish the cash basis to complete the pricing of this contract.

Calculation:

	Seller	Buyer's Hedge		
	HTA	CBOT Sep	CBOT Dec	
Jul 1 HTA (Sep Futures)	$2.60	($2.60) Sold		
Sep 1 Roll HTA to Dec	-.20	$2.65 Bot	($2.45) Sold	
Sep 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 Sep) compared with Seller's HTA of $2.40.

Comparison:

	Jul 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 Dec futures at $2.50, but the loss of $.10 on the Sep/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 shipment period.

The next example expands the risk.

Example 2: HTA in futures month that is not only different than the intended shipment 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 Jul futures. The buyer (elevator/merchant) hedges this purchase by selling an equal amount of Jul futures. On or before July 1, the seller (farmer) will be required to roll the HTA out of Jul futures forward to either Sep or Dec futures. If the farmer chooses to roll the HTA from Jul to Sep futures at that time, the farmer will be required to roll again from Sep futures to Dec futures on or before September 1. The final price will be established when the basis is priced -- in this case the basis on November 1.

Calculation:

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

C. HTA Contract Cont'd:

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

Calculation:	Seller	Buyer's Hedge				
	HTA	CBOT July		CBOT Sep		CBOT Dec
Apr 1 HTA (July 96 Futures)	$2.80	($2.80) Sold		--		--
Jul 1 Roll HTA to Sept	-.30	$2.90 Bot		($2.60) Sold		--
Jul 1 HTA (Sept Futures)	$2.50					
Sep 1 Roll HTA to Dec	-.20	--		$2.65 Bot		($2.45) Sold
Sep 1 HTA (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 Dec futures at $2.50. But the loss incurred in the Jul/Dec spread (or the Jul/Sep and Sep/Dec spreads) reduced the HTA to either $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 spread fluctuations.

Example 3: 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 shipment period in the appropriate crop year. **Using this market strategy requires a thorough understanding by both the buyer and the seller of how futures spreads function.**

Risk to the seller: The seller is accepting a "futures spread risk" each time the futures month of the HTA does not correspond to the intended shipment 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.

Risk 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 both buyer and seller, particularly with multi-year contracts. Improper use of the "rolling" features of a HTA contract can reduce the final contract price below the cost of production and in the process increase contract defaults.

D. HTA Contract: This type of HTA contract allows 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 Sep 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 Sep.

Calculation:

	Seller HTA	Buyer's Hedge CBOT Sep
Apr 1 HTA (Sept Futures)	$2.70	($2.70) Sold
Jul 1 HTA (unprice)	($2.60)	$2.60 Bot
Gain on HTA	$ .10	($ .10) Gain
Sep 1 "reprice" HTA	$2.65	($2.65) Sold
Sep 1 HTA (Sep Futures)	$2.75 Cash Bot	($2.75) Net Futures Sold
Sep 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.

Risk 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.

Risk 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 the legality of the transaction. Permitting the seller to repeatedly price/unprice a HTA may undermine the integrity of the "forward cash contract" status of the HTA, potentially rendering the pricing activity as "off-exchange" futures and violating Commodity Futures Trading Commission (CFTC) regulations.

E. HTA Contracts with walkaway provisions: The term "walkaway" 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.

Some of the contracts reviewed in this study either expressly stated or implied that "walkaway" was permitted. This feature raises serious regulatory concern. Is the contract a legitimate forward cash contract or a futures contract masked in the form of a cash contract? A regulatory review is strongly recommended prior to offering contracts with this feature.

III. "Options-Based" Hybrid Cash Contracts

The use of "options" has expanded the horizon for cash contracts for farmers and consumers.

A range of products has been designed to protect the farmer from an adverse drop in price levels while providing the opportunity to benefit from a portion of an upward movement in prices. Similarly, products have been developed to protect the consumer from an increase in price levels, while leaving the potential to benefit from a drop in prices. These products in their basic form represent a cost in the form of a "put" or "call" that reduce risk. Risk is added to the equation when users leverage their position by writing options to eliminate the costs or to generate "trading" revenue, or when CBOT options months do not correspond to the cash risk. As in the HTA contracts, there are numerous variations.

Contract types include:

A. Minimum Price (price floor) Contract for Sellers (farmers)
B. Maximum Price (price cap) Contract for Buyers (consumers)
C. Minimum/Maximum (price collar or window) Contracts for Farmers or Consumers
D. Ratio Minimum/Maximum Contracts
E. Maximum Price Contract for Sellers

A. Minimum Price Contract for Sellers: This contract is intended to provide the seller (farmer) protection against a drop in prices, but leaves the final pricing until a later date. The farmer establishes a minimum cash price or a minimum "HTA" (futures only) price by paying the cost of an option plus a service fee. The buyer generally adjusts the cash basis level or the HTA (futures level) to reflect the cost of the option and fees.

Example: On April 1, a farmer enters into a minimum price contract for a specified quantity of corn for November delivery. The minimum price is established at $2.15 per bushel after deducting the cash basis and applicable fees. The final price will be set at a later date as requested by the farmer, but not later than the first day of the shipment period or expiration of the applicable option contract, whichever occurs first -- in this case, November 1. The final price will be the minimum price of this contract plus the value of a CBOT $2.60 call on the date of pricing.

Calculation:

	April 1 Minimum Price	April 1 Minimum "HTA"
Apr 1 CBOT Dec	$2.50	$2.50
Cash Basis	-.20	NA
Apr 1 Cash Bid	$2.30	NA
Apr CBOT $2.60 Option	-.15	-.15
Minimum Price or HTA	$2.15	$2.35

The only difference between a "Minimum Price" and a "Minimum HTA" is the cash basis. The "minimum price" locks in the minimum cash price that the seller will receive. The "minimum HTA" only locks in the minimum futures level.

A. Minimum Price Contract for Sellers Cont'd:

Hedging of Minimum Price Contracts:

Buyers currently use two strategies to hedge the futures risk of these contracts. One strategy utilizes CBOT "puts;" the other utilizes selling CBOT futures and buying calls. Both strategies provide an equal hedge for the buyer and provide the same results for the seller (farmer).

Calculation:

	Minimum Price		Hedge Using Puts		Hedge Using Futures & Calls	
CBOT Dec	$2.50		Dec	Dec	Dec	Dec
Option cost	-.15		Futures		$2.50 Puts Futures	$2.50 Calls
			N/A	BUY	SELL	BUY
Min HTA	$2.35			@ .15	@ $2.50	@ .15
Cash basis	- .20					
Min-Price		$2.15				

In both cases, the cash buyer has hedged the guaranteed futures price (HTA) of $2.35.

Final Price Determination:

The minimum price, including the basis, was established on the contract date of April 1. The final cash price will be determined by adding the remaining value on the pricing date of the CBOT $2.50 Dec call option specified in the minimum price contract.

Example: On November 1, the farmer (seller) requests final pricing of the minimum price contract established on April 1.

Calculation:

	Scenario A	Scenario B
CBOT Dec futures on Nov 1	$2.25	$3.00
Apr 1 Minimum Price	$2.15	$2.15
Nov 1 Value of $2.50 Dec call	$ .00	$ .50
Final Cash Price	$2.15	$2.65

Hedge Analysis:

	Scenario A Market drops $ .25		Scenario B Market rallies $ .50	
	Put Strategy	Call Strategy	Put Strategy	Call Strategy
Apr 1:				
Dec Futures	—	($2.50) Sold	—	($2.50) Sold
$2.50 Puts	+$ .15 Bot	—	+ $ .15 Bot	—
$2.50 Calls	—	+$ .15 Bot	—	+$ .15 Bot
Nov 1:				
Dec Futures	($2.25) Sold	—	($3.00) Sold	—
$2.50 Puts	($ .25) Sold	—	($ .00)	—
$2.50 Calls	—	($ .00)	—	($ .50) Sold
Net Futures	$2.35	$ 2.35	$2.85	$2.85
Basis	-.20	-.20	-.20	-.20
Net Cash Price	$2.15	$ 2.15	$2.65	$2.65

A. Minimum Price Contract for Sellers Cont'd:

The example demonstrates that both strategies provide the same result and effectively hedge the buyer's risk in a minimum price contract. For the seller, the use of a minimum price contract improved the sales price by $.35 in Scenario B, but reduced the sale price by $.15 compared to the cash bid of $2.30 available on April 1 when the minimum price contract was established.

Risk to the seller: Although a minimum price contract does not improve the final cash price in every case, the strategy reduces risk by eliminating the downside exposure.

Risk to the buyer: If properly hedged, this contract does not increase the risk to the buyer. It is important that the buyer clearly explain the contract to the seller to avoid confusion concerning the final pricing mechanism.

B. Maximum Price Contract for Buyers: The most common maximum price contract is offered by a seller (merchant/elevator) to a buyer (consumer) to protect the consumer against an upward movement in price, while leaving the final pricing until a later date. The mechanics of this contract and the risk are exactly the same as the minimum price contract for farmers demonstrated in the previous example. However, the hedging requirements are the opposite.

Maximum Price (Price Cap) for Consumers vs. Minimum Price (Price Floor) for Farmers

Maximum Price:

	Maximum Price	Hedge Using Calls	Hedge Using Futures & Puts		
CBOT Dec	$2.50	Dec	Dec	Dec	Dec
Option cost	+.15	Futures	$2.50 Calls	Futures	$2.50 Put
		N/A	BUY	BUY	BUY
Max HTA	$2.65		@ .15	@ $2.50	@ .15
Cash basis			- .20		
Max-Price			$2.45		

Minimum Price:

	Minimum Price	Hedge Using Puts	Hedge Using Futures & Calls		
CBOT Dec	$2.50	Dec	Dec	Dec	Dec
Option cost	-.15	Futures	$2.50 Puts	Futures	$2.50 Calls
		N/A	BUY	SELL	BUY
Min HTA	$2.35		@ .15	@ $2.50	@ .15
Cash basis	- .20				
Min-Price	$2.15				

C. Minimum/Maximum Contracts: These types of contracts are a variation of the basic minimum price contract. They offer the same protection against an adverse movement in price, but reduce the cost of that protection by limiting the user's benefit from a positive move in prices. A minimum price contract offers total protection against a drop in prices, while offering unlimited potential for the seller (farmer) to benefit from an upward movement. The "minimum/maximum" contract limits this benefit of upward price movement, in effect creating a price ceiling. This contract type can be used to manage risk for both sellers and buyers; only the hedging strategies differ.

The industry offers numerous variations of this type of contract. "Mini-Max," "Price Plus," and a "window contract" are just few of the descriptions. The primary features are the inclusion of both a minimum and maximum price, and the introduction of a "short option" into the pricing equation.

Example: Using the previous illustration, on April 1, a farmer enters into a minimum/maximum contract rather than a minimum price contract. The seller (farmer) agrees to limit the upside to CBOT Dec futures of $3.00.

Calculation:

	April 1 Minimum Price Contract	April 1 Mini-Max Contract Minimum	Maximum
CBOT Dec	$2.50	$2.50	$3.00
Cash Basis	-.20	-.20	- .20
Apr 1 Cash Bid	$2.30	N A	N A
CBOT $2.50 Call	-.15	-.15	-.15
CBOT $3.00 Call	N A	+.05	+.05
Minimum Price	$2.15	$2.20	$2.70

The sale of a $3.00 Dec call option as part of the Mini-Max contract improves the seller's (farmer) minimum price by $.05, but establishes a maximum price of $2.70. The seller is investing $.10 for the potential to earn $.40 more than the current cash bid for November delivery of $2.30.

This contract can be hedged by adding the sale of a $3.00 Dec call option to the minimum price hedge.

Hedge:

	Dec Futures SELL @ $2.50	Dec $2.50 Call BUY @ $ .15			Dec $3.00 Call SELL @ $ .05	
Hedge Result:	Futures Sold	$2.50 Call Bought	Sold		$3.00 Call Bought	Sold
Scenario B	Apr 1 $2.50	$ .15	—		—	($ .05)
	Nov 1 —	—	($ .50)		$.06	—
Net Futures	$2.50	+$ .35	($ .01)	=	$2.84	
					Cash Basis	- .20
					Cash Price	$2.64 vs Max of $2.70

Hedge Result:	Futures Sold	$2.50 Call Bought	Sold		$3.00 Call Bought	Sold
Scenario A	Apr 1 $2.50	$ .15	—		—	($ .05)
	Nov 1 —	—	($.00)		$.00	—
Net Futures	$2.50	($ .15)			+$.05 =	$2.40
					Cash Basis	- .20
					Cash Price	$2.20 vs Min of $2.20

C. Minimum/Maximum Contracts Cont'd:

Minimum/maximum contracts require extra effort in the areas of contract administration, working capital to finance margins and hedging activities. However, by eliminating the impact of adverse price movements, they represent a risk-reducing strategy. The economic value of utilizing a mini-max contract is tied to the net cost of the option.

The "options-based" contracts previously described are characterized by "long-options" positions. They are designed to reduce risk and generally are used as such by the trade. There is another group of contracts that incorporates additional "short-option" strategies and permit leveraging of multiple years' crop production. These contracts are designed to enhance price rather than reduce risk and they can limit the seller's (farmer) marketing alternatives. The maximum price contract (for sellers) and a "ratio mini-max" contract are two examples.

D. Ratio Minimum/Maximum Contract: This contract is the same as the minimum/maximum contract illustrated earlier (C.), but has incorporated an additional "short-option" risk. This contract is intended to provide the same price protection of the "minimum price contract" and the "minimum/maximum contract," but at a lower cost. The user (farmer or consumer) accepts added risk for this lower cost by agreeing to buy (consumer) or sell (farmer) additional cash bushels at an equivalent price.

Example: On April 1, a farmer is presented with three different alternatives to protect against a drop in price levels.

Calculation:

	April 1	April 1		April 1	
				1 by 2 Ratio	
	Minimum Price Contract	Mini-Max Contract		Mini-Max Contract	
		Min.	Max.	Min.	Max
CBOT Dec	$2.50	$2.50	$3.00	$2.50	$3.00
Cash Basis	-.20	-.20	- .20	-.20	- .20
Apr 1 Cash Bid	$2.30	NA	NA	NA	NA
CBOT $2.50 Call	-.15	-.15	-.15	-.15	-.15
CBOT $3.00	NA	+.05	+.05	+.10	+.10
Minimum Price	$2.15	$2.20	$2.70	$2.25	$2.75

The farmer's cost of protecting against a drop in futures (CBOT $2.50 call) is reduced by adding the maximum price feature (selling a call). The cost is further reduced by committing additional bushels (selling a second call) at a higher price through ratioing.

Risk comparison:

Minimum price: Establishes a long-option position.

Minimum/Maximum: Uses a long and short option to create a net-even option position.

Ratio Mini-Max: Uses long and short options to create a net-short option position.

Using the previous example as a foundation, a farmer that entered into each of these contracts on April 1 would be faced with the following pricing alternatives on August 1 and Dec futures at the $3.00 maximum price:

D. Ratio Minimum/Maximum Contract Cont'd:

Calculation:

	Minimum Price	Mini-Max	1 by 2 Ratio Mini-Max
April 1:			
Sold Dec Futures	($2.50)	($2.50)	($2.50)
Bought $2.50 Dec Call	$ .15	$ .15	$ .15
Sold $3.00 Dec Call	NA	($ .05)	($ .05)
Sold 2nd $3.00 Dec Call	NA	NA	($ .05)
August 1:			
Sell $2.50 Dec Call	($ .52)	($ .52)	($ .52)
Buy $3.00 Dec Call	NA	$ .22	$ .22
Buy 2nd $ 3.00 Dec Call	NA	NA	$ .22
Net Futures Price	$2.87	$2.70	$2.53
Cash Basis	-.20	- .20	- .20
Final Cash Price	$ 2.67	$2.50	$2.33

The area of price risk in these contracts is the net "short-option" feature highlighted above. The use of short options adds a volatility risk to the pricing equation. The key issues for these types of contracts are the increased potential for confusion, accounting challenges, IRS and CFTC regulations, and margin requirements.

The calculation for the "Ratio Mini-Max" shown above assumes that the buyer permits the seller to apply the $.17 loss on the additional short option (sold at $.05 and covered at $.22) against the original cash sale. In that situation, the seller accepts a lower price ($2.33 vs $2.50) rather than provide additional bushels. Because no additional bushels were required to be delivered, this added short call ingredient could be considered an illegal trade option because delivery is dependent on a price trigger. A legal review of this procedure is recommended. Alternative methods of handling this situation could include the following:

Alternative 1: Establish a new cash contract for the second Dec $3.00 "short call." In this case, the first call short would result in one cash contract at $2.50 (see the base mini-max calculation) and a single Dec $3.00 call short that has $.17 loss when compared to the market. This $3.00 call short can be converted to a new cash sale at $2.63.

Calculation:

April 1	Sell Dec $3.00 Call	($ .05)
August 1	Buy Dec $3.00 Call	$ .22
August 1	Sell Dec Futures	($3.00)
	Net Futures level	$2.83
	Cash basis	- .20
	Final Cash Price	$2.63

Alternative 2: The buyer could permit the seller to price the initial contract at a price of $2.49 as in the previous alternative, but leave the pricing of the second call until a later date. This essentially creates a new "maximum price contract."

The important point in this illustration is that there is more than one way to handle the final pricing on an option based cash contract. Accordingly, it is imperative that the buyer and seller agree on these alternatives when the initial contract is established.

E. Maximum Price Contract for Sellers: The maximum price contract was demonstrated earlier as a risk-reducing contract for consumers. It also is used in various forms as a revenue-enhancing tool for sellers (farmers/dealers). The extra feature is a short call that is intended to improve the ultimate cash sale price.

Example: On April 1, a farmer establishes $3.00 CBOT Dec futures as the targeted sales price for his expected production. Rather than wait and hope for the market to reach that objective, the farmer enters into a November delivery "maximum price contract" for a quantity equal to expected production. **The seller has established the maximum futures level for the cash contract, but has not transferred the downside price risk.** The final price will be established later in the growing season, at which time the farmer expects to be credited with $.05 representing the current value of a $3.00 Dec Call (less a service fee). The cash basis level may or may not be established at the time of the contract.

Hedge for the buyer:	Dec Futures	Dec $3.00 Call
April 1	N/A	Sell @ $.05

By August 1, Dec futures have rallied to the $3.00 target because of weather problems. The farmer requests to establish the final futures price on the cash contract. The buyer (elevator/ merchant) informs the farmer that the futures price can only be fixed at $2.83. A rise in **option "volatility"** has resulted in a loss on the "short-option" contract, partially offsetting the gain in futures prices. Rather than accept a price $.17 below his objectives, the farmer chooses to wait to finalize the futures price on the maximum price contract.

Calculation:	Dec Futures		Dec $3.00 Call
Apr 1	N/A		Sold ($.05)
Aug 1	($3.00)		Bot $.22
Net Futures	$3.00	—	Loss ($.17) = $2.83

On September 1, crop prospects have improved, pushing Dec futures down to $2.45. The farmer calls the buyer to finalize the futures price on the maximum price contract. The buyer informs the farmer that the price will be $2.49 1/2.

Calculation:	Dec Futures		Dec $3.00 Call
Apr 1	N/A		Sold ($.05)
Sep 1	($2.45)		Bot $.005
Net Futures	$2.45	+	Gain $.045 = $2.495

Risks for the seller: This type of contract provides an added source of revenue, but introduces "options volatility risk" to the pricing equation. This strategy only protects against downside price risk.

Risks for the buyer: The only added risk in a properly written and properly hedged maximum price contract is the increased margin requirements. However, clearly communicating the contract terms and risks to the seller is critical.

IV. Derivative-Type Contracts

A. Grain Swap Contract: This contract is a contractual agreement between two parties in which one party agrees to protect the other for a predetermined quantity of a commodity at an agreed price for a future date. Price transparency is achieved by both parties agreeing to a specific cash or futures market to serve as the benchmark by which the contract's gain or loss will be measured. There is *no* actual exchange of physical commodity, so delivery never occurs. There is an exchange of cash flow at a predetermined period or at final settlement.

In 1989, CFTC issued a swaps policy statement giving certain swaps a "safe harbor" from regulation. In 1993 the CFTC issued an exemption from regulation (other than anti-fraud and anti-manipulation) for those swaps satisfying the following requirements *(**Note**: the following are summaries of requirements. For a complete determination, consult legal counsel):*

1. Individually tailored terms -- contract terms may not be standardized.

2. Absence of clearing organization or margin system -- individualized credit agreements; not supported by a mark-to-market margin and variation settlement system.

3. Prohibition against marketing to the public or on any multilateral transaction execution facility, either physical or electronic.

4. May be entered into only with eligible swap participant defined in part as:
   - ➢ Total assets exceeding $10,000,000
   - ➢ Obligations guaranteed by a letter of credit
   - ➢ Net worth of $1,000,000

Swaps allow for the development of creative, customized risk-management tools exclusive to the needs of individual market participants. Counterparty credit risk is significant, since the value as a risk-management tool is dependent upon both parties fulfilling their offsetting obligation at time of settlement. Exchange-traded commodities guarantee performance as a result of the daily margining system and segregated funds held by the clearing corporation; swaps do not.

Example: Assume a food manufacturing company has five plants scattered throughout the country. Primary commodity purchases are based on the price of cash corn tributary to the Mississippi River and west coast rail.

Transaction:

April 1	➢ Food company "Z" buys from grain company "Y" 5 million bushels of US #2 Corn for Sep 1 settlement at a benchmark price of $2.90 based on the delivered bid to St. Louis, Mo., terminal market, comprised of three-bid average.
September 1	➢ St. Louis average cash market is $3.20 -- Grain Company "Y" sends a check to Food Company "Z" for $1.5 million.

Calculation: ($3.20 - $2.90) = $.30 x 5 million bushels = $1.5 million

A. Grain Swap Contract Cont'd:

Swaps can include conventional forward contracts, minimum or maximum price contracts, a basket of different cash markets or any combination of risk-management tools into which the buyer and seller choose to enter. Because of the significant counterparty financial risk associated with swaps, many swaps have a monthly cash flow settlement procedure. Rather than lump sum at settlement. Swaps are common among professional farm management, food and commercial grain industries.

B. Revenue Contracts: These contracts are the latest entrant in the hybrid cash grain contract field. Revenue contracts are the result of combining a traditional price contract with a yield contract to create a quasi-revenue purchase contract. The term "revenue contracts" is somewhat misleading because such contracts do not guarantee revenue for a specific farm; rather they can be used to guarantee a revenue value based on any state yield currently trading on the Chicago Board of Trade. At present, yields in Illinois, Iowa, Nebraska, Indiana, Ohio and the United States are available for trading on an exchange.

The regulatory interpretation of these new revenue contracts remains unclear. Those considering offering this type of contact are advised to submit a proposed contract to the CFTC for input.

Yield contracts trade as bushels per acre. To calculate the number of yield contracts necessary to hedge a particular volume, the following formula is used:

$$\text{Contracts} = \frac{\text{Acres X Price}}{\text{Multiplier}}$$

The multiplier in the case of corn is $100. Yield contracts trade both as futures and options on futures.

Example:

Dec. CBOT Futures	$3.00/Bushel
Dec. $3.00 Put	$0.20/Bushel
Jan. IL Yield Futures	130 Bushels/Acre
Jan. IL Yield 130 Puts	8.5 Bushels/Acre

1000 Acre Farm IL Revenue Contract		Cost of Protection
Dec. Corn Futures Minimum Price	$2.80/Bushel	$26,000.00
Minimum IL Yield Level	121.5 Bushels/Acre	$25,500.00
Guaranteed Minimum IL Revenue:	$338.50/Acre	

The cost for offering a 1,000-acre farmer revenue protection guaranteeing an Illinois state average corn yield of 130 bushels/acre and a futures price of $3.00/bushel would be $51,500, or $51.50/acre.

B. Revenue Contracts Cont'd:

The price component cost is derived as follows:
1,000 acres X 130 Bushels/Acre X $0.20/Bushel = $26,000.00

The yield component cost is derived as follows:
(1,000 Acres X $3.00/$100) X (8.5 Bushels X $100) = $25,500.00

Net revenue protected is derived as follows:
($3.00/Bushel X 130 Bushel/Acre) - $26,000.00 - $25,500.00)/1,000 Acres = $338.50/Acre
Gross Revenue - Price Protection - Yield Protection = Net Minimum Revenue

Risk to the seller: Yield basis risk is significant because of the variance between the state yield used in the contract and the producer's actual yield.

Risk to the buyer: Minimum revenue contracts must be carefully communicated with regard to what is being protected. Price and volatility risks are identical to a traditional minimum price contract.

Revenue contracts will be attractive to large farm operations, industrial-sized farms, seed corn companies, farm management organizations and input providers. Revenue contracts can include all variants afforded price contracts separately, as can yield contracts. Combining various contracting alternatives for both price and yield contracts into one revenue contract requires significant investment in systems to account for and manage the complexity created by the marriage of price and yield.

Contract Risk Comparison

Buyer Risks Contract Type	MARKET RISKS					NON PRICE RISKS/CONCERNS (scale 0 = none, 1 = low, 10 = high)					Relative Risk
	Futures	Basis	Spread	Implied Volatility	Yield	Margin	Legal	Controls	Tax	Counter Party	
Flat Price	✓	✓				5	1	3	2	3	Low
Basis		✓				0	2	2	2	2	Low
Deferred Price						0	2	2	1	0	Low
HTA	✓					5	5	4	4	6	Moderate
HTA (rolling)	✓					7	8	8	6	8	Higher
HTA (multiple Crop)	✓					9	10	10	8	10	Higher
Minimum Price	✓	✓				4	1	3	3	2	Low
Maximum Price	✓			✓		3	3	4	4	3	Moderate
Min/Max (1-1)	✓	✓				3	4	5	5	3	Moderate
Min/Max Ratio	✓	✓				9	9	9	8	9	Higher
Revenue	✓	✓			✓	7	8	8	8	7	Higher
Swaps	Varies by contract					Varies	7	8	7	8	Higher

Seller Risks Contract Type	MARKET RISKS					NON PRICE RISKS/CONCERNS (scale 0 = none, 1 = low, 10 = high)					Relative Risk
	Futures	Basis	Spread	Implied Volatility	Yield	Margin	Legal	Controls	Tax	Counter Party	
Flat Price					✓	0	1	2	1	3	Low
Basis	✓				✓	0	1	2	1	1	Low
Deferred Price	✓	✓				0	1	2	1	3	Low
HTA		✓			✓	0	3	3	3	5	Moderate
HTA (rolling)		✓	✓		✓	0	6	7	5	7	Higher
HTA (multiple Crop)		✓	✓		✓	0	8	10	8	9	Higher
Minimum Price	✓			✓	✓	0	1	3	2	4	Low
Maximum Price	✓	✓		✓	✓	0	2	5	4	3	Low
Min/Max (1-1)	✓			✓	✓	0	2	5	5	4	Low
Min/Max Ratio	✓	✓		✓	✓	0	7	9	8	7	Higher
Revenue						0	7	8	8	7	Moderate
Swaps	Varies by contract					Varies	7	8	7	8	Moderate

Basic Principles and Definitions:

- This matrix is intended to demonstrate the relative risks of a range of cash contracts. It does not represent an inclusive list due to the number of possible variations. The matrix does not differentiate risks associated with time, location, or payment policy. It should be noted that:
  - -- Forward contracts have greater risk than contracts for immediate delivery.
  - -- Contracts for "in store" grain are less risky than contracts for future delivery.
  - -- Contracts providing "cash advance" payment provide more risk to the buyer and less risk for the seller.
- "Buyer" = an elevator operator, merchant, or consumer.
- "Seller" = a farmer.
  - -- Except for the yield factor, the same would be true of an elevator operator or merchant who hedges a flat price purchase.
- "Buyer Risks" = The risks accepted at the time of a cash purchase prior to any hedging activity.
- "Seller Risks" = The risks "retained" after entering into the applicable cash contract. Yield risk assumes a preharvest sale.
- "Margin Risks" = assumes sellers are not required to maintain margin for forward cash contracts.
- For this exercise, it is assumed that the basis level is established in minimum prices contracts.
- The relevant risks in this matrix are intended as fair representation of the risks but should not be viewed as absolute.
- The actual risks depend on the company and local market.
- Each company should complete a matrix that represents their special circumstances.

Critical Issues

The contract risk comparison in the previous section demonstrated the price and non-price risks and issues associated with a range of contracts, including hybrid cash contracts. Effective risk management requires policies, practices, procedures and support systems that address each of the risks in the matrix.

This section of the white paper discusses the key considerations and provides a basic framework to address each area of concern.

Market Risk

➢ Understanding, quantifying and managing price risk.

Counterparty Credit Risk

➢ Why it exists and how to avoid losses.

Internal Systems and Controls

➢ Systems needed to manage new contracts.

Lending Issues

➢ How to manage the impact of hybrid cash contracts on credit lines.

Customer Relations

➢ Understanding the impact of hybrid cash contracts on customers.

Legal and Regulatory Issues

➢ Critical legal issues and status of federal and state regulations.

Tax and Accounting Considerations

➢ Unique issues relating to hybrid cash contracts.

Market Risk

Market (or price) risk results from changes in the market value of an instrument (cash, cash hybrid, futures, options, swaps, etc.) and the resultant financial impact to earnings. The types of market risks -- basis risk, futures risk, spread risk, options risk and yield risk -- are shown in the Contract Risk Comparison Matrix and are demonstrated in the various contract examples.

The futures (flat price) and basis components of risk and, to a lesser extent, futures spreads have been a longstanding part of marketing risk profiles. As such, they generally are well understood. However, the growth in hybrid cash contracts, such as minimum price, maximum price and HTA, have increased the number of individuals or firms directly exposed to futures, futures spreads and/or options risks. Yield risk, from a risk-management perspective, has yet to find a place in marketing strategies.

Two issues complicate the risk management required due to increased exposure to futures spreads and options risks from these more flexible contracts. First, the risks are often a residual or added feature of the cash contract. Options often are embedded within the cash contract and may not be as easily identifiable as a basic cash contract. Second is the fact that options contracts do not move on a one-for-one basis with futures markets because of changes in volatility and the impact of time on the value of options. These factors require buyers and sellers to consider various risk indicators when evaluating their risk positions (see Appendix C for a definition and discussion of these indicators).

The key Market Risk areas include:

- Risk Measurement
- Risk Management
- Controlling Risk

Market Risk Measurement

A variety of methods are used to measure market risk, with varying levels of sophistication. The degree of sophistication in a market risk measurement system should be directly related to:

- the scope of the risks;
- the number and type of contracts offered;
- the magnitude of the risk; and
- the organization's ability to understand the nature, limitations and meaning of the system's results.

Less sophisticated systems are appropriate only when a participant uses very conservative cash contracts. More sophisticated measurement methods that rely on mathematical models to project price behavior are necessary for organizations that utilize contracts with more complex risk structures.

Market Risk-Management

The foundation for an effective risk-measurement and risk-management system is a "position report" that accurately reports the various price risks -- basis risk, futures risk, options risk, etc. A *pro forma* position report is presented at the end of this section. There are countless position report forms that show similar information with more or less detail. The forms presented in this document should not be viewed as absolute, but as a sample to use to develop a position report that effectively communicates the risks in a specific organization.

The *pro forma* position report is supported by *pro forma* reports for "Cash Positions," "Hedge-to-Arrive Contracts" and "Options Positions." These sample reports also are shown for illustrative purposes; they are merely one way of presenting the information. What is important is that each organization should have a reporting system that accurately portrays its risk positions. With that foundation, it is possible to address how to effectively manage the risks.

The various position reports establish the foundation for effective risk management. However, to be effective, the reports must reflect all obligations of cash contracts. The options portion of minimum, maximum, or mini-max contracts and the rolling features in some hedge-to-arrive contracts need special attention.

Example: A maximum price contract establishes a "call short" for the buyer at the specified maximum price. Does the position report reflect this call short even though the market is $.75 below the strike price?

More sophisticated risk-measurement tools and risk management include "Earnings-at-Risk" (EAR) and "Value-at- Risk" (VAR) models that quantify the potential impact of risk positions based on statistical assumptions. These methodologies can be used by firms that wish to maintain a limited risk profile or work within risk tolerance levels set forth by senior management and the board of directors.

Controlling Risk

As with all risks, effective controls of market risk are important for any organization. The controls become even more important when the firm is utilizing hybrid cash contracts. The degree of structure and formality associated with this process should be commensurate with the level of risk in merchandising strategies, the level of risk approved by senior management and, possibly, the demands of other interested parties, such as a lending institution. Factors that contribute to the effective supervision of market risk include:

➢ Appropriate board oversight and management supervision;

➢ Comprehensive policies, practices and procedures;

➢ Formal approval process for new contracts and variations on existing contracts;

➢ Process for establishing market risk limits;

➢ Reliable and independent market valuation systems;

➢ Systems to assess the impact of adverse market moves;

➢ Accurate risk measurement processes;

➢ Timely risk reporting and risk monitoring processes;

➢ Internal or external review of risk management processes.

Limited users of hybrid cash contracts with relatively simple risk profiles or small risk positions are not expected to have sophisticated computer systems and managerial infrastructure support to manage and control market risk. However, an effective risk-position report and sufficient understanding of the factors affecting market risks is required by even the smallest organization. When the managerial, administrative and systems infrastructure cannot adequately support the use of more complicated hybrid cash contracts or merchandising strategies, it would appear appropriate for the individual or firm to refrain from using such instruments.

In addition to the financial impact of market (price) risk, adverse or unexpected market movements and usage of hybrid cash contracts can increase non-price risk. Non-price risks include legal risk, counterparty credit risk and banking operations. These topics are addressed more completely in later sections of this white paper.

Proforma: Position Report

Commodity: _____

Month (000 Bushels)	Cash Position	HTA	Futures			Options Delta	NET POSITION	Futures Month
			Hedge	Gives	Takes			
	A	B	C	D	E	F	G	
APR 96	0	0						
MAY 96	0	0	0	0	0	0	0	MAY 96
JUN 96	0	0						
JUL 96	0	0	0	0	0	0	0	JUL 96
AUG 96	0	0						
SEP 96	0	0	0	0	0	0	0	SEP 96
OCT 96	0	0						
NOV 96	0	0						
DEC 96	0	0	0	0	0	0	0	DEC 96
JAN 97	0	0						
FEB 97	0	0						
MAR 97	0	0	0	0	0	0	0	MAR 97
O/N/D 97	0	0	0	0	0	0	0	DEC 97
Totals	**0**	**0**	**0**	**0**	**0**	**0**	**0**	

Gamma 0

Vega 0

Shaded areas should be zero (0) for "no risk" position

Example: Position Report

Commodity: Corn

Month (000 Bushels)	Cash Position	HTA	Futures			Options Delta	NET POSITION	Futures Month
			Hedge	Gives	Takes			
	A	B	C	D	E	F	G	
APR 96	200	0						
MAY 96	20	10	-190	0	0	0	40	MAY 96
JUN 96	10	0						
JUL 96	-40	100	-120	-10	40	-5	-25	JUL 96
AUG 96	0	5						
SEP 96	50	0	0	0	0	0	55	SEP 96
OCT 96	0	60						
NOV 96	50	0						
DEC 96	0	0	-150	-50	0	0	-90	DEC 96
JAN 97	50	0						
FEB 97	0	20						
MAR 97	0	0	-70	0	0	0	0	MAR 97
O/N/D 97	25	20	0	0	0	-15	30	DEC 97
Totals	**365**	**215**	**-530**	**-60**	**40**	**-20**	**10**	

Gamma -0.078

Vega -13.5

Basis Risk

Cash Spread Risk

Delta Risk

Flat Price Risk

Futures Spread Risk

Key: Proforma Position Report

COLUMN	TITLE	DEFINITION
A	Cash Position	The net of all cash contracts which have "basis" established, including owned inventory.
B	HTA	Cash contracts where only the futures level (not basis) has been established. The HTA "month" represents the futures month, not the intended cash delivery month. A Hedge to Arrive obligation report is recommended to compare the futures month with the intended cash delivery month. (See sample on page 35.)
C	Hedge	The actual board of trade futures position.
D	Gives	Cash basis purchase contracts which have not been priced.
E	Takes	Cash basis sales contracts which have not been priced.
F	Options Delta	The net bushel equivalent (Delta) of all options positions (cash obligations such a "minimum price" and board of trade options hedges.)
G	Net Position	The sum of A through F.

Proforma: Cash Position Report

Commodity: Corn

		Elev. A	Elev. B	Total
APRIL 96	Inventory	300	100	400
	Storage	(100)	(10)	(110)
	Net Ownership	200	90	290
	DP	(50)	(0)	(50)
	Net Inventory	150	90	240
	Purchases	25	20	45
	Sales	(75)	(10)	(85)
	Net Cash	**100**	**100**	**200**
MAY 96	Purchases	20	0	20
	Sales	(0)	(0)	0
	Net Cash	**20**	**0**	**20**
JUNE 96	Purchases	0	10	10
	Sales	(0)	(0)	0
	Net Cash	**0**	**10**	**10**
JULY 96	Purchases	0	0	0
	Sales	(40)	(0)	(40)
	Net Cash	**-40**	**0**	**-40**
AUG 96	Purchases	0	0	0
	Sales	(0)	(0)	0
	Net Cash	**0**	**0**	**0**
SEP 96	Purchases	25	25	50
	Sales	(0)	(0)	0
	Net Cash	**25**	**25**	**50**
OCT 96	Purchases	0	0	0
	Sales	(0)	(0)	0
	Net Cash	**0**	**0**	**0**
NOV 96	Purchases	50	0	50
	Sales	(0)	(0)	0
	Net Cash	**50**	**0**	**50**
DEC 96	Purchases	0	0	0
	Sales	(0)	(0)	0
	Net Cash	**0**	**0**	**0**
JAN 97	Purchases	0	50	50
	Sales	(0)	(0)	0
	Net Cash	**0**	**50**	**50**
O/N/D/ 97	Purchases	25	0	25
	Sales	(0)	(0)	0
	Net Cash	**25**	**0**	**25**
TOTAL NET CASH POSITION		**180**	**185**	**365**

Proforma: Options Position

(000 Bushels)

Short Version						Extended Version							
Strike	Month	Put/Call	Cash Obligations	Board of Trade Position	Net Option	Market Price	Implied Volatility	Delta	Delta Bushel Equiv.	Gamma	Gamma Equiv.	Vega	Vega Equiv.
A	B	C	D	E	F	G	H	I	J	L	M	N	O
CALC					(D+E)				(FxI)		(FxL)		(FxN)
3.00	DEC 96	CALL	-10	0	-10	18.25	20	0.50	-5	0.0038	-0.038	0.35	($3.5)
2.50	DEC 97	CALL	-50	0	-50	23.00	20	0.50	-25	0.0056	-0.280	0.84	($42.0)
3.00	DEC 97	CALL	50	0	50	8.75	20	0.20	10	0.0048	0.240	0.64	$32.0
		TOTAL	**-10**	**0**	**-10**				**-20**	**0.0142**	**-0.078**	**1.83**	**($13.5)**

An options report can be simple ("short version") or complex ("extended version") depending on how options are used. If the obligation in your cash contract is offset with exactly the same board of trade contract, then no net options position will result. For this circumstance, the "short version " can be used. If the obligations in your cash contracts are not hedged, or the exact same strike price or futures month is not hedged, then the "extended version" should be used to ensure identification of various options risks.

Proforma: Hedge to Arrive Position Report

(000 Bushels)

Futures Month	Beginning HTA Balance	Change (New HTA +/- rollovers)	Price Outs	Ending HTA Balance	Cash	
					Delivery Period	Ending Balance
A	B	C	D	E	F	G
MAY 96	110	-100		10	MAY 96	10
JUL 96	30	100	-30	100	J/J 96	0
SEP 96	5			5	A/8 96	5
DEC 96	50	10		60	O/N/D 96	110
MAR 96		20		20	J/F/M 97	20
DEC 96		20		20	O/N/D 97	20
					Unknown (Flex)	50
TOTAL	**195**	**50**	**-30**	**215**	**TOTAL**	**215**

The shaded areas show HTA contracts that will need to be rolled.

This report identifies the difference between the "futures contract month" selected by the customer and the "intended cash delivery month." This type of report can help project facility operations and highlight customer HTA contracts that will need to be rolled.

Counterparty Credit Risk

Counterparty credit risk (or simply credit risk) is the risk of loss due to a counterparty's unwillingness or inability to satisfy contractual requirements or to compensate the other party for the negative financial impact of contract default. Price volatility, length of time between the contract date and the shipment date, and contract complexity are factors that impact the potential for credit risk. The existence of hybrid cash contracts and their use in more complicated marketing strategies require more attention and better systems to manage this risk.

Aside from fraud, there are two primary reasons for contract defaults:

1. The customer is unable to satisfy contractual requirements and unable to meet the financial obligation.

- This can happen if the customer overcommits the volume produced/handled; if the financial results are so poor as to render the customer insolvent, or the contracting party exits the business; or if a farmer loses the ability to farm or the elevator loses its ability to purchase grain.

2. The customer claims that the contract was misrepresented or that the terms and potential financial impact were not fully understood.

- This can happen if the results are unexpected and the risks were not fully explained at the time of the transaction.

A multi-year cash contract, in which a producer uses futures in one crop year to "price" anticipated production in a later crop year demonstrates many of the key issues. The producer is committed to the elevator for a longer period of time; but in the process the elevator becomes an unsecured creditor of the farm operation for multiple years. Will be producer be farming in two to three years and be willing to fill the contract? Will the elevator still be in business? Do both parties understand the rolling provisions of the contract? How large might a price swing be from the contract date to the shipment date? Multi-year contracts present the risk that either the producer or the elevator might default during the life of the contract.

How can this risk be managed?

The grain industry typically relies on relationships as the primary protection against default. This is particularly true for purchase contracts. Local reputation for fairness and consistency in business dealings is an important factor in managing this risk. "Know Thy Customer" reflects the age-old adage of relationship as a business asset. However, even strong relationships are tested when market volatility increases and financial losses are incurred. While knowing the customer may be the most important factor in limiting credit risk, the growth in hybrid cash contracts requires firms to establish systems to control credit risk for business activities that did not seem to need special attention in the past.

Credit Risk Control

The most effective method of minimizing credit risk relating to hybrid cash contracts is to establish appropriate internal guidelines and practices to assess and manage the risk. The credit policy should be a formal, written policy with board of directors and/or senior management oversight. An effective credit risk policy should be established prior to contracting. Such a policy should include:

1. Established credit limits for sales and purchase customers.

   ➢ This is especially important for customers utilizing hybrid cash contracts with higher risk profiles.

2. Regular monitoring of credit exposure by "marking-to-market" open customer contracts.

   ➢ Including periodic estimates of worst-case scenarios for contracts with roll-over provisions.

3. Contracting policy, including criteria for participating in hybrid cash contacts or usage of more complex marketing strategies.

   ➢ It is advisable to identify for individual customers how much volume (bushels or share of production/handle) or dollar risk is acceptable for a specific strategy, the criteria for margins and the follow-up process.

4. Customer profile system that identifies the customer's marketing goals, historical volume and ability to pay for any market losses (source of repayment or collateral).

   ➢ This information can be used to support your contracting policy.

5. Effective risk measurement and reporting systems to improve management of credit exposure.

   ➢ Contract exposure needs to be monitored on a consistent basis throughout the life of the contract.

6. Formal credit review policy.

7. *Risk disclosure process that establishes the overall policy for disclosing contract risks and specific language for each new contract.*

Communication between the individual/unit responsible for cash contracting and the credit function are essential to insure that all parties are informed of a change in the credit line or creditworthiness of a customer. However, to be effective, the control function should be independent. The credit manager or other responsible individual(s) should periodically review the creditworthiness of each counterparty. Independence should be maintained over the initial credit assessment, establishment of credit lines, reporting of exposure, and approval of exceptions. If this is not

practical due to the size of the organization, as in the case of a country elevator with limited staff, then the board of directors should be more actively involved in the credit process. In addition, an outside consultant can be used to help develop an appropriate credit function and review it on a periodic basis.

How can credit risk be avoided?

Establishing effective management controls, as mentioned previously, is an important step. In addition, hybrid cash contracts require special attention to contract clarity and require elevator operators/merchants to understand the risks that the customer is taking. Before entering into a hybrid cash contract, it is crucial that both parties understand exactly how the transaction works: pricing, margins (if any), delivery, and the worst-case risk. This is true of all contracts. But it is even more important with hybrid cash contracts because of the potential for added risk and confusion.

Managing credit risk takes on a new twist with hybrid cash contracts. It no longer is sufficient for a firm to have systems in place to manage its own risk. These contracts demand that the firm also understand the risks its customers are taking and develop systems to assure the customer is not over-extended. **If a customer is permitted to utilize strategies that incorporate more risk than is prudent for the type and size of operation, the counterparty risk increases.**

Internal Systems and Controls

In addition to market risk and counterparty credit risk, companies offering hybrid cash contracts also face administrative risk, defined here as the risk of loss occurring as a result of inadequate systems and controls, human error or management failure.

Grain operations are exposed to administrative risk in all contracting activities. But hybrid cash contracts pose especially challenging control issues because of their complexity, lack of consistent structure, and continual evolution. Adequate systems, sufficient administrative capacity and knowledgeable staff are critical to effectively safeguard against losses from hybrid cash contracts. **Companies should not engage in more complicated marketing strategies if their systems or internal controls are not sufficient** to adequately confirm contracts, execute contracts, and provide enough information to monitor contract exposure and manage related risks. The degree of sophistication of systems and controls should be commensurate with the complexity of the contracts and the level of risk.

Fundamentals of effective internal controls are:

➢ Oversight by senior management and/or board of directors;

➢ Written policies, practices and procedures;

➢ Separation of contracting and control responsibilities;

➢ Integration and reconciliation of reports to the books;

➢ Skilled and experienced personnel;

➢ Timely reporting of financial position, exposure and risk; and

➢ Technology commensurate with the level of risk.

Effective grain accounting and administration must have integrity to provide management with the financial information to run the business and secure required bank financing. Systems have been developed to support traditional cash contracts -- flat price, basis, deferred price, etc. -- with little or no trouble.

The two primary pricing factors, basis and futures levels, are well-defined. The futures level easily can be verified in daily newspapers, and the basis, while not as easily defined, generally can be verified by market information sources or brokers. The ability to identify the price components -- basis and futures -- of traditional cash contracts allows the buyer, the seller, and other interested parties, such as accountants and bankers, to easily establish contract valuation and market exposure.

Common controls for traditional cash contracts are:

➢ Daily reconciliation of manual- and computer-generated position reports;

➢ Daily review of new contracts for reasonableness;

➢ Daily reconciliation of broker statements to position reports;

➢ Daily review of contract changes or deleted contracts;

➢ Receipt of written trade confirmation from the counterparty;

➢ Periodic valuation of market positions (frequency depends on the size and risk profile of the positions).

Hybrid cash contracts and more complicated marketing strategies, as demonstrated in the contract classification section, have added a new twist. Systems and controls are lagging due to the relatively new use of these trading concepts. These newer contracts require increased emphasis on some of the controls used for traditional contracts mentioned previously, plus the development of new reports to manage exposure. The first priority for establishing dependable systems is to **make certain that management, accounting and administrative personnel fully understand the underlying principles, obligations, specific terms and pricing mechanism of all contracts being utilized.**

The most frequently used hybrid cash contracts are: 1) various forms of hedge-to-arrive contracts, which are relatively easy to account for; and 2) options-based contracts (e.g., price floor, price cap, or window contracts), which offer different control challenges.

Basic HTA contracts result in increased forward contracting, which can have a significant impact on margin requirements for hedge accounts. HTA contracts also raise the potential for non-performance because of the deferred nature of most HTAs. Control issues for HTA contracts are very similar to traditional cash contracts. But they require **special attention to contract confirmations, confirmation of contract amendments, customer market exposure, forecasting margin requirements for hedge accounts, identifying the cost of futures margins, and position reporting.**

Options-based contracts present these additional critical systems and control issues:

➢ Identifying the option commitment(s) embedded in a cash contract to insure proper position reporting and hedging.

➢ Periodic valuation of cash contract for financial reporting (requires valuation of embedded options).

➢ Matching option commitments in cash contracts with hedges in the futures market to establish options risk.

- ➢ Contract amendments for expiring options.

- ➢ Proper classification of funds received for option transactions from both the customer and the broker.

One of the biggest concerns with options-based contracts is the possibility that options commitments embedded in the contract are not integrated into position reports. This could result in either a lack of hedging or improper hedging of the options risk. Effectively identifying options exposure and including the options commitment in a position report, as illustrated in the Market Risk section of this white paper, would significantly reduce this concern.

Systems and controls for options-based contracts depend upon the type of contract being considered. **Special attention should be given to pricing mechanics.** Identifying precisely when an obligation exists and at what point price risk is transferred are important factors in managing options risk.

Enhancing Controls Over Hybrid Cash Contracts

In addition to utilizing the common controls for traditional cash contracts, the following are recommended to enhance control over hybrid cash contracts:

1. Include a detailed description of the contract (marketing purpose, mechanics and risk disclosure) with the contract confirmation. Have the customer sign both the contract confirmation and the description.

   - ➢ This should help insure that the customer fully understands the contract.

2. Require the trading partner to certify production capacity (farmer), annual volume (elevator), or usage (consumer) when entering into a hybrid cash contract.

   - ➢ This will help reduce, but not eliminate, the chance that one party will over-commit capacity.

3. Issue a contract amendment for every adjustment to a contract, including pricing of an HTA, rolling of an HTA or expiration of embedded options in cash contracts.

   - ➢ This should be common practice for traditional contracts. But it must be emphasized that proper contract management is even more important with hybrid cash contracts.

4. Develop a system to mark-to-market hybrid cash contracts for each customer on a regular basis, and provide it to the customer.

   - ➢ This will help the customer identify the impact of market changes on his contracts. And it will help the elevator operator identify when customers may be at risk.

5. Establish a policy for a person other than the contracting individual to review all contract amendments, especially any rolling of HTAs, unpricing of HTAs or contract cancellations.

   ➢ This will help insure that contracts are executed consistent with the original intent of the contract.

6. Develop a system to highlight (flag) hybrid cash contracts in the accounting and control system.

   ➢ This will enhance accounting treatment and provide an added check to assure risks are identified. This is particularly important for options-based contracts.

7. Consider establishing control limits for contracting activities which would require either senior management or board of directors review before expanding programs.

   ➢ This is an overall control tool. It can be used to set limits on types of contracts that can be utilized, volume of a type of contract in total or for individual customers, dollar limits on futures margins, etc.

8. Maintain a record of individuals authorized to contract on behalf of each of your customers. The record should include the authorized individual's name, contracts he is authorized to utilize, and any other limits.

   ➢ This is intended to avoid any chance of improper contracting.

Policies and Procedures

Written policies and procedures form the foundation for internal controls. These policies can be very basic or complicated, depending upon the types of contracts used and the experience of the staff. The documents should guide employees through the range of tasks performed and should contain guidance on relevant areas of contract/trade processing, valuations and reconciliations. The document should be comprehensive, covering all operational areas (contracting, amendments, settlements, and valuations). The manuals and procedures need to be updated periodically to reflect changing internal and external needs.

Confirmation Process: The confirmation process is a vital part of any grain contracting operation. The more complex nature of hybrid cash contracts warrants special attention to confirmations. To reduce the likelihood of fraud or human error, the confirmation process should be conducted independently of trading or merchandising personnel, if possible.

Discrepancies and Disputed Trades: Trade discrepancies should be brought to the immediate attention of the appropriate operations manager. All discrepancies should be documented and reviewed regularly. Discrepancy documentation should contain the key financial terms of the transaction, indicate the disputed item, and summarize the resolution. The counterparty should receive notice of the final disposition of the trade. And an adequate audit trail of the notice should be on file in the office. Each company should have clear documented policies and procedures regarding the resolution of disputed trades and contracts. **This is nothing new to the grain indus-**

try, but the use of more complex marketing strategies increases the importance of effective resolution of contract discrepancies.

Valuation Process: The valuation process is critical to risk identification and the integrity of profit and loss reporting. Valuations should be done by accounting/administrative personnel, not by trading personnel. If trading personnel are involved in the valuation process, then administrative personnel should verify market values through an independent source. For risk-management purposes, contract valuation should occur at least monthly, and more often, depending upon market volatility, potential dollar loss, position size and the capital position of the firm.

The valuation procedures should be part of a company's practices and procedures manual. They should cover all aspects of the valuation process, such as:

- ➢ sources of input;
- ➢ frequency;
- ➢ responsibilities; and
- ➢ methods for valuing more complex or illiquid cash contracts.

The valuation process is critical to a sound risk-management program. The process should produce consistent financial results that approach reality and would stand the test of outside scrutiny from a knowledgeable individual.

The internal systems and controls discussed in this section cover primarily the area of controlling contracts following the transaction. However, before a hybrid cash contract is consummated, several critical issues should be reviewed by buyers and sellers:

- ➢ A legal review to determine whether the contract meets current state and federal (CFTC) regulations;
- ➢ Tax implications.

These topics are addressed in other sections of this white paper.

Lending Issues

A critical element in the success of companies in the grain industry is their ability to augment equity capital with debt. The banking industry recognizes the important role in which it serves industry participants, particularly those who are positioned to be effective competitors and good risk managers. It is therefore valuable for a firm to examine the issues associated with hybrid cash contracts that may affect its relationship with its lender.

One of the most critical factors in lending to a grain elevator operation is that the lender understands and is comfortable with the grain business, which is cyclical, seasonal and frequently experiences narrow margins. From the lender's point of view, it is critical to know the customer well and have confidence in the character and integrity of the borrower. This is quite similar to the elevator's need to know its customer.

The Lending Process

Prior to addressing specific issues which should be evaluated as hybrid cash contracts are offered, it may be beneficial to outline the mechanics of the lending process. The process can be divided into three parts. These are:

- **credit underwriting;**
- **reporting;**
- **monitoring**.

Credit Underwriting involves the process of analyzing and evaluating the credit risks associated with extending credit to the borrower. The analysis of a grain trading operation is based upon a number of factors including:

- evaluation of character and reputation of the principals;
- market presence and strategy;
- management depth and expertise;
- the firm's financial condition/strength, including liquidity and capital to absorb losses during cyclical periods;
- recent operating trends;
- risk-management philosophy (i.e. hedging versus speculation);
- collateral coverage or cushion; and
- management of counterparty exposure.

The other key factor in the credit approval process is determining the security or collateral required to support the credit line. Collateral requirements, including advance rates and eligible collateral, will vary from customer-to-customer and bank-to-bank. Typically, as part of the reporting requirement, and to enable the lender to monitor collateral coverage, a borrowing base is submitted periodically (see the sample "Borrowing Base Report" at the end of this section).

The borrowing base may include advance rates on only warehouse receipts. Or it may also include other categories of collateral, such as:

- accounts receivable;
- unreceipted but hedged grain inventory;
- assignment of hedge account equity via a three-party hedge account agreement; and
- assignment of purchase/sale contracts.

In rare cases, when open contracts are to be used on a borrowing base, **the advance rate for contracts with higher perceived risk may be reduced by lowering the collateral value and credit available under the line.** Once the lender makes the credit decision, the level of credit availability and pricing on the credit facilities then are negotiated based upon these factors, taking into consideration the overall relationship and market environment.

Reporting requirements vary from customer to customer and bank to bank, too. Lenders typically require audited annual financial statements prepared by a CPA firm acceptable to the lender, preferably either a large national/regional firm or a firm with expertise in this area. In addition, interim period statements (e.g., monthly or quarterly) are typically required to monitor interim operating trends. This is done because of the market volatility of the grain business so that adverse trends can be addressed in a timely fashion.

Monitoring approaches of various types are used, including submission of a periodic collateral borrowing base and position report. The borrowing base is used to validate or report collateral coverage compliance, particularly in situations in which a pool of collateral is pledged. The position report is provided to keep the lender informed of the flat-price position. It should be accompanied by broker statements and disclosure of any counterparty exposure. Since maintaining a hedged position within the elevator's risk-management policy is typically required, the broker statement should be obtained directly from the broker to confirm the hedged position with the company's position report.

Explaining Hybrid Cash Contracts to Lenders

As hybrid cash contracts evolve and represent a tool to either increase or competitively protect grain origination, the use of these contracts could potentially have a material impact on financing needs and financial results. It then becomes critical for management to be able to explain and quantify to its lender:

- the strategy for originating grain bushels using the contracts;
- the risks associated with such contracts;
- the elevator's inventory/contract position;
- the firm's risk-management philosophy for minimizing flat-price and basis risk;
- the risk/return of the contracts on the books;
- the financial impact of meeting margin requirements and basis movements; and
- an evaluation of counterparty risk in terms of financial strength and the ability to perform as contracted.

Factors Considered by Lenders

With changes occurring in the marketplace and the advent of more complex strategies, lenders should take into consideration:

- the expertise of the management/traders to manage these market risks;
- the selectiveness with which hybrid contracts are offered to counterparties after evaluating their financial condition and ability to perform;
- the counterparty's ability to perform as described in the discussion on counterparty or credit risk; and
- the overall financial ability of the borrower to survive the cycles of the industry.

In some cases, the lender also must evaluate the credit risk from both the elevator and the producer's position since both may be customers.

To the extent that the financial impact of offering certain hybrid cash contracts could negatively affect the viability of the operation or impact its market position, the decision to finance an elevator operation may be re-evaluated by the lender. In addition, if certain contracts are perceived to carry greater risk, this could incrementally affect the level of credit line availability, pricing and reduce advance rates on pledged collateral. Even though the credit facilities may be adequate at a certain point in time, the impact of adverse market movements and unexpected margin calls may affect the lender's decision to extend the necessary credit. Increasingly, lenders may evaluate the borrower's ability to manage various risks associated with hybrid cash contracts and their ultimate impact on profitability.

Based upon the importance of keeping lenders informed of the financial impact of contract positions and basis movements, an important factor will be the systems and accounting procedures in place to track and provide the profit/loss impact of hybrid and traditional cash contracts. This may require modifications to systems and procedures to support more frequent financial statement reporting; position reports; and, obviously, the ability to mark-to-market contracts on a periodic basis. More frequent reporting should be required by management so all parties remain informed of contract obligations.

Summary

In summary, key factors in maintaining the necessary availability of credit to effectively manage a grain operation include management's ability to manage and communicate the elevator's origination, merchandising, and risk management strategy, plus the ability to manage the liquidity and capital required to support the credit line during the cycle and seasonality of the business.

Customer Relations

Production agriculture today may well be changing faster than any other segment of the

Borrowing Base Certificate

To: _____
(Name of lender or agent for bank group)

_____ _____
(Company Name) *(Date)*

Collateral	Gross Value	Advance Rate	Net Value
Cash	$ _____	_____%	$ _____
Accounts Receivable			
Grain Trade	_____		
Less Past Due ___ Days	_____		
Eligible Accounts Receivables	_____	_____	_____
Grain Storage	_____	_____	_____
Other	_____		
Less Past Due ___ Days	_____		_____
Eligible Accounts Rec.	_____	_____	_____
Total Eligible Account Receivables	_____	_____	_____
Advances Received on Grain			
Net of Advances Due	_____	_____	_____
Inventory			
Warehouse Receipted Hedged Grain	_____		
Less Outstanding Payables	_____		
Total Eligible Inventory	_____	_____	_____
Unreceipted Hedged Grain	_____		
Less Outstanding Payables	_____		
Total Eligible Inventory	_____	_____	_____
Eligible Other Inventory	_____	_____	_____
Margin Account Balances	_____	_____	_____

Borrowing Base Gross Total $_____ Net Total $_____

Less: Letters of Credit Issued _____
Outstandings on Line of Credit _____
Excess (Deficit) Borrowing Base _____

This Borrowing Base Certificate is issued pursuant to Sections _____ of the Secured Revolving Credit Agreement

dated _____ between _____ *(Borrower)* and _____ *(Lender/Agent).*

The undersigned officers of _____ *(Borrower)* hereby certifies that:

1. the amounts set forth in this Borrowing Base Certificate are true and correct as of the date prepared;
2. position report is attached;
3. to the best of my knowledge, since the Preparation Date there has been no material change in the value of the Borrowing Base;
4. there exists no Event of Default or Default under the above referenced Credit Agreement;

_____ *(Borrower)* By: _____ *(Authorized Signer)*

Its: _____ *(Title)* Date: _____

Note: Grain Contracts -- Will be considered in certain situations at the discretion of lender.
Equity in Netted Contracts
Hedged Equity

industry. From revolutionary farm programs to "precision agriculture" technology using satellite imaging, a host of management and technological challenges face today's producer. As a consequence, many farmers are looking for ways to increase marketing opportunities and flexibility to enhance profitability and efficiency. Undoubtedly, this desire on the part of farmers to exercise greater marketing autonomy is a large part of the force behind new forms of hybrid cash contracts.

As discussed in the previous Counterparty Credit Risk section, "Know Thy Customer" has been a catch-phrase in the grain industry for years. However, it is every bit as important for the producer to "Know, Trust and Communicate with Thy Grain Elevator" if marketing strategies utilizing hybrid cash contracts are to be successful for all parties to the contract.

Government Influence in Agricultural Programs

With passage of Freedom to Farm Act concepts in the 1996 farm bill, producers face new challenges and opportunities. No longer strictly tied by government policy to commodity-specific planting and acreage-idling requirements, farmers have greatly enhanced planting and management flexibility. With the income safety net provided by pre-determined market transition payments, farmers will be examining new strategies to maximize income from the marketplace. Clearly, hybrid cash contracts will be an integral part of farmer's marketing and risk- management strategies.

Communication is the Key to Avoiding Customer Relations Problems

Organizations offering hybrid cash contracts to customers have several responsibilities to fulfill to maintain positive customer relations. Matching an appropriate marketing strategy (including hybrid cash contracts) with the appropriate producers is critically important to maintaining good customer relations. Several questions are important to answer, for both the producer and the elevator, when entering into hybrid cash contracts:

1. Is a particular strategy suitable for a specific customer's needs?

   ➢ Determining whether a strategy is suitable for a customer may entail developing a written marketing plan for the producer, analyzing his financial capacity, reviewing his balance sheet and/or operating statement, and becoming familiar with his production capacity.

2. Have the market risks associated with the strategy been fully reviewed with the customer before any grain is bought or sold?

   ➢ Among other things, this involves reviewing market risk, basis risk, spread risk, etc., with the customer, as well as potential contract outcomes in various market scenarios.

3. Does the customer fully understand the contract before entering into it?

   ➢ Educational meetings or workshops may be appropriate to insure proper understanding among customers.

4. Have financial performance requirements (if any) been discussed with the farmer-customer?

   ➢ If margins may be required of the farmer-customer, the producer needs to understand fully the potential financial exposure and be confident sufficient working capital is available to cover exposure in a poor year. Any service fees or other charges should be fully disclosed and discussed with the farmer-customer.

5. Is the contract's performance discussed regularly with the farmer-customer during the course of the contract?

   ➢ If adverse marketing outcomes occur, the producer should be informed of their developments continually as the situation unfolds.

These and other questions are contained in the Customer Checklist on page 68. Answering these questions, providing proper disclosure of both opportunities and risks of a particular marketing strategy, and regular communication with customers serve the dual purpose of maintaining positive customer relations and, potentially, obviating the need for future government regulation of hybrid cash contracts and other marketing tools.

Producer Responsibilities

The producer has certain responsibilities to the organization to which he markets his production. First and foremost, the producer needs to make sure he or she fully understands and is comfortable with using hybrid cash contracts. "I do not completely understand this; let's go over it again," is a request that grain buyers should welcome from their customers.

It has been suggested that being able to explain the strategy to a partner or neighbor upon returning home should be a prerequisite for producers utilizing hybrid cash contracts in their marketing strategies.

Agreement on a marketing strategy, full disclosure of all contract terms and risks, complete customer understanding of the marketing strategy/contract, and regular and open communication between the elevator and producer will help to insure performance by both parties on contracts, positive buyer/customer relations, and best results in using hybrid cash contracts.

Legal Risk/Enforceability of Contracts

Legal Risk Versus Risk of Dispute

If the customer or other party to a contract has a different expectation of what the "deal" is, there is a risk a dispute could develop.

Simple, but true. Thus, rule number one should be to make sure that both parties to the contract understand their rights, obligations and expectations. This will help minimize or eliminate the risk of disputes. Face it -- you don't want to spend time and money fighting with the companies and people with whom you do business, regardless of the legal risks accompanying litigation or arbitration.

General Contract Law Applicable

Remember the fundamentals! This is a lesson that seems forgotten time and time again.

The commercial grain, feed and processing 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 sent later to the other party or parties. Note that these "confirmations" confirm 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.[1]

In the grain and feed industry, an enforceable contract is an agreement that a court or arbitration committee[2] will enforce. 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.[3]"*

In the case of hybrid cash contracts and other grain contracts, it is important to remember that all of the normal rules of contract law apply. State law generally provides the rules on the formal requirements of legally enforceable contracts. Apart from that, it is important that each contract cover the rights and obligations that each party to the contract is undertaking. The sample contract

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[1] In 1990, the NGFA developed sample forms and explanatory material for consideration by country elevators and other firms that purchase grain from producers. *Memorandum To: Recipients of "Sample Grain Purchase Contract" and "Sample Grain Purchase Confirmation Memorandum"*, National Grain and Feed Association (Aug. 15, 1990). This material is available to NGFA members on the NGFA FAX-on-Demand System.

[2] NGFA arbitration of disputes between NGFA Active and/or Allied members is compulsory under the NGFA Bylaws and NGFA Arbitration Rules. In addition, many NGFA members now include arbitration clauses in their contracts with non-member commercial firms (including producers).

[3] Black's Law Dictionary 291-92 (5th Ed. 1979).

forms attached to this white paper (Appendix A) 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[4]. In all cases, competent legal counsel should be consulted before deciding on the contract terms appropriate to a particular firm's transactions.

One of the most fundamental rules of contract law is the so-called statute of frauds provision embodied in state-enacted versions of the Uniform Commercial Code (UCC). The general rule set forth in UCC § 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. However, there are important exceptions to the general rule. The one which commercial grain and feed firms should be concerned with is the "merchant rule" embodied in UCC § 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]."*

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 receiving 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 UCC.[5]

Regular commercial firms are almost always considered merchants. Producers usually are merchants, but grain firms should be aware that some state courts have concluded that farmers are not merchants[6]. However, the trend of recent cases has been to find that farmers are merchants just like other businessmen[7]. In addition, the "merchant" rule may take on new importance given the

[4] The NGFA Trade Rules were developed primarily for use on transactions between commercial grain firms. Ordinarily, the references in the NGFA Trade Rules to transportation-related specifications, bills of lading, etc., would not be applicable to transactions with producers. Thus, a careful review of the NGFA Trade Rules should be made before deciding to reference them in whole or in part in contracts with producers.

Even if a firm decides not to reference the NGFA Trade Rules in its contracts with producers, the NGFA Arbitration Rules provide a cost-effective and accepted method to resolve disputes when at least one of the contracting parties is a NGFA member. Thus, the sample contractual documents attached to the white paper do provide that all disputes will be resolved by NGFA arbitration.

[5] "'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** [emphasis added]." The judicial interpretations of this definition of "merchant" vary from state to state and by courts within a particular state.

rise of "farmer-advisers" often cited as recommending new forms of forward contracting to producers. 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, even in those states that have otherwise found farmers not to be merchants.

➢ 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[8]. Some state laws require that arbitration or mediation clauses be included in agricultural contracts under certain circumstances.[9] Some state grain and feed associations can provide a list of special laws applicable to grain contracts in a particular state.[10]

➢ 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[11]. However, CFTC and federal law determine whether a contract has crossed the line from being a legal cash/forward contract to either an illegal off-exchange trade option or futures contract under the Commodity Exchange Act[12].

A discussion of the Commodity Exchange Act is beyond the scope of this white paper. Suffice it to say that the Commodity Exchange Act 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 such contracts except where Congress has said otherwise. Agreements or transactions

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[6] See, for example, Dickson vs. Delhi Seed Co., 760 S.W.2d 382 (Ark. App. 1988) (finding that under Arkansas law farmer is not a merchant).

[7] Some recent cases finding farmers to be merchants and bound by confirmations include: Colorado vs. Reifenschneider, 379 P.2d 637 (Colo. App. 1991); Busby, Inc. vs. Smokey Valley Bean, Inc., 767 F.Supp. 235 (D.Kan. 1991); Agrex, Inc. vs. Schrant, 379 N.W.2d 751 (Neb. 1986); and Thunderbird Farms, Inc. vs. Abney, 343 S.E.2d 127 (Ga. App. 1986).

[8] See e.g. Wis. Stat. § 127.10(5).

[9] See e.g. Minn. Stat. §§ 17.90 and 17.91 (Aug. 1, 1990); Idaho Code § 22-436; and Ark. Code Ann. § 2-23-101 *et seq.* (July 1, 1991).

[10] The ***NGFA 1995-96 Directory/Yearbook*** (pages 54-55) contains a list (including phone numbers and addresses) of those associations which are NGFA Affiliated Association members.

[11] Of course, many federal laws affect the sale/purchase of grain (*e.g.* Federal Food, Drug, and Cosmetic Act, 21 U.S.C. § 301 *et seq.*; Protection for Purchasers of Farm Products, Section 1324 of the Food Security Act of 1985, 7 U.S.C. § 1631; United States Grain Standards Act, 7 U.S.C. § 71 *et seq.*; and a host of others).

[12] 7 U.S.C. § 1 *et seq.*

involving cash forward contracts generally are exempt from CFTC oversight because the Commodity Exchange Act provides that "[t]he term 'future delivery' does not include any sale of any cash commodity for deferred shipment or delivery."[13]

Contracts involving agricultural commodities can be broken down as follows:

OFF-EXCHANGE GRAIN TRANSACTIONS

Cash/Forward Contracts[14]	Agricultural Trade Options	Agricultural Futures Contracts
No CFTC Jurisdiction to regulate contracts	CFTC Jurisdiction Current ban on off-exchange ag trade options	CFTC Jurisdiction Ban on off-exchange futures

While the preceding chart is helpful to illustrate that only cash or forward contracts are legal off-exchange transactions, determining the line that distinguishes a cash/forward contract from 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 be examined to determine whether it has crossed the legal boundaries between permissible off-exchange transactions not covered by the Commodity Exchange Act and transactions which may only be transacted on a CFTC-regulated exchange. In addition, even a seemingly "safely-worded" contract can become something else if the practices between buyer and seller are in actuality different than the contract's terms.

In 1985, the CFTC published an interpretive opinion from the CFTC Office of General Counsel to "provide guidance to the public" on how the CFTC Office of General Counsel viewed aspects of the CFTC's jurisdiction and the exceptions.[15] That interpretive opinion (see Appendix B) provides firms with examples of prohibited off-exchange transactions and examples amounting to "safe harbors." A transaction not fitting within the "safe harbor" examples does not necessarily violate the Commodity Exchange Act.

Prohibited Transactions

Off-exchange trade options[16] involving agricultural commodities currently are not permitted by

[13] 7 U.S.C. § 1a(11).

[14] 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 called "THE CFTC GLOSSARY: A LAYMAN'S GUIDE TO THE LANGUAGE OF THE FUTURES INDUSTRY," CFTC P-105 (Revised 3-93).

[15] *Characteristics Distinguishing Cash and Forward Contracts and "Trade" Options*, 50 Fed. Reg. 39656-61 (Sept. 30, 1985) (full text of opinion contained in the appendix). 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.

the CFTC (although off-exchange trade options on non-agricultural commodities generally are permitted). Since the Commodity Exchange Act 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. It is important to note that the "right" to make delivery is different than the "obligation" to make delivery. With that in mind, the courts and the CFTC have said an option has these characteristics:

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

The CFTC Office of General Counsel has described a prohibited off-exchange trade option[17] 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."*[18]

Since the contract in the aforementioned example does not <u>require</u> 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 <u>not</u> the type of off-exchange contract currently permitted under current regulations. CFTC may, in the near future, consider lifting the regulatory ban on trade options

[16] 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, for example,* 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).

[17] CFTC regulations define a trade option as "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 byproducts 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."

[18] 50 Fed. Reg. 39660

through new rulemaking procedures.

Safe-Harbor Transactions

The CFTC staff has focused primarily on the issue of whether an agreement requires "delivery" in setting forth its examples of off-exchange, safe-harbor transactions. The following types of forward contracts meet the safe-harbor examples, provided that the seller of the commodity 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 does not establish a final price to be paid for the commodity, but rather the method by which a final price will be determined." 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, concerning this example, has said 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]." [19]

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 is generally outside the Act's regulatory scheme." Importantly, the CFTC said that "the option component [of the contract] is inseparable from the actual delivery of the commodity between participants in normal marketing channels."[20]

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 contract" does not turn the contract into a prohibited trade option or futures contract.[21] The down-side, however, is that an area of uncertainty remains. When do the contract's option-like or futures-like terms transform 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.

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[19] 50 Fed. Reg. 39660 (popularly known as the 1985 Interpretive Statement of the CFTC Office of the General Counsel)

[20] 50 Fed. Reg. 39660

[21] This was reaffirmed recently during the *CFTC Chairman's Roundtable on the Prohibition of Agricultural Trade Options* (Dec. 19, 1995) by Paul Architzel, CFTC Chief Counsel, Division of Economic Analysis. Transcript at pp. 8-12.

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 such guidance letters (CFTC Letters 95-104 and 96-23) issued recently are attached[22]. CFTC Letter 96-23 should be reviewed by those firms offering contracts with options-related features. In the example discussed in CFTC Letter 96-23, if the farmer-customer determines 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.

The Regulatory Environment/Role of CFTC Staff

As part of the process resulting in this white paper, the NGFA met with various CFTC staff members to determine their views on hybrid contracts. While the ultimate official interpretation of the Commodity Exchange Act is made by the courts and the CFTC commissioners, the CFTC staff do influence the day-to-day actions taken by the CFTC. Therefore, its views are extremely important. The following are some points to consider[23]:

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. It is not just what's on paper, but also how the parties actually conduct business. Does the final result have any relationship to the initial merchandising intent of the written contract?

2. Both CFTC legal professionals and economists are involved in analyzing particular fact situations.

3. So-called "walkaway" features in cash forward contracts are likely to be viewed by CFTC staff as turning the contract into a prohibited off-exchange option. 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/

[22] 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 agency. While guidance letters may be reliable indicators of the CFTC staff's current opinions, such letters do not prevent later action by the CFTC and/or private parties once the contracts are actually used.

23 The following points represent NGFA's interpretation of the views expressed by various CFTC staff members. Those CFTC staff members have not reviewed or endorsed NGFA's interpretation.

year different from the actual delivery period set forth in the contract. Does the futures month/ year referenced in the contract have a legitimate merchandising purpose? Are rollovers from one crop year to another consistent 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. However, in some cases, it may be difficult to obtain any official positive guidance letter on the issue.

7. Contracts which involve routine and repeated unpricing/repricing moves are not looked upon favorably. However, CFTC staff understands that uncontemplated situations might arise subsequent to contracting which 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.

9. If the CFTC decides to lift the ban[24] 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[25] specific cash forward contracts and fact patterns. This appears caused in part by the fact that no decision on whether to lift the ban on off-exchange agricultural trade options has been made yet. However, the CFTC staff has continued to provide written guidance in response to specific requests as to proposed contracts. Such requests can be made[26] by writing to: Paul M. Architzel, Esq., Chief Counsel, Division of Economic Analysis, U.S. Commodity Futures Trading Commission, 1155 21st Street, N.W., Washington, D.C., 20581; Phone: (202) 418-5000.

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

In addition to the CFTC's broad injunctive and enforcement powers, the agency may seek both civil and criminal penalties against individuals or firms violating the provisions of the Commodity

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[24] 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. 43560 (Sept. 3, 1991).

[25] 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.

[26] Firms are strongly urged to consult competent legal counsel before submitting such a request.

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**."

Moreover, it is a general rule of contract law that agreements involving promises that are otherwise illegal or immoral are not enforceable. A contract involving an off-exchange trade option or futures contract prohibited by the Commodity Exchange Act[27] runs the risk of being found wholly or partially unenforceable by state and federal courts.

As the 1985 interpretative statement issued by the CFTC Office of General Counsel shows, a cash forward contract does not automatically become a prohibited off-exchange options or futures contract merely because it contains some options-like features. Since 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 to rewrite the contract. That's a situation to be avoided.

Tax/Accounting Issues

Tax Issues

[27] 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." *See* 7 U.S.C. § 6.

The acquisition, maintenance, and sale of physical commodities in cash transactions embody many of the tax rules that apply to all commodity transactions. A taxpayer (in this discussion, a grain elevator) can acquire, maintain, and sell physical commodities in cash transactions with or without financing and with or without establishing an offsetting position.

As a first step, a taxpayer can simply purchase a physical commodity for immediate or deferred delivery, paying the entire purchase price with his own funds (outright purchase). The taxpayer can accept immediate delivery or agree to take delivery at a later date. Upon subsequent sale of the commodity at the prevailing market price, the taxpayer may realize an unlimited economic profit or a total loss of the investment. With selected options, a hedger or speculator may create a financial risk with unlimited downside potential.

Second, a taxpayer can finance all or a portion of the purchase price (financed purchase). Tax questions include whether the interest expense is deductible and whether the financing is included in the basis of the property. The taxpayer is not protected from the risk that the commodity will decline in value, and faces the potential for unlimited economic profit or a total loss of the investment. In addition, the taxpayer can lose more than the down payment on the purchase.

Third, a taxpayer can purchase or sell a commodity outright and establish an offsetting position, which could be subject to either hedging or straddle rules. This reduces the risk of loss in owning a commodity. The offsetting position might sell the commodity for a fixed price at a future date (futures or forward contract) or establish an options position or other offsetting position. By entering into an offsetting position, the taxpayer can lock in the sales price, thereby reducing both the risk of market price fluctuations and the profit potential.

Finally, a taxpayer can finance a purchase and establish an offsetting position subject to the straddle and hedging rules.

A taxpayer can acquire a physical commodity in the cash or spot market by purchasing it outright, for immediate or deferred delivery for the entire purchase price. The taxpayer can purchase the commodity for deferred delivery by:

- entering into a long futures contract position;
- privately negotiating a forward contract;
- establishing a short put option position (which may or may not result in delivery); or
- establishing a long call option position.

The character of any gain or loss on these contracts is determined by the status of the taxpayer -- that is, as an investor, trader, dealer or hedger. It is assumed for purposes of this discussion that most of the taxpayers will be classified as hedgers.

Hedgers use the commodity markets to protect the price at which they will acquire products needed in their businesses and to assure a market to sell their inventories, thereby generating ordinary income or loss treatment on their hedging transactions.

Traditionally, hedgers have used the futures market to hedge ordinary income positions in the underlying property. Hedging treatment depends on all relevant facts and circumstances. In general, however, a taxpayer using a futures contract, option, forward contract, notional principal contract, or other position to lock in the purchase or sale price of a product used in the ordinary course of his business is deemed to be a hedger under well-established legal doctrines.

Hedgers obtain ordinary income or loss on their financial product hedging transactions. In addition, those transactions that qualify as hedging transactions under the Internal Revenue Code are exempt from both the straddle loss deferral rules and the Section 1256 mark-to-market regime.

A hedging transaction is a transaction that a taxpayer enters into in the normal course of the taxpayer's trade or business, primarily:

- to reduce the risk of price changes or currency fluctuations with respect to ordinary property that is held or to be held by the taxpayer;

Or

- to reduce risk of interest rate or price changes or currency fluctuations with respect to borrowings made or to be made, or ordinary obligations incurred or to be incurred, by the taxpayer.

Recent Internal Revenue Service (IRS) regulations expand the scope of the hedging regulations in several ways. First, the regulations specifically describe various transactions as meeting the risk-reducing requirement. Second, the term "normal course of business" is defined broadly for purposes of these regulations. Third, the definition of ordinary property is expanded to include non-inventory supplies under certain circumstances.

A taxpayer is required to identify both its hedge and what it is hedging. Identification is to be unambiguous and retained as part of the taxpayer's books and records. The regulations contain additional identification requirements. For inventory hedges, a taxpayer is required to specify the type or class of inventory to which the transaction relates.

There are questions as to exactly what these identification requirements mean. Unfortunately, for those taxpayers unable to meet the identification requirement, the consequence is that the transaction fails to qualify for hedge treatment. Failure to qualify could convert the tax character on hedging transactions from ordinary to capital, resulting in a tax character whipsaw. A taxpayer who only hedges and does not speculate should be able to elect into ordinary treatment for all hedging activities. This election should be conditioned on practices and procedures of the taxpayer affirmatively prohibiting speculation. This blanket hedger election would replace any other identification requirements. Taxpayers are also allowed to establish hedge accounts where hedge positions are recorded in the taxpayer's books and records.

The IRS regulations contain rules for the timing of when hedging gains and losses are taken into account for tax purposes. Under the regulations, such timing is to clearly reflect the taxpayer's income and reasonably match the timing of similar items from the item being hedged. In other words, hedges of inventory are generally treated as adjustments to the cost or sales price of the corresponding inventory.

IRS regulations provide that if a hedging transaction is entered into to offset purchases of inventory, the resulting gain or loss on the transaction may be accounted for during the same time frame as it would be accounted for if the gain or loss were treated as an element of the cost of inventory. Similarly, if the hedging transaction offsets sales of inventory, the resulting gain or loss on the hedge may be taken into account during the same time period as it would be accounted for if the gain or loss were treated as an element of the sales proceeds.

Accounting Issues

The primary issues of concern in accounting for commodity instruments, including hybrid cash contracts, are:

- timing of recognition of the commodity contract;
- amounts to be recognized in the balance sheets and income statements with respect to such contracts; and
- disclosures required with respect to such contracts.

Many commodity contracts are accounted for by recognizing the fair value or market value of the contract, with changes in value recognized currently as income in gains or losses. The controversial recognition and measurement issues flow from the concepts and application of "hedge" or "deferral" accounting. Under the hedge or deferral accounting model, accounting recognition and/or changes in measurement of contracts or transactions may be deferred if the contract is used to "hedge" the risk in another consummated or anticipated transaction. FAS 80[28] sets forth certain criteria required to apply hedge accounting. The three general criteria for hedge accounting are:

- a market price risk exists and the contract accounted for as a hedge modifies the exposure to risk;
- the contract is designated to the specific transaction or portfolio of transactions that present the market risk; and

[28] Statement of Financial Accounting Standards No. 80, *Accounting for Futures Contracts*

- there must be high correlation between the offsetting effects of the hedging contract and the hedging contract at inception and throughout the life of the hedge.

Hedging Criteria

1. Exposure to and Reduction of Risk

The purpose of hedging is to reduce or manage risk. FAS 80 describes risk as "the sensitivity of an enterprise's income for one or more future periods to changes in market prices or yields of existing assets, liabilities, firm commitments, or anticipated transactions." FAS 80, paragraph 4.a., indicates that, for a futures contract to qualify as a hedge, the item to be hedged must expose the enterprise to price or interest rate risk. Thus, if a risk condition is offset or mitigated by other transactions or contracts in the enterprise, this criterion would not be met. If a company operates business units on a decentralized basis, the risk assessment may need to be made at the business unit level.

In addition, although risk reduction has frequently been identified as a necessary criterion for hedging, that criterion is frequently redefined as "risk management." Arguments have been put forth that risk reduction is a function of assumptions about future market conditions. Thus, a forward sale contract reduces risk if one assumes that prices will drop in the future but increases risk (reduces profit opportunity) if prices rise. It has become increasingly prevalent to refer to hedging strategies as risk management rather than risk reduction.

2. Designation

FAS 80 requires that the hedging item be designated as a hedge. It further provides that one or more hedging contracts may be designated as a hedge of an identified individual item or a portfolio of items. Designation of the item(s) being hedged is necessary to identify the characteristics and term of the hedge, to provide the basis for correlation measurement and ultimately to determine the timing and amount of gain or loss recognition on the strategy.

Hedge accounting is permissible for anticipated transaction under FAS 80 if the significant characteristics and expected terms of the anticipated transaction are identified and it is probable that the anticipated transaction will occur. This is a principal difference between FAS 52 and FAS 80. FAS 52 permits hedge accounting for anticipated foreign currency transactions only when the anticipated transaction is a firm commitment (rather than merely probable as in FAS 80).

3. Correlation

The third criterion concerns correlation between the hedge position and changes in the market value of the hedged item. FAS 80 requires that at the inception of the hedge, and throughout the hedge period, there must be high correlation between changes in the market value of the hedging instrument and changes in the market value of the hedged item. Although there is no formal defini-

tion of the level of correlation that is considered "high," correlation is generally considered high if it is 80 percent or higher. Further, to continue to apply hedge accounting, high correlation must be maintained throughout the life of the hedge. In practice, temporary lapses of high correlation do not require immediate cessation of hedge accounting. But lapses that are significant and sustained would require termination of hedge accounting.

The high correlation criterion is required because FAS 80 permits cross-hedging; that is, hedging may be accomplished through use of offsetting contracts with different but related prices. Because the effectiveness of cross-hedging depends on a sustained relationship between the cross-hedged items, it is necessary to demonstrate high correlation at the inception of the strategy and to test the continued correlation through the duration of the strategy.

Summary

Accounting for futures contracts is governed by FAS 80 and requires that changes in the market value of futures contracts must be recognized as income in the period in which the changes occur unless the contract qualifies for hedge accounting. Although many commodity contracts do not fall within the definition of futures contracts, FAS 80 generally is applied by analogy. Thus, hedge accounting may be applied in accounting for commodity contracts that meet the criteria set forth in FAS 80 and generally are accounted for at market value with changes recognized as income in the period of the change.

Conclusions

Hybrid cash contracts are intended to provide flexible marketing tools for producers and consumers. Used properly, they can allow a customer to fine-tune pricing decisions, especially the futures portion of the cash contract. Effectively incorporating these contracts into an overall marketing plan can improve average prices received by the customer and,

potentially, help stabilize annual revenues. Historical price patterns, changes in farm support programs, and expanded free trade suggest the need for improved risk-management tools, which should result in further growth in the utilization of flexible cash contracts and more complex marketing strategies.

However, properly utilizing these contracts requires extra effort and diligence on the part of both buyers and sellers. Strong organizational support -- legal, accounting, risk management, finance and administration -- is required to develop effective systems and controls to identify and manage the added risk of these products and to assure that they are used for the purpose intended. Most importantly, both buyer and seller should understand all contract terms and conditions prior to entering into contracts with higher risk profiles.

Are hybrid cash contracts useful marketing tools?	YES!	
Are all hybrid cash contracts appropriate?		NO!
Are all customers candidates for hybrid cash contracts?		NO!
Are hybrid cash contracts appropriate for all companies?		NO!

Each situation needs to be judged on its merit. A contract generally considered appropriate would not be acceptable if offered inappropriately or offered to the wrong customer. Much depends on how prepared both the buyer and seller are to utilize the contract.

The following recommendations, supporting checklists, and *pro forma* contract forms provide critical guidelines for elevators offering hybrid cash contracts. In addition, they can serve as a useful tool for users to manage the risk associated with hybrid cash contracts. The recommendations are not intended to be all inclusive, but will provide a dependable framework to determine the suitability of hybrid contracts.

Supporting the recommendations are two checklists. One checklist, identified as an "Internal Checklist," is intended to help guide decision-making to determine whether to offer hybrid cash contracts and whether appropriate internal controls exist. Each new contract should be tested against this checklist prior to offering a new contract strategy. A second checklist, identified as "Customer Checklist," provides guidelines to help determine if certain contracts are suitable for specific customers. The checklist can be used by both buyers and sellers to determine the appropriateness of a specific contract strategy for either or both parties.

Recommendations

Recommendation #1: Develop an "Internal Checklist" to insure that management properly reviews a new contract/strategy before it is offered to customers. See the following "Checklist" section for suggestions on the construction of such an "Internal Checklist."

Recommendation #2: Develop a second "Customer Checklist" to evaluate the suitability of engaging in a specific hybrid cash contract/strategy with a specific customer. The checklist should help insure that the customer thoroughly understands the contract and determine the risks a customer is willing/able to assume. See the "Checklist" section for suggestions on the construction of a "Customer Checklist."

Recommendation #3: Risks associated with entering into a hybrid cash contract should be completely disclosed and explained to customers. It is recommended that buyers offering such contracts develop an appropriate risk disclosure statement to help customers understand some potential outcomes under various market scenarios. To that end, it is recommended that the Trade Rules Committee of the National Grain and Feed Association consider the appropriateness of a trade rule concerning disclosure of risks involved in hybrid cash contracts.

Recommendation #4: Providers of hybrid cash contracts should provide regular, timely updates to customers on the market value of their hybrid cash contracts. Communicating with the customer after the contract is written is very important to avoid potential conflict regarding the outcome of a strategy/contract.

Recommendation #5: A "Risk Assessment & Control Diagnostic" is recommended for the operations of those engaging in hybrid cash contracts. To a certain extent, this kind of "self-monitoring" can be accomplished by adhering to a pre-contract checklist, as in the following sections. If internal resources are insufficient, or as an additional safeguard, an outside independent consultant should be considered. In addition, at a minimum, the following should be reviewed:

- Policies, practices and procedures guiding the approval, usage, operations, accounting and control over cash hybrid instruments;
- Reporting, measurement and valuation of exposures resulting from cash, cash hybrid, and derivative transactions and instruments;
- The capabilities of hardware and software systems to effectively support the confirmation, monitoring, amendment, risk management and settlement processes;
- Management understanding and approval of these instruments, as well as their current and future financial impact on the organization.

Recommendation #6: Having detailed, *daily* management information is important when using or offering hybrid cash contracts. This is critical for management/merchandisers to be able to correctly measure/manage risk. This information includes, but is not limited to:

- a daily position report showing price, basis and spread risk by delivery time periods. This position report should include all option positions held against company risk or against customer obligations.

- a summary listing of open contracts, showing totals by type of contract and by delivery period.

- overdue contracts.

Recommendation #7: All firms that offer/use hybrid cash contracts need to insure that the appropriate personnel thoroughly understand all strategies that are offered and know how to manage the associated risks. Firms that offer such strategies also are encouraged to provide meetings or programs for customers to help them better understand the strategies. This also provides an opportunity for the buyer to evaluate how well the customer is informed.

Recommendation #8: Communication is critical. Firms that use hybrid cash contracts need to insure that information on the type and level of risk exposure is shared to provide checks and balances. This includes internal communication from "line" personnel to upper management/board, and communication with appropriate outside parties, including lenders.

Recommendation #9: Establish regular meetings (probably seasonal) with lending institutions. The purpose of the meetings is to communicate marketing strategies, describe any new contracts, and project potential financing needs under different market conditions.

Recommendation #10: Establish a customer risk disclosure document. The document would identify the risks of each contract type the customer is utilizing in his marketing program. This document should be signed by the customer in addition to signing the individual contract, which should also include an appropriate risk disclosure.

Internal Checklist

✔ Is there state law/regulation governing the introduction and use of new contract types/language? If so, has the contract been subjected to appropriate review to determine if it complies with such law/regulation?

✔ Has management reviewed and approved the use of a new contract type?

✔ Has the contract been thoroughly reviewed by competent legal counsel?

✔ Is the contract worded clearly for the customer?

✔ Is the internal accounting system properly configured to track and report positions, both overall and customer-by-customer? The system should show all of the following company positions, at a minimum:

- ➢ net price risk for the company;
- ➢ net impact on basis exposure;
- ➢ subtotals on price/basis risk by delivery time periods;
- ➢ Hedge-to-arrive contracts separate from fixed-basis contracts;
- ➢ spread risk exposure.
- ➢ mark-to-market contracts by customer.

✔ Is management satisfied that all involved personnel understand the strategy and how to manage the associated risks?

✔ Is there a process for approving the offering of hybrid contracts to individual accounts?

- ➢ Is there a mechanism for gathering and evaluating the financial capability of producer/customers to engage in hybrid contracts?
- ➢ Are landlord/tenant accounts set up correctly? Is trading legally authorized?
- ➢ Is there a contingency for requesting margins from the producer?
- ➢ Is there a plan for customer education?

✔ Has a risk-disclosure statement/customer agreement been developed and consistently used?

✔ Has the financial impact of offering a type of contract been reviewed?

- ➢ Does the lender understand and endorse the offering of the contract?
- ➢ Has the impact on the company's credit line been evaluated?
- ➢ Has a model for cash flow (margin) borrowing been developed?

✔ Is there a confirmation process for initial contracts and amendments?

- ➢ sending confirmations/contracts with sufficient detail;
- ➢ monitoring receipt of signed contracts;
- ➢ confirmations/contracts signed by authorized persons.

✔ Is there a means to track overdue contracts? Contracts with inter-crop spreads? Significant negative contract equity?

✔ Have position limits been developed for the elevator's positions and customer positions?

✔ Is there a regular internal account/position review process?

- ➢ basis exposure within approved limits;
- ➢ price exposure within approved limits.

Customer Checklist

✔ Is a particular strategy suitable for a specific customer?

- ➢ Has the customer's financial capability been analyzed? Balance sheet? Operating statement? Production capacity?
- ➢ What is the individual's pattern of doing business? Reputable individual? Known to be litigious?
- ➢ What type/volume of business does the individual do with other elevators?

✔ Have the market risks associated with the strategy been reviewed with the customer before any grain is bought or sold?

- ➢ price risk, basis risk, spread risk.

✔ Does the customer have legal authorization to enter contracts on behalf of the farm/business?

✔ Is the account current on contract deliveries? Accounts receivable?

✔ Has the customer participated in educational meetings? Does the customer fully understand the contract?

✔ Does the customer have sufficient working capital to cover exposure in a poor year?

✔ Is the legal account name consistent with financial capability?

✔ Are all contract confirmations signed and returned?

✔ Is the customer assigned to a specific company representative?

✔ Have internal "trade rules" been shared with the customer?

✔ Does the customer understand that rules and allowable positions may change over time?

✔ Will you be able to monitor the customer's sales (purchases, if a consumer) compared to annual production (usage, if a consumer)?

APPENDIX A

Appendix A contains two sample contracts:

1. A sample hedge-to-arrive contract;

2. A sample minimum price contract.

Both sample contracts are intended to be used for discussion purposes only. They are **not** intended to be used verbatim in their current form. In some cases, state law may require different or additional terms. Likewise, an organization's own business practices may necessitate different or additional terms. Organizations considering offering these or other types of contracts should first consult competent legal counsel to determine the appropriateness of particular contracts and business practices.

APPENDIX B

Appendix B contains several documents generated by the Commodity Futures Trading Commission relevant to the discussion of hybrid cash contracts. Documents include:

SAMPLE

HEDGE-TO-ARRIVE PURCHASE CONTRACT

BUYER: [XYZ Grain Company, full address] (the Buyer)

SELLER: [Joe Pro Family Farm, Inc. full address] (the Seller)

The Buyer and Seller agree, with the intent that each be contractually bound, as follows:

1. The Buyer has this ____ day of _____, 19___, purchased from Seller and Seller agrees to deliver the following described agricultural commodity in the amount and subject to the terms, conditions and specifications set forth in this contract.

2. a.) Description:

Net Quantity	Commodity	Grade	Delivery Period	Delivery Location	Weights to Apply	Grades to Apply

b.) Pricing Terms: The parties agree that the final cash price of the agricultural commodity being sold by the Seller shall be the sum of the **Futures Contract Price + The Basis** as determined under the terms of this contract referencing the following factors:

Futures Exchange	Futures Contract	Futures Contract	A. Futures Contract Price	B. Basis	Final Cash A+B	Pricing
				not yet determined	not yet determined	

c.) other terms:

_____

_____

_____

3. **IMPORTANT -- Future action needed by Seller to establish Final Cash Price:** The price (*Referred to as the **Final Cash Price***) paid by the Buyer for the commodity being sold by the Seller shall be determined by the formula set forth in this contract. One portion of the formula used for determining the Final Cash Price is called "the Basis."

   In this contract, the Basis is to be determined at a future date. The Final Cash Price to be paid by the Buyer to the Seller will be determined by the Basis, which changes with market conditions. It is the Seller's responsiblity to monitor this contract and market conditions. It is the Seller's responsiblity to take action to establish the Basis prior to the Pricing Deadline set forth in this contract.

4. **Final Cash Price** -- The Final Cash Price to be paid to Seller shall be the Futures Contract Price set forth above plus the applicable Basis, determined according to the terms of this contract. **A negative basis shall result in a Final Cash Price lower than the Futures Contract Price set forth above.**

5. **Payments to Seller**: Payments due Seller under this contract will be paid after delivery and acceptance by Buyer of the contracted commodity at the Final Cash Price determined according to the terms of this contract. In addition to any other allowable deductions or offsets, any payments to Seller for grain delivered under this contract shall be subject to prior deduction for applicable discounts, storage, drying or other service charges owed to Buyer.

6. **Applicable Basis**: The basis level (Basis) shall be determined by (1) the Buyer's then-cash bid for the delivery period and location shown in this contract at the time the Seller elects to fix the basis minus (2) the then-currently tradeable futures price of the futures contract month/year shown above, at the time the Seller elects to fix the basis. **Seller has the responsibility to make a timely election as to the date on which basis is determined, but Seller acknowledges that Buyer's then-cash bid used for establishing basis is a decision made by the Buyer.**

7. **Pricing Deadline**: Seller has the right and obligation to elect the date on which basis is established (*i.e.* fix the basis) provided that such election is made before expiration of the pricing deadline set forth above. Seller may only exercise its right to fix the basis by actual notification to Buyer during an actively trading daytime session of the futures exchange referenced in this contract.

   Consequences of Seller's Failure to Meet Pricing Deadline: If Seller fails to fix the basis by the pricing deadline, then Buyer has the right to fix the basis on the next business day following the pricing deadline. Any basis established by the Buyer shall then be used to determine the final cash price due the Seller.

8. **No futures contract month/year "rollover" allowed**: The Seller is not entitled to change the referenced futures contract month/year set forth above.

9. ***Seller's Delivery Warranty**: Seller has an obligation to deliver the agricultural commodity described in this contract during the Delivery Period. Seller's obligation to deliver is absolute and Seller warrants that it will deliver the quantity described above regardless of any other similar delivery commitments Seller has or may have with Buyer or any other parties.*

10. **Seller's Obligation to Provide Cash Performance Guarantee(s)**: Seller acknowledges that it has the obligation to provide Buyer with assurances that it will perform and make timely delivery of the agricultural commodity set forth in this contract. The Seller also acknowledges that the nature of this contract may result in financial exposure to Buyer. **Seller agrees, that within 48 hours of a request made by Buyer, to provide Buyer with a cash deposit not to exceed the then-current market value for an agricultural commodity of like kind and delivery period minus the then-contract value as determined by the Buyer.**

11. **Grade and Quality Specifications/Premiums and Discounts**: The quality of agricultural commodity delivered under this contract shall be determined at the time of delivery, with the weights and grades at the destination location to govern. Seller is obligated to deliver the grade and quality specified in this contract. Buyer reserves the right to reject individual shipments not complying with the contract terms. If the Buyer elects to accept deliveries not meeting the contract grade and quality, the scale of discounts and premiums at time of delivery shall apply, unless otherwise specified in writing. Refusal of the Buyer to accept delivery of agricultural commodities not meeting this contract's terms shall not release Seller from this contract.

12. **Merchantable Quality**: All grain delivered by Seller to Buyer under this contract shall be of merchantable quality, unadulterated, and unrestricted from movement in interstate commerce within the meaning of the Federal Food, Drug, and Cosmetics Act, the U.S. Grain Standards Act, and all other applicable local, state and federal laws.

13. **Buyer's Right to Delay Delivery Period**: The Buyer has the right, without penalty, to delay the time for accepting delivery and making payment under this contract if such delay is caused by government regulation or action, labor strikes, riots, insurrection, freight embargoes, or transportation delays. It shall be the duty of the Buyer to accept delivery and make payment under this contract as soon as practicable after the cause for delay has ceased.

14. **Title/Liens/Offsets**: Seller warrants and represents that the grain delivered under this contract shall be free and clear of all liens and encumbrances and that good and clear title to the agricultural commodity is being conveyed to Buyer. If any security interests or other liens are made known to or discovered by Buyer prior to delivery of the agricultural commodity, acceptance of the agricultural commodity shall be at the option of Buyer. The Seller expressly agrees that Buyer has the right to issue multiple party checks for payment of the agricultural commodity should the Buyer have any reason to believe that any third party has or may assert a lien or encumbrance against the agricultural commodity delivered under this contract. Buyer shall also have the right to offset any monies otherwise payable to Seller against debts or charges due Buyer from Seller.

15. **Seller Liable for Attorney Fees, Cost of Collection, Interest**: In the case of Seller's default of any of its obligations in this contract, Seller shall be liable to Buyer for all costs incurred (including attorney fees) in enforcing this contract and/or collecting any damages found owing to Buyer. Seller shall also be liable for the payment of interest at the rate of ___ % per annum from the date of default on any damages or sums found owing to Buyer.

16. **NGFA Arbitration of Disputes**: The parties to this contract agree that the sole remedy for resolution of any and all disagreements or disputes arising under this contract shall be through arbitration proceedings before the National Grain and Feed Association (NGFA) pursuant to the NGFA Arbitration Rules. The decision and award determined through such arbitration shall be final and binding upon the Buyer and Seller. Judgment upon the arbitration award may be entered and enforced in any court having jurisdiction thereof. (Copies of the NGFA Arbitration Rules are available upon request; or by contacting the National Grain and Feed Association, 1201 New York Ave., N.W., Suite 830, Washington, DC 20005.)

17. **Applicable Law**: This contract shall be governed by, and construed in accordance with, the laws of the State of _____.

18. **Final and Complete Agreement**: This contract shall represent the final, complete and exclusive statement of the agreement between the parties and may not be amended, supplemented or waived, except in writing signed by both parties.

19. **Successors and Assigns**: This contract, and any valid written and signed amendments, shall be binding upon and inure to the benefit of the parties hereto and their respective heirs, personal representatives and successors of the respective parties. *This contract may not be assigned by Seller unless express written consent is first obtained from Buyer.*

The parties and/or their authorized representatives set forth their agreement to the terms of this contract:

Name of Seller:
[Authorized Signature(s)]:_____

Title(s) of signatory(s), if applicable:_____

Name of Buyer:
[Authorized Signature(s)]: _____

Title: _____

SAMPLE

"MINIMUM PRICE" PURCHASE CONTRACT

BUYER: [XYZ Grain Company, full address] (the Buyer)

SELLER: [Joe Pro Family Farm, Inc. full address] (the Seller)

The Buyer and Seller agree, with the intent that each be contractually bound, as follows:

1. The Buyer has this ____ day of _____, 19___, purchased from Seller and Seller agrees to deliver the following described agricultural commodity in the amount and subject to the terms, conditions and specifications set forth in this contract.

2. a.) Description:

Net Quantity	Grade	Commodity	Delivery Period	Delivery Location	Weights to Apply	Grades to Apply

b.) Pricing Terms: The parties agree that the Final Cash Price of the agricultural commodity being sold by the Seller shall be the sum of the **Minimum Cash Price plus Price-Out Value, if any,** as determined under the terms of this contract referencing the following factors:

Futures Exchange:	Beginning Cash Price	
Futures Contract Month/Year:	Less: Strike Price Cost/ Service Charges	
Futures Strike Price:	= Minimum Cash Price	
Pricing Deadline:	+ Price-Out Value (if any)	Not yet determined
	= Final Cash Price	Not yet determined

IMPORTANT -- Future action needed by Seller to establish Final Cash Price: *The price (referred to as the* ***Final Cash Price****) paid by the Buyer for the commodity being sold by the Seller shall be determined by the formula set forth in this contract.* ***It is Seller's responsiblity to monitor this contract and market conditions. It is the Seller's responsiblity to take action to establish the Final Cash Price prior to the Pricing Deadline set forth in this contract. This contract's references to a regulated futures exchange and other "futures" terms are solely for purposes of calculating the Buyer's payment obligations to Seller hereunder.***

c.) other terms:

_____

_____

_____

3. **Price Out Value**: The Price-Out Value shall be the amount, if any, by which the commodity price of the above referenced Futures Contract Month/Year and trading on the stated Futures Exchange shall exceed the Strike Price on the Pricing Date as determined in accordance with the "Pricing Deadline and Procedure" set forth in this contract.

4. **Final Cash Price/Minimum Cash Price** -- The Final Cash Price to be paid to Seller shall be the guaranteed Minimum Cash Price plus the Price-Out Value, if any, determined according to the terms of this contract. Prior to the Pricing Deadline, Seller has the right to notify Buyer to establish a Price Out Value.

5. **Pricing Deadline and Procedure**: Seller has the right and obligation to elect the Pricing Date on which the Price-Out Value and Final Cash Price is established provided that such election is made before expiration of the Pricing Deadline. Seller may only exercise its right to establish the Final Cash Price by actual notification to Buyer during times of an actively trading daytime session of the futures exchange referenced in this contract.

   Consequences of Seller's Failure to Meet Pricing Deadline: If Seller fails to establish the Final Cash Price before _____ (time of day) on the Pricing Deadline date, then Buyer has the right to establish the Price-Out Value and the Final Cash Price during any subsequent actively trading daytime session of the futures exchange referenced in this contract.

6. **Payments to Seller**: Payments (including the Price Out Value, if any) due Seller under this contract will be paid after delivery and acceptance by Buyer of the contracted commodity at the Final Cash Price determined according to the terms of this contract. In addition to any other allowable deductions or offsets, any payments to Seller for grain delivered under this contract shall be subject to prior deduction for applicable discounts, storage, drying or other service charges owed to Buyer. Seller shall receive any appropriate credits for items prepaid by Seller.

7. ***Seller's Delivery Warranty**: Seller has an obligation to deliver the agricultural commodity described in this contract during the Delivery Period. Seller's obligation to deliver is absolute and Seller warrants that it will deliver the quantity described above regardless of any other similar delivery commitments Seller has or may have with Buyer or any other parties.*

8. **Grade and Quality Specifications/Premiums and Discounts**: The quality of agricultural commodity delivered under this contract shall be determined at the time of delivery, with the weights and grades at the destination location to govern. Seller is obligated to deliver the grade and quality specified in this contract. Buyer reserves the right to reject individual shipments not complying with the contract terms. If the Buyer elects to accept deliveries not meeting the contract grade and quality, the scale of discounts and premiums at time of delivery shall apply, unless otherwise specified in writing. Refusal of the Buyer to accept delivery of agricultural commodities not meeting this contract's terms shall not release Seller from this contract.

9. **Merchantable Quality**: All grain delivered by Seller to Buyer under this contract shall be of merchantable quality, unadulterated, and unrestricted from movement in interstate commerce within the meaning of the Federal Food, Drug, and Cosmetics Act, the U.S. Grain Standards Act, and all other applicable local, state and federal laws.

10. **Buyer's Right to Delay Delivery Period**: The Buyer has the right, without penalty, to delay the time for accepting delivery and making payment under this contract if such delay is caused by government regulation or action, labor strikes, riots, insurrection, freight embargoes, or transportation delays. It shall be the duty of the Buyer to accept delivery and make payment under this contract as soon as practicable after the cause for delay has ceased.

11. **Title/Liens/Offsets**: Seller warrants and represents that the grain delivered under this contract shall be free and clear of all liens and encumbrances and that good and clear title to the agricultural commodity is being conveyed to Buyer. If any security interests or other liens are made known to or discovered by Buyer prior to delivery of the agricultural commodity, acceptance of the agricultural commodity shall be at the option of Buyer. The Seller expressly agrees that Buyer has the right to issue multiple party checks for payment of the agricultural commodity should the Buyer have any reason to believe that any third party has or may assert a lien or encumbrance against the agricultural commodity delivered under this contract. Buyer shall also have the right to offset any monies otherwise payable to Seller against debts or charges due Buyer from Seller.

12. **Seller Liable for Attorney Fees, Cost of Collection, Interest**: In the case of Seller's default of any of its obligations in this contract, Seller shall be liable to Buyer for all costs incurred (including attorney fees) in enforcing this contract and/or collecting any damages found owing to Buyer. Seller shall also be liable for the payment of interest at the rate of ___ % per annum from the date of default on any damages or sums found owing to Buyer.

13. **NGFA Arbitration of Disputes**: The parties to this contract agree that the sole remedy for resolution of any and all disagreements or disputes arising under this contract shall be through arbitration proceedings before the National Grain and Feed Association (NGFA) pursuant to the NGFA Arbitration Rules. The decision and award determined through such arbitration shall be final and binding upon the Buyer and Seller. Judgment upon the arbitration award may be entered and enforced in any court having jurisdiction thereof. (Copies of the NGFA Arbitration Rules are available upon request; or by contacting the National Grain and Feed Association, 1201 New York Ave., N.W., Suite 830, Washington, DC 20005.)

14. **Applicable Law**: This contract shall be governed by, and construed in accordance with, the laws of the State of _____.

15. **Final and Complete Agreement**: This contract shall represent the final, complete and exclusive statement of the agreement between the parties and may not be amended, supplemented or waived, except in writing signed by both parties.

16. **Successors and Assigns**: This contract, and any valid written and signed amendments, shall be binding upon and inure to the benefit of the parties hereto and their respective heirs, personal representatives and successors of the respective parties. *This contract may <u>not</u> be assigned by Seller unless express written consent is first obtained from Buyer.*

The parties and/or their authorized representatives set forth their agreement to the terms of this contract:

Name of Seller:
[Authorized Signature(s)]:_____

Title(s) of signatory(s), if applicable:_____

Name of Buyer:
[Authorized Signature(s)]: _____

Title: _____

1. *Characteristics Distinguishing Cash and Forward Contracts and "Trade" Options*, published in the ***Federal Register*** on September 30, 1985. Provides guidance from the CFTC's Office of General Counsel on areas of CFTC jurisdiction.

2. Correspondence from CFTC Off-Exchange Task Force (undated), regarding the exclusion of forward contracts from CFTC jurisdiction. (CFTC Letter No. 95-104)

3. Correspondence from CFTC Division of Economic Analysis (undated), regarding CFTC staff's definition of contract delivery requirements and CFTC jurisdiction. (CFTC Letter No. 96-23)

Authority. 49 U.S.C. 1348(a), 1354(a), 1510; Executive Order 10854; 49 U.S.C. 106(g) (Revised Pub. L. 97-449, January 12, 1983); 14 CFR 11.69.

6. Section 75.100 is amended as follows:

J-11, J-44, J-18, J-19, J-102, J-65, and J-181 [Amended]

Where "Phoenix" appears substitute "Salt River"

J-4 and J-50 [Amended]

Where "Casa Grande" appears substitute "Stanfield"

J-92 [Amended]

Where "Phoenix" appears substitute "Salt River" and where "Casa Grande" appears substitute "Stanfield"

Issued in Washington, D.C., on September 20, 1985.

Daniel J. Peterson,

Manager, Airspace-Rules and Aeronautical Information Division.

[FR Doc. 85-23211 Filed 9-27-85; 8:45 am]

BILLING CODE 4910-13-M

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14 CFR Parts 71 and 75

[Airspace Docket No. 84-AWA-24]

Alteration of Jet Routes and VOR Federal Airways—Indiana

AGENCY: Federal Aviation Administration (FAA), DOT.

ACTION: Final rule.

SUMMARY: This amendment realigns one Jet Route and five Federal Airways and cancels one Federal Airway. All actions arise from decommissioning of the Lewis, IN, Very High Frequency Omni-Directional Radio Range and Tactical Air Navigation Aid (VORTAC). The affected Jet Route and Federal Airways will be realigned using the upgraded Terre Haute, IN, VORTAC. These actions are expected to help increase utility and efficiency in use of navigational aids (NAVAID) by users of the National Airspace System (NAS).

EFFECTIVE DATE: 0901 GMT, November 21, 1985.

FOR FURTHER INFORMATION CONTACT: Gene Falsetti, Airspace and Air Traffic Rules Branch (ATO-230), Airspace-Rules and Aeronautical Information Division, Air Traffic Operations Service, Federal Aviation Administration, 800 Independence Avenue, SW., Washington, D.C. 20591; telephone: (202) 426-8783.

SUPPLEMENTARY INFORMATION:

History

On November 15, 1984, the FAA proposed to amend Parts 71 and 75 of the Federal Aviation Regulations (14 CFR Parts 71 and 75) to realign one Jet Route, five VOR Federal Airways and cancel one VOR Federal Airway (49 FR 45171. These actions were proposed due to decommissioning of the Lewis, IN, VORTAC. Functions of the old Lewis VORTAC are transferred to the upgraded Terre Haute, IN, VORTAC. Interested parties were invited to participate in this rulemaking proceeding by submitting written comments on the proposal to the FAA. No comments objecting to the proposal were received. Except for editorial changes, and a slight change to the original proposed alignment of Federal Airway V-7, these amendments are the same as those proposed in the notice. As proposed in the NPRM the revised V-7 would have been realigned direct between Pocket City and Terre Haute. However, to ensure airway clearance from the Red Hills MOA, the airway is configured from the Pocket City 016° and the Terre Haute, IN, 191° radials. Sections 71.123 and 75.100 of Parts 71 and 75 of the Federal Aviation Regulations were republished in Handbook 7400.6A dated January 2, 1985.

The Rule

These amendments to Parts 71 and 75 of the Federal Aviation Regulations realign Jet Route J-73, Federal Airways V-7, V-12, V-171, V-221 and V-243 and cancels V-514.

The FAA has determined that this regulation only involves an established body of technical regulations for which frequent and routine amendments are necessary to keep them operationally current. It, therefore—(1) is not a "major rule" under Executive Order 12291; (2) is not a "significant rule" under DOT Regulatory Policies and Procedures (44 FR 11034; February 26, 1979); and (3) does not warrant preparation of a regulatory evaluation as the anticipated impact is so minimal. Since this is a routine matter that will only affect air traffic procedures and air navigation, it is certifed that this rule will not have a significant economic impact on a substantial number of small entities under the criteria of the Regulatory Flexibility Act.

List of Subjects in 14 CFR Parts 71 and 75

Aviation safety, VOT Federal airways and Jet routes.

Adoption of the Amendments

Accordingly, pursuant to the authority delegated to me, Parts 71 and 75 of the Federal Aviation Regulations (14 CFR Parts 71 and 75) as amended (49 FR 48532, 50 FR 14092 and 50 FR 28398) are further amended, as follows:

PART 71—[AMENDED]

1. The authority citation for Part 71 continues to read as follows:

Authority: 49 U.S.C 1348(a), 1354(a), 1510; Executive Order 10854; 49 U.S.C. 106(g) (Revised Pub. L. 97-449, January 12, 1983); 14 CFR 11.69.

2. Section 71.123 is amended as follows:

V-7 [Amended]

By removing the words "INT Pocket City 015° and Lewis, IN, 198° radials, Lewis; Terre Haute, IN;" and substituting the words "INT Pocket City 016° and Terre Haute, IN, 191° radials; Terre Haute;

V-12 [Amended]

By removing the words "Lewis, IN;"

V-171 [Amended]

By removing the word "Lewis;" and substituting the words "Terre Haute;"

V-221 [Amended]

By removing the words "via INT Bible Grove 087° and Bloomington, IN, 253° radials; Bloomington;" and substituting the words "via Bloomington, IN;"

V-243 [Amended]

By removing the words "Lewis, IN." and substituting the words "Terre Haute, IN."

V-514 [Revoked]

3. The authority citation for Part 75 continues to read as follows:

Authority: 49 U.S.C. 1348(a), 1354(a), 1510; Executive Order 10854; 49 U.S.C. 106(g) (Revised Pub. L. 97-449, January 12, 1983); 14 CFR 11.69.

4. Section 75.100 is amended as follows:

J-73 [Amended]

By removing the words "Lewis, IN;" and substituting the words "Terre Haute, IN;"

Issued in Washington, D.C., on September 23, 1985.

Daniel J. Peterson,

Manager, Airspace-Rules and Aeronautical Information Division.

[FR Doc. 85-23210 Filed 9-27-85; 8:45 am]

BILLING CODE 4910-13-M

COMMODITY FUTURES TRADING COMMISSION

17 CFR Ch. I

Characteristics Distinguishing Cash and Forward Contracts and "Trade" Options

AGENCY: Commodity Futures Trading Commission.

ACTION: Interpretative Statement of the Office of the General Counsel.

SUMMARY: In 1982, Congress authorized the Commodity Futures Trading Commission to establish a pilot program for option trading on agricultural commodities. The Commission determined to permit the offer and sale of agricultural options on contract markets. At the same time, it considered whether to permit so-called "trade" options, *i.e.*, off-exchange options on a physical commodity entered into among commercial users of the commodity or its byproducts, in the initial phase of the pilot agricultural program. However, the Commission deferred the final decision whether to permit trade options until there had been greater experience with the agricultural option pilot program.

Since this pilot program began, the staff has received inquiries and information about various proposed and already existing commodity contracts between agricultural producers and merchants in which the producer pays a "premium" in return for a minimum guaranteed price for the commodity. Certain of these contracts have characteristics of both "forward" and option contracts. Forward contracts are generally exempt from the Commodity Exchange Act's regulatory scheme. In contrast, trade options are not currently permitted under the agricultural option pilot program. Therefore, the Office of the General Counsel is issuing this interpretation regarding the nature of these types of instruments and distinctions between them to provide guidance to the public.

ADDRESS: Any comments on this interpretation should be sent to Kenneth M. Raisler, General Counsel; Office of the General Counsel; Commodity Futures Trading Commission; 2033 K Street, NW; Washington, DC 20581.

FOR FURTHER INFORMATION CONTACT: Joan L. Loizeaux, Assistant General Counsel; Office of the General Counsel: Commodity Futures Trading Commission; 2033 K Street, NW; Washington, DC 20581; (202) 254-9880.

SUPPLEMENTARY INFORMATION: The Commodity Exchange Act ("Act") creates a comprehensive framework for the regulation of futures contracts and options. Thus, no person may offer, enter into or confirm a commodity option transaction unless that transaction is specifically permitted under the Commission's rules.[1] Similarly, the Act prohibits the offer and sale of a contract for future delivery of a commodity unless that contract is effectuated on or subject to the rules of a board of trade (exchange) that has been designated a contract market.[2] To obtain this designation, a board of trade must satisfy the criteria set forth in the Act including enforcing its rules to prevent manipulations and corners of the market.[3] After its designation the contract market must continue to satisfy these initial criteria, as well as fulfill ongoing requirements set forth in the Act.[4]

However, Congress generally exempted from the Act's regulatory scheme commercial, merchandizing transactions in a physical commodity in which delivery was delayed or deferred for commercial convenience or necessity. Thus, section 2(a)(1)(A) provides that the term "future delivery" does not include "any sale of any cash commodity for deferred shipment or delivery." [5] The history of this exemption and its use in commercial practice, together with a brief description of options and the Commission's regulation of options, are set forth below.

A. The Exclusion of Forward Contracts from the Scope of the Commodity Exchange Act

In 1921, Congress enacted the Futures Trading Act to curb both the increasingly disruptive activities by grain speculators on exchanges and the proliferation of off-exchange "bucket" shop operations.[6] Congress sought to bring federal control to futures trading to prevent economic disturbances in the price of grain, by imposing a "prohibitive tax" [7] on contracts for future delivery not traded on contract markets. However, witnesses testified before the Congressional committees considering the bill that there were a variety of legitimate off-exchange commercial transactions in which delivery of the grain was delayed.[8] Thus, then-Secretary of Agriculture Henry Wallace urged that the bill preserve the right to buy or sell part of next season's crop which had not yet been planted or harvested "but which would exist in time for delivery." [9] Another witness urged Congress to distinguish prohibited futures contracts.

> from transactions which might be made for forward delivery or forward shipment, such, for example, as an exporter might enter into obligating himself to ship a certain amount of grain three months hence, which would be a transaction for future delivery, but which the Secretary thought was not really intended to be governed by this bill.[10]

Therefore, to make clear that forward contracts were not to be subject to taxation, the Senate added language to section 2 of the bill to exclude "any sale of cash grain for deferred shipment" from the term "future delivery." [11] This exclusion was designed to make clear that all "cash grain sales in which actual delivery of the physical commodity is deferred for later shipment" were exempt from taxation under the Act.[12]

To determine whether a particular contract is exempt from the Act's jurisdiction as a forward contract, the courts and the Commission have required that the contract's terms and the parties' practice under the contract make clear that

> both parties to the contracts deal in and contemplate future delivery of the *actual* . . . [commodity].[13]

First, the contract must be a binding agreement on both parties to the contract: one must agree to make delivery and the other to take delivery

[1] Sections 4c(b), 4c(c), 4c(d), 7 U.S.C. 6c(b), 6c(c), 6c(d) (1982). *See, e.g.*, Parts 32 and 33 of the Commission's rules, 17 CFR Parts 32, 33 (1984).

[2] Section 4(a), 7 U.S.C. 6(a) (1982).

[3] Sections 5, 5(d), 7 U.S.C. 7, 7(d) (1982).

[4] Section 5a, 7 U.S.C. 7a (1982).

[5] 7 U.S.C. 2 (1982). *But see*, section 6(b), 7 U.S.C. 9 (1982) (granting the Commission enforcement jurisdiction over manipulation and attempted manipulation of "the market price of any commodity, in interstate commerce").

[6] Act of August 24, 1921, ch. 86, 42 Stat. 187, *et seq.* *See, e.g.*, S. Rep. No. 212, 67th Cong., 1st Sess. 4–5 (1921).

[7] *Hearings on H.R. 168, H.R. 231, H.R. 2238, H.R. 2331, H.R. 2363, H.R. 5228 Before the House Committee on Agriculture*, 67th Cong., 1st Sess. 10 (1921) (colloquy between Mr. Kincheloe and Mr. Tincher).

[8] *Futures Trading in Grain: Hearings on H.R. 5676 Before the Senate Committee on Agriculture and Forestry*, 67 Cong., 1st Sess. 8–9, 214, 431, 462 (1921) (statements of Chester Morrill, George T. McDermott, F. B. Wells, Henry Wallace) ("1921 Senate Hearings").

[9] 1921 Senate Hearings at 462.

[10] 1921 Senate Hearings at 9 (statement of Chester Morrill).

[11] S. Rep. No. 212, 67th Cong., 1st Sess. 1 (1921). In agreeing to the addition of this exclusionary language to section 2, the House added the words "or delivery" after the word "shipment." *See* H.R. Rep. No. 345, 67th Cong., 1st Sess. 7 (1921).

[12] 1921 Senate Hearings at 431 (statement of F. B. Wells). *See also*, 1921 Senate Hearings at 213–215 (statement of George T. McDermott); 61 Cong. Rec. 4762 (1921) (statement of Senator Capper).

In *Hill* v. *Wallace*, 259 U.S. 44 (1922), the Futures Trading Act of 1921 generally was declared unconstitutional as an impermissible attempt at regulation through the taxing power. Therefore, Congress enacted the Grain Futures Act of 1922 which regulated grain futures trading under the commerce clause. 42 Stat. 998. The exemption for forward contracts was included without change in the Grain Futures Act of 1922. 42 Stat. 998. In 1936, the Commodity Exchange Act broadened the exclusion to apply to sales of "any cash commodity" for deferred shipment or delivery since that Act covered commodities in addition to grains. 49 Stat. 1491.

[13] *CFTC v. CoPetro Marketing Group, Inc.*, 680 F.2d 573, 578 (9th Cir. 1982) (emphasis in the original). ("*CoPetro*").

of the commodity.[14] Second, because forward contracts are commercial, merchandizing transactions which result in delivery, the courts and the Commission have looked for evidence of the transactions' use in commerce. Thus, the courts and the Commission have examined whether the parties to the contracts are commercial entities that have the capacity to make or take delivery and whether delivery, in fact, routinely occurs under such contracts.[15]

Forward contracts frequently are not standardized. Contract terms are often negotiated, particularly grade, delivery point and settlement date. Even in those instances when contract terms are standardized by a single contracting party, certain terms may nonetheless be left open to negotiation.[16] Historically, forward contracts have set a fixed price for grain or cotton at the time the contract was entered.

However, an instrument, called a "deferred pricing" contract, has evolved in which the price is not established at the time the contract is entered. Rather, the contract sets a formula to determine the final contract price by a later "closing date." The formula may specify a particular base price, such as a futures contract price or major cash market price. The agreement may also set a differential to be added to or subtracted from the base price to determine the final price. The contract also specifies a period of time during which the producer may "fix" the final price. For example, the parties might enter into a contract in March which guarantees the farmer the price of the December futures contract plus or minus an agreed-upon differential. The farmer may set the final price for the commodity between the time at which the contract is entered and the "closing date," *e.g.* the last business day in November, based on the producer's expectation of the price trend for that contract.[17]

Some deferred pricing contracts require immediate delivery. Title passes upon delivery. However, the contract permits the farmer to delay fixing the final price for the commodity until the agreed-upon closing date although the commodity has already been delivered and title has passed to the merchant. The contract also eliminates the producer's need to secure storage space for the commodity. The Commission staff views such deferred pricing contracts as a form of spot contract. These contracts are used solely to merchandize the commodities. Both parties have transferred title to the commodity and delivery has occurred.

B. Commodity Options

The Commodity Exchange Act vests the Commission with plenary jurisdiction over "any transaction which is of the character of, or is commonly known to the trade as an 'option'. . . ." [18] The Act does not define the term "option." Therefore, to determine whether an instrument is an option, the Commission and the courts have examined pre-existing contract law, commercial practice and the economic nature of the contract.[19]

Traditional contract law defines an option as a contract in which

> the option holder makes no promise, but pays cash or gives some other executed consideration. The option giver's promise is enforceable, in spite of lack of mutuality of promise.[20]

Similarly, the Commission relied on traditional contract analysis in its determination whether a particular instrument was an option. Thus, an option is

> necessarily a unilateral contract which binds the optionee to do nothing but grants him the right to accept or reject the offer in accordance with its terms within the time and manner specified in the option. The outstanding factor is that the optionee is not bound until he acts on the option one way or another. At the same time, during the period when the optionee is free to accept or reject, the optionor cannot act in derogation of the terms of the option.[21]

The courts and the Commission have carefully examined "the economic reality of the transaction, not its name" to determine whether an instrument is an option.[22] In particular, an option is a limited risk instrument. That is, the option purchaser is not liable for payment resulting from any adverse price movement of the commodity underlying the option. Rather, the option purchaser will benefit from a favorable price move and will not be liable for any other losses beyond the premium or other payment that the purchaser pays for the option.

Following the Congressional and Commission bans on options in 1978,[23] certain companies began to offer and sell instruments with a variety of names which had the characteristics of options. In *CFTC v. U.S. Metals Depository Co.*, the Commission alleged that defendants were selling options in another guise. The Honorable Edward Weinfeld stated that the determination whether the instrument was an option

> must begin with the definition of "options." Although neither the Act nor the Commission's regulations define the term, Courts have often differentiated between options and deferred delivery (or futures) contracts. The latter is a transferable contractual agreement "to buy or sell a fixed amount and grade of a certain commodity on some specified date. A commodity option, on the other hand, confers upon the holder the right to buy ('call option') or to sell ('put option') either a specified amount of a commodity or a futures contract for that amount of a commodity within a certain period of time at a given price (the 'strike price')." [24]

From that definitional basis, Judge Weinfeld identified three aspects which convinced the court that defendants' instruments were options. An option gives the purchaser the right to make or take delivery of the commodity. The initial charge for an option is normally a nonrefundable premium covering the grantor's commissions, costs and

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[14] *In re Stovall*, [1977–1980 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶20,941 at 23, 77–78 (C.F.T.C. 1979); Office of the Chief Economist, U.S. Commodity Futures Trading Commission, Forward Contracting in Selected Agricultural Commodities: An Inquiry into Defaults 1–5 (1977). *See also* Gillen & Jaeger, *Forward Contracting in Agricultural Commodities: A Case History Analysis of the Cotton Industry*, 12 J. Mar. J. Prac. & Proc. 253, 267 (1979) ("Gillen & Jaeger"); E. Roy, *Contract Farming and Economic Integration*, 248–249 (1972).

[15] *CoPetro*, 680 F.2d at 578–579; *NRT Metals, Inc. v. Manhattan Metals (Non-Ferrous), Ltd.*, 576 F. Supp. 1046, 1050 (S.D.N.Y. 1983); *In re Stovall*, Comm. Fut. L. Rep. at 23,778–23,779. *See also CFTC v. Commercial Petrolera International S.A.*, [1980–1982 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶21,222 at 25,096–97 (S.D.N.Y. 1981).

[16] Advisory Committee on Definition and Regulation of Market Instruments, U.S. Commodity Futures Trading Commission, Recommended Policies on Futures, Forward and Leverage Contracts and Transactions, 18–19, 21 nn. 5, 6 (1976).

[17] A. Paul, R. Heifner & J. Helmuth, U.S. Department of Agriculture, Agriculture Economic Report No. 320, Farmers' Use of Forward Contracts and Futures Markets 17–18 (1976). ("Farmers' Use of Forward Contracts and Futures Markets").

[18] Section 2(a)(1)(A), 7 U.S.C. 2 (1982). *See also* section 4c, 7 U.S.C. 6c (1982).

[19] *CTFC v. Precious Metals Associates*, 620 F.2d 900, 907–908 (1st Cir. 1980) ("*Precious Metals Associates*"); *British American Commodity Options Corp. v. Bagley*, 552 F.2d 482, 484–485 nn. 4, 5; *cert. denied*, 484 U.S. 938 (1977) ("*BACO*"); *CFTC v. Goldex International Ltd.*, [1977–1980 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,839 at 23,441 (N.D. Ill. 1979) at 23,441 ("*Goldex*").

[20] A. Corbin, Contracts section 152 at 222 (1952). *See* Precious Metals Associates, 620 F.2d at 907 *citing with approval* A. Corbin, Contracts § 259 at n.5 (1952).

[21] *In the Matter of Precious Metals Associates*, Comm. Fut. L. Rep. ¶ 20,882 at 23,596 n.8, citing with approval, 1 Williston, Contracts section 61B at 199, 200 (3d ed. 1957).

[22] *Precious Metals Associates*, 620 F. 2d 908. *See also CFTC v. Morgan, Harris & Scott, Ltd.*, 484 F. Supp. 669, 675 (S.D.N.Y. 1979).

[23] Section 4c(c), 7 U.S.C. 6c(c) (1982); Rule 32.11, 17 C.F.R. 32.11 (1984).

[24] *CFTC v. U.S. Metals Depository Co.*, 468 F. Supp. 1149, 1154–1155 (S.D.N.Y. 1979). (*U.S. Metals Depository*").

profits.[25] The purchaser's losses on an option are normally limited to the premium. Therefore, the Court concluded options are "limited risk" investments—the buyer is under no obligation to exercise his option and will, at most, lose the initial fee . . .[26]

Thus, an option is a contract in which only the grantor is obligated to perform. As a result, the option purchaser has a limited risk from adverse price movements. This characteristic distinguishes an option from a forward contract in which both parties must routinely perform and face the full risk of loss from adverse price changes since one party must make and the other take delivery of the commodity. In contrast, in an option, only the grantor of a call (put) is required to sell (buy) a given quantity of a commodity (or a futures contract on that commodity) on or by a specified date in the future if the option is exercised. The purchaser of the option may buy or sell the commodity, but he or she is under obligation to do so.[27] If the price of the underlying commodity moves in the manner favorable to the option purchaser, the purchaser can exercise the option. If the price does not move in a favorable direction, the purchaser can simply abandon the option and forfeit any premium.[28]

C. The Commission's Consideration of "Trade" Options on Agricultural Commodities

In 1982, Congress determined to permit a pilot program in the trading of options on agricultural commodities.[29] The Commission therefore began a rulemaking to determine whether and under what circumstances agricultural options should be offered.[30] Among other issues, the Commission considered whether to permit so-called "trade" options on agricultural commodities. "Trade options" generally are off-exchange options in a physical commodity entered into in normal commercial channels for that commodity or its byproducts.[31] Section 4c(c) of the Act authorizes the Commission to permit trade options to be offered and sold to a purchaser who is

> a producer, processor, commercial user of, or a merchant handling, the commodity involved in the transaction, or the products or by-products thereof.[32]

The Commission specifically asked for comments whether the agricultural option pilot program should include trade options, recognizing that there might be benefits to producers and commercial handlers of agricultural commodities in permitting trade options. However, the Commission ultimately deferred a determination whether to permit trade options until there had been experience with the offer and sale of exchange-traded agricultural options. The Commission was of the view that limiting options to exchanges initially would provide additional self-regulatory oversight by the exchanges in the offer, sale and trading of agricultural options which would not be available for off-exchange trade options.[33] Thus, agricultural trade options may not be lawfully offered or sold at this time.[34]

D. Examples of Agricultural Contracts.

As noted above, various agricultural contracts either are currently being entered into between producers of agricultural commodities and elevators or merchants handling or dealing in that commodity or its byproducts in commercial channels or are being proposed to be offered by merchants to producers. Three examples of contracts are described and analyzed below.

1. The producer agrees to deliver a specified quantity and grade of a commodity to a dealer by a specified date in the future. Delivery of the commodity is mandatory, absent an intervening event such as crop failure.[35] Generally, the contract does

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[25] *U.S. Metals Depository*, 468 F. Supp. at 1155. *See also, CFTC v. Morgan Harris & Scott, Ltd.*, 484 F. Supp. 669, 675–676 (S.D.N.Y. 1979) ("Morgan, Harris & Scott"). *See* A Corbin, Contracts § 152 at 222, section 259 at n.5 (1952) (the purchaser of an option pays a premium or other consideration); *SEC v. Commodity Options International, Inc.*, 553 F.2d 628–631 (9th Cir. 1977) (a rebate was paid on the permium in addition to any profit realized).

[26] *U.S. Metals Depository*, 468 F. Supp. at 1155. *See also BACO*, 552 F.2d at 485; *Morgan, Harris & Scott*, 484 F. Supp. at 675, 676.

[27] *Precious Metals Associates*, 620 F.2d at 907–908; *BACO*, 552 F.2d at 484–485.

[28] *CFTC v. Morgan, Harris & Scott, Ltd.*, 484 F. Supp. 669, 675–676 (S.D.N.Y. 1979) ("*Morgan, Harris & Scott*"); *CFTC v. U.S. Metals Depository Co.*, 468 F. Supp. at 1155.

[29] "The Commission may . . . establish a pilot program for a period of three years" in agricultural options. "The Commission may authorize commodity option transactions during the pilot program in as many commodities as will provide an adequate test" of these options. Section 4c(c), 7 U.S.C. 6c(c) (1982). Options may be permitted on "Wheat, cotton, rice, corn, oats barley, rye, flaxseed, grain sorghums, mill feeds, butter, eggs, 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, cottonseed, peanuts, soybeans, soybean meal, livestock, livestock products, and frozen concentrated orange juice. . . " Section 2(a)(1)(A), 7 U.S.C. 2 (1982).

[30] 48 *FR* 46797 (October 14, 1983); 48 *FR* 6128 (February 10, 1983). The Commission also convened an Agricultural Options Advisory Committee, pursuant to 5 U.S.C. App. I, Section 1, *et seq.*, to provide advice on the nature of a pilot program. That committee was succeeded by an Agricultural advisory Committee with a broader membership and mandate. The issue of "trade" options was extensively discussed at the new committee's first two meetings.

[31] Report of the Advisory Committee on Market Instruments, reprinted in *Hearings Before the Subcommittee on Agricultural Research and General Legislation of the Senate Committee on Agriculture, Nutrition, and Forestry*, 95th Cong., 2d Sess. 337, 345–346 (1978).

[32] 7 U.S.C. 6c(c) (1982).

The Commission currently permits trade options only in the commodities which are not enumerated in Section 2(a)(1)(A) (*see* n. 30 *supra*). These options may be "offered by a person who has a reasonable basis to believe that the option is offered to a qualified commercial entity if "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." Rule 32.4(a), 17 CFR 32.4(a) (1984).

[33] 49 FR 2752, 2756 (January 23, 1984). *See also* 48 FR at 46800.

[34] Further, Section 4c, 7 U.S.C. 6c (1982), generally prohibits any person "in the business of buying, selling, producing, or otherwise using" an agricultural commodity from granting options on a physical agricultural commodity. Pub. L. 97–444, section 206(4), 96 Stat. 2301 (1983). *See* 50 FR 10786, 10787 n.2 (March 18, 1985).

[35] Some contracts provide for a liquidated damages or penalty clause if the producer fails to deliver. For example, if the seller fails to deliver any part of the crop specified in the contract, the seller is liable to the merchant for the difference between the contract price and the current market value of that commodity. Some contracts appear to require that the farmer obtain the grain from another source if the producer's crop is not sufficient to meet the contract's requirements. Other contracts are silent as to the effect of non-performance. In each of these instances, however, it is intended that delivery of the physical crop occur, absent destruction of all or a portion of the crop by forces which neither party can control. The presence of such clauses in a contract does not change the analysis of the nature of the contract.

Some commodities are sold through acreage or output contracts in which the farmer agrees to sell the total output on a specified number of acres, based generally on prior output. *See Gillen & Joeger* at 268–269. However, if the farmer cannot produce the anticipated amount of commodity using accepted agricultural techniques for the crop, there is no penalty as long as the producer delivers the remaining production from the contracted for acreage. Again, the parties intend delivery and, but for intervening conditions, such as weather, insects or disease, would transfer title to the entire crop. Indeed, it appears that a party who did not deliver his crop under such a contract and instead marketed it elsewhere would be in breach of the contract and likely liable for damages. *Gillen & Joeger* at 269.

However, a contract provision which permitted a producer to avoid delivery for a reason other than for an intervening condition not in the control of either party could change any conclusion about the nature of the contract. Moreover, the Commission is aware that public marketing and sales presentations made to prospective purchasers of certain instruments sometimes differ markedly from the written offering material. Thus, the Commission and the courts have consistently looked beyond written materials and examined the day-to-day operations of a transaction to determine its underlying purpose.

not establish the final price to be paid for the commodity, but rather the method by which a final price will be determined. In some contracts, the agreement establishes a particular futures contract which will be used as the base price. In addition, some contracts may establish the "basis" which will be used to calculate the final price for the commodity.[36]

This particular contract mandates delivery by the producer and acceptance of that delivery by the dealer. The parties are commercial participants in the stream of commerce for the commodity. The unique feature common to these contracts is a "minimum price guarantee." The merchant guarantees the producer a minimum price for the commodity. In return for this minimum price guarantee, a premium is deducted from the final price paid for the commodity. The producer is required to deliver the commodity but has the right to receive the minimum price for the commodity. If, however, the pricing formula or the subsequent market price specified in the contract entitles the producer to a higher price, the producer may demand this higher price for the commodity.

The Office of the General Counsel believes that this type of contract comes within the forward contract exemption of section 2(a)(1)(A) since legally the contract's predominant feature is its use by producers and merchants to market a commodity through actual delivery. The producer, absent depredation to the crop, must make delivery of the commodity. The merchant or the elevator must accept that delivery. Because both parties are participants in the normal commercial channels for these commodities, each is in a position to fulfill all obligations under the contract, and both parties intend that commercial marketing of the commodity by means of delivery will occur.

In stating this view, we recognize that these contracts have characteristics of a cash-settled put option because the minimum price guarantee places a floor on the producer's losses. In addition, the guarantee is secured by the payment of a premium which covers the merchant's expenses and exposure in offering these contracts, such as the cost of the merchant's purchasing of an exchange-traded option to offset its risks. If the commodity price is above the minimum guarantee price, the producer receives the prevailing price. If the commodity price is less than the minimum guarantee price, the producer receives the guaranteed amount. However, these contracts lack a salient characteristic of an option: the farmer cannot "accept or reject the offer."[37] Rather, the parties use this contract as a marketing vehicle. Thus, the producer is normally required to deliver the commodity. Moreover, in order to collect any payment for the commodity, including the minimum price guarantee, the producer must first make delivery. Further, under the contracts described in this example, the producer would be in breach of the contract if he or she failed to deliver to the merchant and could be liable for damages under the contract.

Because this type of contract is a hybrid of both a forward and an option contract, an examination must be made of the parties' use of the contract in their marketing program, as well as the contract's terms. In this example, 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 the hybrid contract, and particularly from that contract's requirement of delivery. The intent of the exemption for forward contracts in section 2(a)(1)(A) is to exclude marketing transactions in the normal stream of commerce for a commodity or its byproducts where delivery is intended, but delivery is delayed for commercial convenience or necessity. In this Office's view, the contract in this example serves these purposes and, as such, is exempt under section 2(a)(1)(A) of the Act.

2. The producer and merchant enter into a contract to make and take delivery of the commodity immediately, but the price is fixed later. Title to the commodity passes to the merchant upon delivery. However, although the producer may receive some payment upon delivery, the final price is not set at that time. However, as in example 1, the merchant offers a minimum price guarantee on the commodity to the farmer in return for a premium. Thereafter, the producer has an agreed-upon period after delivery occurs in which to determine whether to elect the minimum price guaranteed by the merchant or a higher final price based on that contract's pricing formula or an agreed-upon cash market price for the commodity.

The Office of General Counsel is of the opinion that this is a spot contract which is generally outside the Act's regulatory scheme.[38] As in example 1, both parties are obligated to perform under this type of contract, and delivery occurs at the time that the contract is entered. Both parties have performed upon the contract and transferred title to the commodity. However, the final determination of price may be delayed for a substantial period after delivery occurs.

This contract is a hybrid of a spot contract and a cash settled put option in which the strike price is equal to the minimum price guarantee. Nonetheless, this is an agricultural marketing vehicle under which both parties are obligated to perform under the contract. The producer actually delivers the crop before he or she can demand any price, under the minimum price guarantee or otherwise, for the commodity. Thus, the option component is inseparable from the actual delivery of the commodity between participants in normal marketing channels. In this Office's view, this example is generally exempt from Commission regulation as a spot contract.

3. 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 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.

This instrument is a "trade" option. For the payment of a premium, the buyer has the right, but not the obligation, to sell his crop to the merchant who must accept delivery and pay the minimum contract price. The producer, however, can determine not to exercise the option and sell the crop to another buyer. The producer thereby forfeits the premium, but that is the limit of his or her liability. Thus, unlike the examples above, this contract does not require delivery. This type of contract is currently not permitted under the Commodity Exchange Act and the rules thereunder.

The Office of the General Counsel hopes that these examples will provide useful guidance to participants in

[36] Basis is defined as the difference between the price of a particular futures contract and the price for the same or similar commodity for spot delivery at a particular location. Farmers' Use of Forward Contracts and Futures Markets at iv.

[37] 1 Williston, Contracts section 61B at 199 (3d ed. 1957).

[38] *See* n.5f *supra*.

agricultural commerce and to interested members of the public as to the types of agricultural marketing instruments which are permitted under the Act. The staff will continue to provide its views on specific instruments if written requests are submitted to the Office of the General Counsel, Commodity Futures Trading Commission, 2033 K Street NW, Washington, DC 20581.

Issued in Washington, DC on September 23, 1985 by the Office of the General Counsel.

Kenneth M. Raisler,

General Counsel.

[FR Doc. 85-23270 Filed 9-27-85; 8:45 am]

BILLING CODE 6351-01-M

DEPARTMENT OF LABOR

Employment Standards Administration

20 CFR Parts 701, 702 and 703

Longshore and Harbor Workers' Compensation Act and Related Statues

AGENCY: Employment Standards Administration, Labor.

ACTION: Extension of interim final rule.

SUMMARY: This notice extends the interim final rules published in the **Federal Register** on January 3, 1985 (50 FR 384) until December 31, 1985. These rules, which implement the Longshore and Harbor Workers' Compensation Act Amendments of 1984, Pub. L. 98-426, 98 Stat. 1693, were effective on December 27, 1984, and were to remain in effect until October 1, 1985, unless extended. The Department has determined that additional time is necessary to evaluate the procedures established by the interim final regulations in light of the concerns expressed in the written comments submitted to the Department.

EFFECTIVE DATE: September 30, 1985. The interim final rules will remain in effect until December 31, 1985, unless extended or suspended by another issuance.

FOR FURTHER INFORMATION CONTACT: Richard A. Staufenberger, Deputy Director, Office of Workers' Compensation Programs, Employment Standards Administration, U.S. Department of Labor, Washington, DC. 20210, telephone (202) 523-7503.

Signed at Washington, DC., this 26th day of September 1985.

William E. Brock,

Secretary of Labor.

[FR Doc. 85-23366 Filed 9-27-85; 8:45 am]

BILLING CODE 4510-27-M

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 301

[T.D. 8053]

Reduction of Tax Overpayments by Amount of Past-due Legally Enforceable Debt Owed to Federal Agency

AGENCY: Internal Revenue Service, Treasury.

ACTION: Temporary Regulations; final regulations.

SUMMARY: This document contains temporary regulations and final regulations relating to the reduction of a taxpayer's overpayment (*i.e.*, tax refund) by the amount of any past-due legally enforceable debt owed to a Federal agency and referred by that agency to the Internal Revenue Service for offset. The text of the temporary regulations set forth in this document also serves as the text of the proposed regulations cross-referenced in the notice of proposed rulemaking in the Proposed Rules section of this issue of the **Federal Register.** Changes to the applicable law were made by the Spending Reduction Act of 1984. The regulations affect any taxpayer who owes a past-due legally enforceable debt to any Federal agency identified as eligible to participate in the tax refund offset program by the Commissioner of Internal Revenue and who has made an overpayment of taxes, and such Federal agency to which the past-due legally enforceable debt is owed.

DATES: The regulations apply to refunds payable under section 6402 of the Internal Revenue Code of 1954 after December 31, 1985 and before January 1, 1988 and are effective upon publication.

FOR FURTHER INFORMATION CONTACT: Sharon L. Hall of the Legislation and Regulations Division, Office of Chief Counsel, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, D.C. 20224, Attention: CC:LR:T, 202-566-3288 (not a toll-free call).

SUPPLEMENTARY INFORMATION:

Background

This document amends the Procedure and Administration Regulations (26 CFR Part 301) to provide rules under section 6402 (d) and (e) of the Internal Revenue Code of 1954, and section 3720A of subchapter II of chapter 37 of title 31, United States Code. Section 6402 (d) and (e) was added to the Internal Revenue Code, and section 3720A was added to title 31 of the United States Code, by section 2653 of the Spending Reduction Act of 1984 (Pub. L. 98-369, 98 Stat. 1153). The temporary regulations contained in this document will remain in effect until superseded by additional temporary or final regulations published in the **Federal Register.**

Explanation of Statutory Provisions

Section 6402(d) of the Internal Revenue Code requires the Internal Revenue Service (1) to reduce the amount of any overpayment (*i.e.*, tax refund) otherwise payable to a taxpayer by the amount of any past-due legally enforceable debt owed to a federal agency of which the Service has been notified, (2) to pay the amount of the reduction to the agency to which the debt is owed, and (3) to notify the taxpayer that the overpayment has been reduced. That subsection also provides that before reduction for past-due legally enforceable debt, an overpayment shall be reduced for an outstanding liability for past-due support assigned to a State under section 402(a)(26) or 471(a)(17) of the Social Security Act, and in case more than one debt is owed by a taxpayer, the reduction of the overpayment shall be applied to the debts in order in which they accrued.

Section 6402(e) provides that no court of the United States shall have jurisdiction to hear any action brought to restrain or review a reduction of an overpayment for past-due support under 6402(c) or past-due legally enforceable debt under 6402(d), and that no such reduction can be reviewed by the Service in an Administrative proceeding.

Section 3720A(a) of title 31 provides that any Federal agency that is owed a past-due legally enforceable debt shall notify the Internal Revenue Service of the amount of the debt. Under section 3720A(b), a Federal agency must, before notifying the Service, notify the taxpayer who is responsible for the debt that the agency plans to refer the taxpayer's debt to the Service for offset of any Federal tax refund; determine that the debt is past-due and legally enforceable after providing the taxpayer at least 60 days in which to present evidence to the contrary; and make reasonable efforts to collect the debt. Section 3720A(c) requires the Service to reduce the tax refund, if any, payable to a taxpayer by the amount of the past-due legally enforceable debt owed to the creditor agency and to pay the amount of the reduction to the agency. Under section 3720A(d), the Service is directed to issue regulations providing the time and manner of submission of notification. Section 3720A(e) requires any Federal agency which has received

"REDACTED VERSION"

CFTC Letter 95-104

Dear :

By letters to the Commodity Futures Trading Commission ("Commission") dated July 27, August 17, September 1 and October 24, 1995, ("the cooperative"), through its counsel, requested that the staff confirm that certain contractual arrangements for the delivery of live hogs proposed to be offered by the cooperative are not futures or option contracts under the Commodity Exchange Act, and Commission regulations thereunder. In general, and as described more fully below, the transactions are proposed to consist of two contracts: long-term, minimum price guaranteed purchase contracts by the cooperative with producers; and long-term, supply contracts by the cooperative with hog processors priced at the spot price at the time of delivery.

The cooperative, in its July 27, August 17, September 1 and October 24, 1995, letters, has represented the facts to be as follows.

The cooperative is owned directly by local cooperative associations, primarily feed stores and elevator operations, and individual farmers or family farm corporations or partnerships. It is one of the nation's largest sellers of hog feed and also operates its own large swine business raising hogs through the complete production cycle for sale to processors. Accordingly, it has a direct and strong commercial, economic and organizational interest in the hog market.

The cooperative is proposing to contract with individual producers who are members of a local cooperative association which is a member of the cooperative or who are themselves members of the cooperative. These contracts are for the long-term purchase of the producers' hogs for a period, which may be as long as twelve years, at a price which will fluctuate based on the fluctuations of corn and soybean prices, two major inputs in the production of hogs. In turn, each participating producer will be required to purchase his hog feed requirements from the cooperative and to make delivery of the hogs to the cooperative or to a processor designated by the cooperative.

Separately, the cooperative may enter into contracts with hog processors to sell the hogs purchased from the producers to the processor. Such contracts could be either spot sales or longer-

term agreements that would obligate the processor to take delivery of the hogs. It is anticipated that the sale price would be the market price for hogs on the date of delivery, which may be calculated by the processor on a formula-pricing basis.

Prior to delivery, the cooperative will direct the producer to deliver the hogs to a specified processor. Title to the hogs will actually pass from the producer to the cooperative at the time of delivery by the producers at the processing plant. Immediately thereafter, the cooperative will transfer title to the processor.

Under the terms of its contract with hog producers, the cooperative will pay producers a guaranteed minimum price in accordance with an established matrix derived from the cost of feed, plus or minus any premiums and/or discounts applied by the processor, based upon the quality of the hogs delivered. In addition, as specified in the contract, the cooperative may pay the producer a portion of the amount that the base market price offered by the processor exceeds the minimum price guaranteed to the producer by the cooperative. The guaranteed minimum price paid by the cooperative will change weekly, as specified in the contract, based on a moving average of the prices of corn and soybean meal. Typically, the processor would pay the producer directly the net amount owed for the delivered hogs and would bill or pay the cooperative for its gross profit or loss on the transaction. The cooperative may hedge all, or part of its risk, in the regulated commodity futures or options markets.

Based on the facts, as represented above, the staff views the proposed contracts, which are part of an overall program for the marketing of hogs, as fitting within the forward contract exclusion, i.e., as commercial, merchandizing transactions in a physical commodity in which delivery is delayed or deferred for commercial convenience or necessity, even though they incorporate certain option-like characteristics. See Interpretative Statement of the Office of the General Counsel, 50 Fed. Reg. 39656, 39657-58 (Sept. 30. 1985)("1985 interpretative statement").

In their essential economic characteristics, these transactions resemble a contract also involving the delivery of hogs described in a second interpretative letter of the Office of the General Counsel, CFTC-OGC Interpretative Letter No. 86-7, [1986-1987 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶23,455 (1986) ("1986 interpretative letter"). They differ from the contract described in the 1986 interpretative letter, however, in several respects that make them closer to those described in the earlier 1985 interpretative statement.

In particular, the contract which was the subject of the 1986 interpretative letter provided the producer with a fixed cash price at the time of entry into the agreement and the arrangement

consisted of a single agreement involving three parties, one a Futures Commission Merchant ("FCM"). In contrast, the transactions proposed by the cooperative provide that the producer receives a minimum guaranteed price and may receive, as specified in the contract, if cash prices at the time of delivery are above the minimum price, a specified portion of the difference between the guaranteed price and the price paid by the processor. In addition, unlike the 1986 interpretative letter, where the processor received a futures-like adjustment to the contract price from the third party, here, the processor is obligated to pay the cash price at the time of delivery. Moreover, the cooperative, unlike the FCM in the 1986 interpretative letter, is a commercial seller of hogs in its own right, does not enter into one agreement with both other parties, but rather enters into separate agreements with producers and processors, and consequently may itself take delivery of the commodity from the producers with whom it has contracted.

As with the transactions in the 1986 interpretative letter -- and those of the earlier 1985 interpretative statement, as well -- the contracts proposed by the cooperative "obligate() all parties to perform," and actual delivery under the contracts is expected. Id. Here, the producer must deliver, and the cooperative must accept delivery, of the full amount of the commodity indicated in the contract, at a location specified by the cooperative. Where the cooperative has entered into sales contracts with processors, each of those parties also is obligated to make or take delivery. Moreover, the contracts proposed by the cooperative are not intended to be used primarily as hedging or speculative vehicles, but rather to merchandize commodities in normal cash market channels. In the view of the staff, therefore, the transactions proposed by the cooperative do not constitute commodity futures or option contracts under the Commodity Exchange Act or regulations thereunder, but, rather, cash forward contracts.

The views expressed in this letter are those of the staff and do not necessarily reflect the views of the Commission or of any office or division within the Commission. Moreover, this position is based upon the representations that have been made by the cooperative in its letters. Any different, changed, or omitted facts might require us to reach a different conclusion.

Sincerely yours,

Elisse B. Walter, Co-chair
Off-exchange Task Force

Andrea M. Corcoran, Co-chair
Off-exchange Task Force

"REDACTED VERSION"

CFTC Letter 96-23

Dear Mr. :

This is in reply to your letter to Commissioner Joseph B. Dial of the Commodity Futures Trading Commission ("Commission") dated December 18, 1995. Commissioner Dial has referred that letter to the Division of Economic Analysis ("the Division") for a response. In that letter you ask for guidance regarding a contract denominated as a " producer option contract" ("the contract").

We understand the facts to be as follows. The contract obligates the seller ("the producer") to sell and deliver to the buyer ("the elevator") a specified amount of grain at a future date. The price to be paid for the grain is specified at the time the contract is entered. As part of, and included on the face of this contract, the elevator agrees to purchase exchange-traded call options for the commodity and agrees to pay to the producer the value of the options when terminated. The premium necessary to purchase the options, plus a service charge, are paid by the producer to the elevator by an adjustment to the contract price. The amount of the grain covered by the options which can be included under the contract cannot exceed the amount of grain required to be delivered by the producer. Both the contract itself and any oral representations made to the producer clearly reflect that the exchange-traded option position is that of the elevator and that it is solely the elevator's obligation to make payment to the producer in satisfaction of the contract, including any value derived from the option component.

Under this contract, the producer can elect to terminate the option component of the price for the grain at any time before the final expiration date and the account will be credited based on the liquidated remaining value of the option position. Moreover, if the producer delivers the grain before expiration of the option position, the elevator may maintain the option position until its expiration. You have further indicated that if the producer determines to terminate the option component, he is not permitted to reestablish an option component under the contract and that the options positions may not be rolled from one expiration month to another.

You asked whether a contract with these features may be lawfully offered by an elevator to a producer. The Commission's Office of the General Counsel issued an interpretative statement in 1985 distinguishing forward contracts, which are excluded from regulation by the Commission, from "trade options" in agricultural commodities, which may not be legally offered or sold. A copy of that interpretative statement is enclosed.

The contract you have described differs from the forward contract described in example No. 1. of the 1985 interpretative statement by permitting the producer to cancel the optional pricing aspect of the contract at any time during its lifetime. The Division is of the opinion that this feature of the contract, which as described above does not permit the option pricing feature to be reestablished once terminated, and which does not permit "rolling" of the option month, is consistent with the contracts described in the 1985 interpretative statement, based upon its understanding that:

> the contract mandates delivery, . . . 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 the hybrid contract, and particularly from that contract's requirement of delivery.

OGC Interpretative Statement, 50 Fed. Reg. 39656, at 39660 (September 30, 1985).

You further asked whether the contract lawfully could extend the option's price benefit beyond delivery of the physical commodity until any remaining time value of the option expires. This would be consistent with the spot contract delineated in example No. 2 of the 1985 interpretative statement, describing a contract in which delivery of the commodity is made but the price is fixed later and which contemplates partial payment to the producer at the time of delivery in anticipation of a complete settlement at a specified later time.

Accordingly, the Division is of the view that the contract, viewed in its entirety, and consistent with the examples described in the 1985 interpretative statement as analyzed above, is not subject to Commission regulation. The views expressed in this letter are those of the Division of Economic Analysis and do not necessarily reflect the views of the Commission or any other office or division of the Commission. Moreover, our position is based upon the representations that have been made to us. Any different, changed or omitted facts might require us to reach a different conclusion.

Sincerely,

Paul M. Architzel
Chief Counsel

Attachment

APPENDIX C

As discussed in the Market Risk Section of this white paper, there are various measures of options risk, which can be measured in terms of sensitivity of the options price to changes in market risk variables. The following are the primary measures of options risk:

Delta: Delta is a measure of the amount an option's price would be expected to change per unit of change in the price of an underlying instrument. When the price of the underlying instrument (basis or cash grain price) changes by a small amount, the resulting change in the value of the option is reliably predicted by the data. However, in almost all cases, for larger movements in the value of the underlying instrument, the delta itself will change. The size of the change in delta is predicted by gamma.

Gamma: Gamma is a measure of the amount delta would be expected to change in response to a unit change in the price of the underlying instrument.

Vega: Vega is a measure of the amount an option's price would be expected to change in response to a unit change in the price volatility of the underlying instrument. The value of an option depends on the likelihood that the price of the underlying instrument will change in the desired manner. The more volatile the price of the underlying instrument, the greater the likelihood of a favorable event occurring. Consequently, volatility is a major determinant of the price of most options.

Theta: Theta is a measure of the amount an option's price would be expected to change to reflect the passage of time. All things equal, the longer the option's time to maturity, the greater the option's price. Consequently, the value of an option generally declines with the passage of time.

Rho: Rho is a measure of the amount an option's price would be expected to change to reflect a change in market interest rates.

GLOSSARY

AREA YIELD CONTRACTS: Futures contracts at the CBOT that trade the market's perception of the eventual USDA yield per acre of specific commodities in a specific state (e.g., Iowa "area yield" futures reflect the Iowa corn yield per acre as quoted by USDA).

BASIS (cash grain): The difference between a cash grain price and a futures price. More exactly, basis is cash minus futures (i.e., the cash price of grain at a specific point minus the price of an appropriate futures contract).

BASIS CONTRACT: A contract initially unpriced, but with a fixed differential versus a futures contract set in the contract.

BEAR SPREAD: To sell a nearby instrument or asset and buy an equal quantity of a more deferred period (e.g., to sell January and buy March soybean futures is a "bear spread").

BID: An "offer" to buy, at a specified price or basis. The grain trade, among others, commonly refers to a proposal to buy as a bid and a proposal to sell as an offer.

BULL SPREAD: To buy a nearby instrument or commodity and sell an equal amount of a more deferred period (e.g., to "buy March/sell May" is an example of a corn futures "bull spread").

BUY IN: To purchase grain commercially in order to fill an existing sales commitment. A buy-in can also be made by the buyer in the original trade for the account of the seller in the original trade, if the seller has failed to fulfill the contract commitment.

CALENDAR SPREAD: An options arbitrage between different futures months (e.g., "long March $2.50 corn calls and short July $2.50 corn calls" would be a calendar spread). Also known as a horizontal spread.

CALL: An option that gives the buyer the right to buy something at a specified price (the strike price) for a fixed length of time. In the grain trade, calls usually refer to options on futures.

CARRYING CHARGES (reference values): The amount by which shipments in the future exceed values for more nearby shipment slots. What the market is paying for grain storage. Carrying charges can exist in the futures (spreads) and in the basis (cash grain carries being the sum of the two.) Often shortened to "carry."

CFTC: The Commodity Futures Trading Commission. Federal regulatory agency that oversees commodity futures trading, and enforces the Commodity Exchange Act and the Futures Trading Practices Act.

CONFIRMATION OF TRADE: In the grain, feed and processing industry, a "confirmation of trade" generally is deemed to be a writing confirming an oral contract already made by the

parties. The NGFA Trade Rules set forth specific requirements for such confirmations in NGFA Grain Trade Rule 6, NGFA Feed Trade Rule 2 and NGFA Barge Freight Trading Rule 2.

CONTRACT: In the grain, feed and processing industry, an agreement between buyer and seller that a court or arbitration committee will enforce. Contracts may be formed orally, but state-enacted versions of the Uniform Commercial Code (UCC) generally require that contracts must be evidenced by some writing if involving the sale or purchase of goods worth $500 or more. Such writing can either be an agreement signed by both parties or a confirmation evidencing the parties' agreement. Under the UCC, a written confirmation(s) exchanged between "merchants" is deemed evidence of the formation of a contract between the parties. Likewise, the UCC provides that conduct by both parties which recognizes the existence of a contract can be sufficient to establish a contract for sale of goods in some cases.

CONVENTIONALLY HEDGED: Placing and keeping hedges in the futures months immediately following the shipment period of cash grain trades, and keeping inventories hedged in the nearby months.

COVERED CALL: Usually used in options trading. Refers to a short-option position backed by owning an offsetting asset that will rise in value if the option position declines in value.

CROP YIELD FUTURES: Futures and options contracts at the CBOT that trade the market's perception of the USDA yield per acre of specific commodities in a specific state. One such contract, the Iowa "area yield" futures contract, reflects the Iowa corn yield per acre as quoted by USDA.

DEFERRED PAYMENT: A payment term in which the buyer and seller agree to defer payment. (Note: Deferred payment is *not* the same as Delayed Price.)

DELAYED PRICE: (Also know as Deferred Price, No Price Established - 'NPE') An unpriced grain trade in which title passes upon delivery, but neither the basis nor a futures price is set. The seller has the right to price later, at the price in a specified local market at that time, less service charges (if any). (Usually used as a substitute for storage.)

DERIVATIVES: Any financial instrument whose value is derived from, or based on, the value of another asset, instrument, or commodity. (E.g., corn futures are actually a derivative; their value is based on the value of cash corn in Chicago. "Swaps" are also derivatives.)

EXERCISE: To invoke the rights of a long option position to take a futures position.

EXERCISE PRICE: The price level of the futures contract that will result if an option is exercised.

EXERCISE VALUE: The amount of immediate potential gain if an option owner exercises an option into a futures position at the option's strike price. (E.g., "I own a Dec 2.60 call, and Dec futures closed today at $2.83. That call has 23¢ of exercise value, but the total option premium is 28¢.")

EXTRINSIC VALUE: (Also known as "time value".) That part of any option premium that is not exercise value. (E.g., "The Dec $2.80 call closed today at 18¢; 12¢ was exercise value, so its extrinsic value is 6¢/bu.")

FIRST NOTICE DAY: The first day on which a notice of intent to deliver a commodity to fulfill a (short) futures contract can be made by the clearinghouse to a buyer (long). Sellers (shorts) can first give notice of intent to deliver to the clearing corporation on the day before First Notice Day. These notices are then processed overnight, and passed on FND to the oldest longs in the nearby futures month. First notice day in grain and soybean futures is the last business day of the month preceding a futures delivery month (e.g., first notice day for December corn is the last business day of November).

FORWARD CONTRACT: A cash grain contract calling for shipment in the future. Used often to refer to purchases from farmers. Some farmers make it a practice to forward contract a portion of their production at planting time.

FULL CARRY (delivery markets): A futures market where the price difference between delivery months reflects the total costs of interest, insurance, and storage. The amount by which a deferred futures month must trade over a nearby month to make it economically feasible to take delivery via the nearby contract, hold the grain, and deliver against the deferred. (E.g., "If storage in Chicago is 4.5 cents per month and interest costs 3 cents per month, full carry between the December and March corn futures is around 22 1/2 cents.")

FUTURES CONTRACT: An agreement to purchase or sell a commodity for delivery in the future: (1) at a price that is determined at initiation of the contract; (2) which obligates each party to the contract to fulfill the contract at the specified price; (3) which is used to assume or shift price risk; and (4) which may be satisfied by delivery or offset.

FUTURES ONLY: Cash market forward contracts whereby the futures price level is fixed, but the basis is not. See also "Hedge to Arrive."

HEDGE: A transaction intended to reduce risk. Often refers to taking a futures position that is equal and opposite from one's position in the cash market.

HEDGE(D) TO ARRIVE: Cash market forward contracts in which the futures price has been fixed in the contract, but not the basis. Therefore the final cash price is not fixed until a later point in time. See also "Futures Only."

HORIZONTAL SPREAD: In options trading, a spread between options of the same class (e.g., calls) but with a different expiration. Sometimes referred to as a calendar spread. (E.g., long May $6.00 Puts and short July $6.00 Puts is a horizontal spread.) Strike prices may be the same or different.

IN THE MONEY: An option with exercise value (e.g., a call at $2.00 is "in the money" $.50 if the futures market is trading at $2.50).

INTRINSIC VALUE: The amount by which an option is in the money.

INVERSE: A market in which nearby values are higher than deferred ones. Can refer to basis, futures, freight, and futures spreads. Also "inverted."

LIEN: A security interest used to secure a debt. In grain, a bank may take a lien on a growing crop (thus, a crop lien) to secure a loan to the grower.

MARGINS (futures): An amount of money deposited by both buyers and sellers of futures contracts and by sellers of options contracts to ensure performance on the terms of the contract. In futures trading, there are two kinds of margins: initial margin and variation (maintenance) margin. Initial margin is the "good faith" margin deposited when a trade is made, and variation margin reflects the day to day changes in price.

MARK TO THE MARKET: To determine the immediate market value of all assets and liabilities. All futures markets use "mark to the market" to determine the daily gains or losses on open futures and options positions for variation margin purposes. Daily "mark to market" collection and payout in futures protects buyers and sellers against default. Also, one method commonly used in cash grain accounting.

MINIMUM PRICE (CONTRACT) - (Also MPC's): A cash grain contract in which the buyer agrees to set a price floor but no ceiling. The buyer uses options to offset the risk. MPC's are popular as a way for farmers to sell cash grain, yet retain a chance for higher prices.

NET POSITION: The amount by which purchases exceed sales (net long) or sales exceed purchases (net short). Should specify whether it refers to a flat price position, a basis position, etc. When referring to basis positions, usually broken down by time periods (e.g., "Our net basis position for this fall is long 1/2 million").

NO PRICE ESTABLISHED (NPE): A cash market contract type, similar to Delayed Price.

OPTIONS: Contracts that give the buyer the right, but not the obligation, to (1) buy a commodity or futures contract, or (2) sell a commodity or futures contract. The right to buy a commodity is a CALL; the right to sell a commodity is a PUT. Options are traded based on some predetermined price (strike price), for a fixed period of time. Still used by some to incorrectly refer to the futures contract itself.

OUT OF CONTRACT: A buyer or seller who has not fulfilled contractual obligations. A shipment that does not meet the contract specification.

OUT OF POSITION: A hedger who has failed to hedge all or part of his/her priced cash grain position with futures and is exposed to market risks associated with changes in futures prices. To be net long or short by more than a designated tolerance, often 2500 bushels or less at the country elevator level.

OUT OF THE MONEY: An option whose strike price is away from the current market price and that has no exercise value (e.g., an option to sell at $2.20 is "out of the money" if the market is at $2.34).

POSITION REPORT: A report for management, the purpose of which is to provide information on the company's exposure to price and basis risks.

POSITIVE (basis): A basis that is greater than zero (e.g., the local soybean processor is bidding $6.10, and futures closed at $6.05, the basis is +5).

PREMIUM (options): The price or cost of an option.

PRICE RISK: Risk associated with possible changes in prices, usually futures prices as opposed to basis risk.

PUT: An option giving the buyer the right to sell futures at a specified price (strike price) for a specified time.

ROLL: To move a cash grain or futures position into a different (usually more deferred) time slot by simultaneously buying one futures month and selling another.

SELL OUT: An actual sale of grain of like kind and quantity on the open market, or to establish a fair market value on unshipped grain. Used to determine market value and assess damages due to a buyer's failure to perform on a contract. A trade made by a seller for the account of a buyer who has failed to provide billing on a shipment. (Reference NGFA Grain Trade Rule 13.)

SPREAD: The difference between two futures prices. Spreads may be intercommodity (e.g., corn vs. wheat) or time-related (e.g., March vs. May corn). When used as a verb, "to spread" means to buy one futures month and simultaneously sell another.

STRIKE PRICE: The exercise price of an option. The price at which the rights of an option can be exercised into a futures contract. (E.g., a Dec $2.40 call has a $2.40 strike price. You can buy futures at $2.40 if you want to exercise the call.)

SYNTHETICS: Options and futures can be combined to form other net options or equivalent futures positions. These combinations are called synthetics. This is also useful when futures are limit up or down and cannot be traded. (E.g., long a call and short a put is a synthetic long futures contract.)

TARGET PRICE (cash market): A type of cash contract in which the seller agrees to sell grain (and the buyer agrees to buy grain) at a specified price that is higher than the current price. Also refers to the desired selling price. Often called a "firm offer" when it involves a producer selling to a country elevator. No commitment to deliver exists unless the target price is reached. No correlation to now-obsolete USDA term "TARGET PRICE."

TIME DECAY: The decline in the "time value" portion of any option's premium over time. This assumes the underlying futures price (and market volatility) remain constant. Time decay is greatest in the latter stages of an option's life, gaining momentum especially in the final weeks before expiration.

TIME VALUE: (Also known as "extrinsic" value.) That part of any option premium that is not immediate exercise value. (E.g., "Dec futures closed today at $2.92. The Dec $2.80 call closed at 18¢; 12¢ was exercise value, so its time value is 6¢/bu.")

TRADE OPTIONS: Cash market options on the physical commodity, as opposed to exchange-traded options on futures. Trade options are currently banned in agricultural commodities (as of April 1996) under federal law, but are legal in certain other commodities.

VERTICAL SPREAD: In options, to be long at one strike price and short at another (e.g., "I'm long 10 Dec $2.80 corn calls and short 10 Dec $3.20 corn calls").

VOLATILITY: Generally, the degree of price change in a market. In options trading, refers to a specific measurement of past (historic volatility) or future (implied volatility) price movement.

WRITE: To sell options as an initial position. Writing options is comparable in concept to selling insurance coverage. Selling options to liquidate an existing long option position is *not* the same as writing options.