An Agricultural Law Research Article

Understanding the Hedge-to-Arrive Controversy

by

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Originally published in Drake Journal of Agricultural Law
2 Drake J. Agric. L. 371 (1997)

www.NationalAgLawCenter.org
UNDERSTANDING THE HEDGE-TO-ARRIVE CONTROVERSY

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The hedge-to-arrive (HTA) controversy, with farmers arrayed on one side and grain elevators, agriculture consultants, and commodity brokers on the other, is a misnomer. The traditional or “basic” HTA contract, which has given its name to the controversy, is a variant of a cash forward contract that has nothing whatsoever to do with this crisis other than to engender additional misunderstanding and confusion. Because the HTA name is now indelibly stamped on the controversy, that name will be used in this article to describe the initial single crop year version of what are known as flex-hedge and convertible flex-hedge contracts.1 The evolution of the cash forward contract and the traditional HTA contract, to these new HTA contracts, came as the farming community anticipated the demise of government farm programs and farmers and grain merchants searched for a way to obtain price stability beyond the term

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1. A variety of HTA and flex-hedge contracts exist. Some use futures contracts as the pricing mechanism while others use options or a combination of both. See RISK EVALUATION TASK FORCE ON HYBRID CASH CONTRACTS, NATIONAL GRAIN & FEED ASS'N, A WHITE PAPER—HYBRID CASH GRAIN CONTRACTS: ASSESSING, MANAGING AND CONTROLLING RISK 4 (1996) [hereinafter WHITE PAPER]. For the purposes of this Article, the pricing mechanism will be the commodity futures contract, which is the simplest and most widespread pricing mechanism.
Farmers face two basic risks: the price of grain may fall to a level that diminishes or eliminates any profit from their farming operation, or the crop may fail. Farmers have sought to reduce the price risk in one of two ways. The farmer either sold “short” commodity futures contracts on a regulated futures exchange, generally the Chicago Board of Trade (the Board), or entered into a cash forward contract with the local elevator. Selling a futures contract in the contract month that most closely coincided with the anticipated delivery period (the delivery month futures contract), insures that any decline in the expected cash price of the crop is offset by a corresponding increase in the value of the short commodity futures position. If the cash price rose, the increased price the farmer received at delivery offset the loss sustained on the short futures contracts. The farmer could also hedge price risk with the local elevator by entering into a cash forward contract based on the current price of the delivery month futures contract. The use of either hedging option increases the farmer’s production risk. For example, the amount of crop harvested could be less than that committed to the hedging strategy. In addition to the loss of income from the failed portion of the crop, the farmer would now be responsible for any loss suffered by the elevator for failure to deliver or for any losses suffered as a result of the rise of short futures contracts if that option is selected. The farmer can reduce this increased production risk by hedging only a portion of his expected production.

Each hedging option has advantages and disadvantages. The futures contract permits the farmer to lock-in a futures price and speculate on the

2. See id. at 5.
3. The purpose of hedging is to neutralize adverse price movements by establishing a price prior to delivery. CHICAGO BOARD OF TRADE, UNDERSTANDING BASIS—THE ECONOMICS OF WHERE & WHEN 32 (1990).
4. This is known as the “futures reference month.” Farmers traditionally sold the corn in the futures month that most closely coincided with delivery and did not use futures reference months prior to the anticipated delivery.
5. For this Article, the example will be corn because it is the crop in the eye of the present storm.
6. Although a cash forward contract calls for the future delivery of the crop, it is specifically exempted from the definition of “future delivery” as used in the Commodity Exchange Act (CEA). Commodity Exchange Act (CEA) of 1922, ch. 369, 42 Stat. 998 (1922); ch. 545, 49 Stat. 1491 (1936) (codified as amended at 7 U.S.C. § 1a(11) (1994)). The CEA defines what constitutes a commodity. See 7 U.S.C. § 1a(3). Contracts for future delivery of such commodities are required to be traded on a designated contract market. See id. § 6(a). Off-exchange futures contracts and trade options are illegal. See id. §§ 6(a), 6c(b). The Commodity Futures Trading Commission (CFTC) has exclusive jurisdiction in this area: “Because the off-exchange marketing of these transactions is unlawful under federal law, it may not be permitted by the states.” The Regulation of Leverage Transactions and Other Off-Exchange Future Delivery Type Instruments—Statutory Interpretation, 50 Fed. Reg. 11,656, 11,657 (1985) (interpreting 17 C.F.R. ch. I); see also Statutory Interpretation Concerning Forward Transactions, 55 Fed. Reg. 39,188, 39,190 (1985) (requiring exclusive federal jurisdiction over commodity accounts and agreements).
tendency of the local basis to narrow into the harvest.\textsuperscript{7} Once the basis strengthens to the farmer's liking, he covers the short futures positions and enters into a cash forward contract with the local elevator.\textsuperscript{8} Using the futures contract to hedge price risk requires that the farmer open a regulated commodity account and entails payment of initial margin and brokerage fees, and when necessary, the deposit of additional funds to meet maintenance margin requirements. The farmer must absorb any loss on the futures position until payment is received from the elevator upon delivery of the cash crop. Both the posting of margin and temporarily absorbing the cost of adverse market movements are significant drawbacks and have traditionally limited the use of the futures market as a hedge by farmers. With a cash forward contract, the farmer deals directly with the elevator and knows that regardless of what happens to the price, he will receive the current delivery month futures price less the local basis. The farmer using a cash forward contract to hedge part of the price risk has no need to deal with a commodity firm, nor is there a requirement to post margin, because the elevator now hedges its price risk by going short the Board in its commodity hedge account or by reselling the contract to a processor or end user, less the local basis as the delivery price.\textsuperscript{9} In that situation, the farmer who cash forwarded traditionally had to accept the local basis.

\section*{II. THE BASIC HTA CONTRACT}

The original or basic HTA contract was merely a cash forward contract in which the farmer received the current delivery month futures price and could set the basis to any time prior to delivery.\textsuperscript{10} The basic HTA provided two advantages

\textsuperscript{7} Basis is generally defined as the local cash price minus the price quoted on the Chicago Board of Trade and includes transportation cost, crop carryover, foreign and domestic demand, change in government policies, weather, government reports, and storage availability. \textsc{Chicago Board of Trade, Understanding Basis—The Economics of Where \& When} 3-5 (1990). Depending on the location of the farmer and of the processor or end user as well as the current demand for harvested cash grain, the basis can be either positive or negative. \textit{See id.} at 4. In normal crop years the basis is a negative number (the cash price is lower than the futures price) for the majority of producers and is subtracted from the futures price to determine the price of a forward contract. \textit{See generally} \textsc{Chicago Board of Trade, Improving Margins Using Basis, Grain Merchandiser Series} (1995) (describing how to use basis and future spreads and discussing different trading applications using basis and spreads). If all other components of the basis remain constant, the local basis reflects the cost of transportation between the local elevator and the Board approved storage facility in Chicago. \textit{See id.} at 4.

\textsuperscript{8} The farmer could also enter into a basis contract (i.e., a contract where the basis is set and the farmer later sets the price of the grain at any time prior to delivery). \textit{See generally} \textsc{Chicago Board of Trade, Offering Farmers Cash Contracts, Grain Merchandiser Series} 9-11 (1994).

\textsuperscript{9} Elevators had originally engaged in “back-to-back” hedging which is the safest hedging mechanism and occurs when the elevator immediately hedges a grain purchase by selling the Board using the futures contract that coincided with expected delivery of the grain. \textit{See, Chicago Board of Trade, Improving Margins Using Basis, Grain Merchandiser Series} 7-12 (1995). Elevators later began to speculate on the basis by using futures reference months for their hedges (long or short) for crop years that did not coincide with the expected delivery period in an attempt to “capture the carry” by rolling from one futures month to another. \textit{See id.} at 11.

\textsuperscript{10} The farmer had four basic hedging options: (1) the traditional forward contract if the price and the basis were satisfactory; (2) the basis contract if the farmer was satisfied with the basis
over “selling the Board.” First, the farmer no longer needed a regulated commodity futures account to speculate on the basis, and second, the elevator met all the initial and any subsequent margin calls. The elevator charged the farmer a fee for this service, which was deducted from the amount due the farmer when the crop was delivered. The Commodity Futures Trading Commission (CFTC) described this type of HTA in its general description of deferred price marketing tools:

[A]n 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.

The basic HTA contract, like the cash forward contract, established the contract price using the delivery month futures contract, without the capability to “roll the hedge,” so that the farmer still priced the new crop grain with a new crop futures price. This basic HTA contract, from a Commodity Exchange Act (CEA) vantage point, is indistinguishable from the traditional cash forward contract.

III. THE NEW HTA CONTRACT

In the 1980s, a few aggressive agricultural consultants and grain merchants conceived the idea of modifying the basic HTA contract to increase their competitive advantage which, in turn, caused other elevators to adopt similar marketing tools to retain their customers. Under the new HTA contract, the farmer could set an initial HTA price in a futures month earlier than the delivery contract month. This new HTA contract permitted the farmer to roll the hedge but believed the price of grain would increase into harvest; (3) the basic HTA contract if the farmer was satisfied with the price of grain but believed that the basis would strengthen; and (4) do nothing and accept the full risk of price decline.

11. See CHICAGO BOARD OF TRADE, OFFERING FARMERS CASH CONTRACTS, GRAIN MERCHANDISER SERIES 9 (1994). Farmers with traditional cash forward contracts run the risk that the basis may significantly strengthen between the date the contract is entered and delivery. See id. The farmer with a basic HTA contract runs the opposite risk, that the basis may weaken. See id.


13. See WHITE PAPER, supra note 1, at 11.

14. The term “HTA contract” in this article will refer to this new type of contract as opposed
from the initial futures reference month to the delivery futures month, with or without intermediate rolls. The final futures price was determined by adding or subtracting the net roll profit or loss from the ultimate delivery month futures price. The ostensible purpose of the new HTA contract was to "capture the carry" (that part of the basis exclusive of the transportation differential). In a normal carry market, the near futures contract has the lowest price with each successive deferred month progressively higher to produce a step-ladder effect. When current demand pays a premium to encourage instant delivery, the market may invert with the near futures month quoting the highest price and successive deferred months stepped progressively lower until harvest.

In concept, a farmer captures the carry by going short a near futures reference month, and later when that futures contract nears expiration and the carry has theoretically converged, buying back the short futures position and simultaneously selling another futures contract. The farmer could select the delivery month as the initial futures reference month, roll backward to an old crop futures month and then roll forward again into the delivery month. The farmer could also set the initial HTA contract price in an old crop futures contract and later roll into the delivery month contract or execute an intermediate roll into another old crop futures contract to capture additional carry. The final roll into the delivery month futures contract sets the final futures price which is the delivery month futures price plus or minus the cumulative roll profits or losses to the original or basic HTA contract. See WHITE PAPER, supra note 1, at app. A.

The radical departure that inherent rolling brings to the new HTA contract can be seen from the prevailing literature such as Offering Farmers Cash Contracts, which stated the following concerning the rolling of the original HTA contracts: "Although it doesn't happen often, there may be times when a farmer wants to amend an HTA contract. This could happen if a farmer cannot meet a delivery deadline and wants to 'roll' the contract forward to another physical delivery period and futures contract." CHICAGO BOARD OF TRADE, OFFERING FARMERS CASH CONTRACTS, GRAIN MERCHANDISER SERIES 10 (1994) (emphasis added).

If the futures price for the December contract is $2.80 and the cash price is $2.50, the basis is $0.30. If the transportation differential is $0.20 then the futures carry is $0.10. For purposes of the examples used in this Article, the transportation component or local basis will be assumed to remain a constant $0.20 per bushel.

Both a positive and negative carry can exist in different crop years for the same commodity. See id. at 4-5. For example, current old crop demand may place a premium for available grain in storage while an expectation exists for a new crop harvest that will exceed the projected demand.

This is the example selected by the National Grain and Feed Association (NGFA) to explain the pricing mechanics of the HTA contract. See WHITE PAPER, supra note 1, at 13. This type of activity is relevant to the determination of whether the HTA contract violates the CEA.
and less the elevator’s HTA charges (the initial HTA charge plus the cumulative roll charges). For example, if the farmer enters an HTA contract using the current May futures, the elevator sells short a corresponding May futures contract. Prior to the expiration of the May contract, the elevator buys back or “covers” the short May futures position and simultaneously sells a December futures contract or, if the farmer chooses an intermediate roll, sells a July or September futures contract. The profit or loss on the May futures contract (and on any intermediate roll) is added or subtracted from the delivery month futures contract and that figure, after subtracting all elevator fees, determines the final futures price. At any time prior to a specified number of days before delivery (either before or after the roll into the delivery month futures contract) the farmer sets the basis.

Permitting the farmer to roll into or out of the delivery month futures contract fundamentally changed the HTA contract and vastly increased the risk. By entering a cash forward contract, the farmer sold short what he did not currently possess (new crop corn), but what he reasonably anticipated possessing when he was obligated to deliver; therefore, the farmer is short the same commodity he expects ultimately to possess. Under the new HTA contract, the farmer sells something that he does not possess (old crop corn), which he never anticipates possessing until some time after the futures reference month contract has expired and, therefore, cannot be delivered to fulfill the futures contract obligation. Unlike non-seasonal commodities, each crop year of an agricultural commodity has its own supply and demand fundamentals. By pricing the anticipated new crop grain using an old crop futures contract as the initial reference price, the farmer assumed an inherently speculative position. The farmer is short one commodity (May corn) and is long a different commodity (December corn). Because the price of the various old crop futures months and

21. The steps are as follows: (1) Buy-back the futures contract; (2) calculate the profit or loss; (3) add that amount to the profit or loss from any previous rolls; (4) sell the futures contract in the new reference month; and (5) add or subtract the cumulative roll profits or losses to that new reference price. See WHITE PAPER, supra note 1, at 9-16. See generally CHICAGO BOARD OF TRADE, OFFERING FARMERS CASH CONTRACTS, GRAIN MERCHANDISER SERIES (1994); CHICAGO BOARD OF TRADE, IMPROVING MARGINS USING BASIS, GRAIN MERCHANDISER SERIES (1995). If the roll is to the anticipated delivery month, that price, less any HTA initiation fee and roll fees, is the price (less the basis) that the farmer receives upon delivery.

22. While some HTA contracts (as that term is used here) state that the futures contracts are being purchased for the elevator, the risk of the futures position is being passed through to the farmer. The losses or gains on the futures transaction are subtracted from or added to the initial futures reference price at which the grain has been priced. See WHITE PAPER, supra note 1, at 12-17.

23. The CFTC defines a crop year as the 12 month period which begins with the availability of newly harvested grain and concludes 12 months later. Division of Economic Analysis Statement of Policy in Connection with the Unwinding of Certain Existing Contracts for the Delivery of Grain and Statement of Guidance Regarding Certain Practices, [Current Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 26,691, at 43,849 (May 15, 1996) [hereinafter CFTC Statement of Guidance]. The harvested grain is termed “old crop” grain and that yet to be harvested “new crop” grain. See id. The futures contract months for a corn crop year are December, March, May and July, with September designated as a transitional month. See id. The CFTC has designated a similar pattern for soybeans. See id. at 43,849 n.1.

24. The inherently speculative risk involved in using old crop futures to price new crop grain was accurately and colorfully expressed by the grain merchandisers themselves. "Using old
the futures prices for the new crop may differ sharply, and are therefore essentially different commodities, the CFTC has determined that old crop/new crop spreads constitute speculative transactions.

IV. THE "SPREAD" RISK IN THE HTA CONTRACT

The farmer with an HTA contract has what is known as a "bear" spread. This means the farmer is short old crop futures contracts, and will eventually possess his anticipated new crop harvest. For a number of commodities, the opposing legs of a spread tend to move in sympathy so that if the holder of the spread has guessed wrong, the profit or loss on one futures contract is offset by the profit or loss on the opposing futures contract. In such instances, the holder of the spread loses less than the holder of an outright long or short position. However, the opposing legs of the spread can move in opposite directions. When this occurs, the holder of a spread loses on both legs of the spread and suffers a

crop futures to price new crop grain is speculative. Period. Would you allow the producer to price '96 crop corn by using pork belly futures? Just because the producer stays within the corn futures market, it doesn't mean the 'cross' hedge isn't speculative." DIANA KLEMME, 24TH ANN. COUNTRY ELEVATOR COUNCIL MEETING, NATIONAL GRAIN & FEED ASS'N, CASH MARKET STRATEGIES PANEL DISCUSSION 11 (1995). In fact, the elevators were cautioned that "[b]etting on old crop/new crop spread relationships isn't even a good speculative bet!" Id. at 19.


27. See CFTC Statement of Guidance, supra note 23, at 43,850-51; see also RULES AND REGULATIONS OF THE BOARD OF TRADE OF THE CITY OF CHICAGO § 431.03(3) (1997) (stating spreads within the same crop year are merely marketed to the market; inter-crop year spreads require margin). The old crop/new crop spreads also count against speculative position limits. See 17 C.F.R. § 150.3(a)(3) (1997). The reason is obvious. Because each "leg" of the spread has its own separate supply and demand, the legs can move in opposite directions. CFTC Statement of Guidance, supra note 23, at 43,851 n.12.

28. See COMMODITY FUTURES TRADING COMM'N, THE CFTC GLOSSARY: A LAYMAN'S GUIDE TO THE LANGUAGE OF THE FUTURES INDUSTRY 3 (1992). For commodities that have seasonal variations in supply or demand, a bear spread is initiated by shorting the near month and going long a deferred month. See ROBERT W. KOLB, UNDERSTANDING FUTURES MARKETS 203 & tbl. 5.9 (4th ed. 1996). Because near month futures contracts tend to rise or fall more than the deferred month, the direction of the near month futures contract determines the nature of the spread. The opposite of the HTA contract position, long the March futures contract and short the December contract, would be considered a "bull" spread. The holder of the bull spread believes that the market will rise and that the March futures will rise faster than the July futures. See COMMODITY FUTURES TRADING COMM'N, THE CFTC GLOSSARY: A LAYMAN'S GUIDE TO THE LANGUAGE OF THE FUTURES INDUSTRY 6 (1992).

29. If the March futures are sold at $2.56 and the December futures are purchased at $2.72, then the spread is $0.16. Should the March futures contract fall to $2.46 and the December contract fall to $2.66, the spread is $0.20 and there is a $0.04 profit (a $0.10 profit on the short March futures contract and a $0.06 loss on the long December contract). If the March futures instead rise to $2.65 and the December futures rise to $2.78, the spread is $0.13 and the holder has lost $0.03 (a loss of $0.09 on the short March futures and a $0.06 profit on the long December futures).

30. If the March future is sold at $2.56 and the December future purchased at $2.72 and the March futures rise to $2.70 while the December futures rise to $2.80, the holder of a short position loses $0.14 on the March futures. The holder of the bear spread fairs better having gained $0.08 on the December future for a net loss of $0.06.
greater loss than the holder of an outright position.\textsuperscript{31} Therefore, the risk of any spread position is no different than the risk associated with a naked short position—unlimited.\textsuperscript{32} In theory, a farmer with a substantial portion of his crop committed to HTA contracts could lose the entire value of his crop and then some.\textsuperscript{33} Because the unlimited risk associated with a short futures position can be realized at any time, the longer the farmer waits to roll the HTA contract into the delivery month futures contract (the more crop years the farmer has committed to the program), the greater the likelihood that the risk will materialize.\textsuperscript{34} While the loss actually sustained on any one roll will be finite, the effect of each roll is cumulative\textsuperscript{35} so that a few manageable, but substantial, roll losses can accumulate into a catastrophic loss.\textsuperscript{36}

\textsuperscript{31} If the March future is sold at $2.56 and the December futures are purchased at $2.72 and the March futures rise to $2.70 while the December futures fall to $2.60, the holder of an outright short position still loses the $0.14 on the March futures. The holder of the bear spread loses the $0.14 on the March futures and $0.12 on the December futures for a total loss of $0.26. For this reason, the CFTC requires the following admonition as part of the standard commodity risk disclosure: "A ‘SPREAD’ POSITION MAY NOT BE LESS RISKY THAN A SIMPLE ‘LONG’ OR ‘SHORT’ POSITION." 17 C.F.R. § 4.34(b) (1997).

\textsuperscript{32} Short positions carry unlimited risk because, unlike long positions where prices can only fall to zero, a price can theoretically rise indefinitely.

\textsuperscript{33} The elevator also faces a new credit risk. If the price moves too drastically against the farmer, the risk of default increases. See \textit{White Paper}, supra note 1, at 15; \textit{Chicago Board of Trade, Offering Farmers Cash Contracts, Grain Merchandiser Series 9} (1994).

\textsuperscript{34} As the \textit{White Paper} states, "The amount of risk is directly correlated to the time spread between the intended shipment period and the futures month chosen for the HTA." \textit{White Paper}, supra note 1, at 13. Rolling from one crop year to the next "expands the risk." \textit{Id.} at 14. Also, "[t]he longer the time between the HTA futures month and the intended delivery period, the greater the risk." \textit{Id.} at 15.

\textsuperscript{35} See \textit{id.} at 15. The mere use of HTA contracts for multiple crop years, even without rolling, provides significant risks which are only exacerbated. "Buying grain on a multi-year contract (even without allowing spread/rollover provisions) has significant risks. Allowing producers to use ‘inappropriate’ futures months as a preliminary pricing step with rollover provisions adds spread risk to the position." \textit{Diana Klemme, 24th Ann. Country Elevator Council Meeting, National Grain & Feed Ass’n, Cash Market Strategies Panel Discussion 10} (1995).

\textsuperscript{36} In the various cases pending, farmers have alleged that they were misled into believing that the HTA contract was either risk-free or that risk was limited to a few cents per bushel. The one document that might have alerted the farmer to the potential risk—the margin call—was absent because the futures position is carried in the elevator’s account. Under such a situation, effective risk management no longer rested with the person who, unwittingly or otherwise, would ultimately bear any loss and who, presumably, would be most sensitive to the increased risk. On the other hand, the elevator believed, whether correctly or incorrectly, that it would eventually receive the farmer’s crop and subtract the roll losses from any payment due the farmer. Therefore, the elevator had a less immediate apprehension of the risk and was more likely to let the market take its course. This was a recipe for disaster. What duties, if any, the elevator owed the farmer is now the topic of the debate between elevators and farmers. One thing is certain: Effective risk management, whether for itself or the farmer, required the elevator to institute policies, practices, procedures, and support systems that addressed each of the risks involved. See \textit{White Paper}, supra note 1, at 28. According to the \textit{White Paper}, "[t]he 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.” \textit{Id.} at 30.
V. THE FUTURES SPREAD

Unlike the holder of a long or short position, the holder of a futures spread is unconcerned with the value of either leg of the spread. The profit or loss for the futures spread is determined by the relative change in price between the two opposing futures contracts. Following is an example of an inverted market in which prices are stepping down due to an anticipated decrease in demand or overabundant supply:

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The futures spreader sells the March contract at $2.72 while simultaneously buying the December contract at $2.47. The futures spreader does not care if the final price of December corn is $2.10 or $2.60. The spreader’s only interest is whether the spread differential between the two contracts (+$0.25) moves in his favor. The spreader profits if this spread narrows (if the near futures contract either falls faster or rises slower than the deferred month). For example, if March futures fall to $2.65 and December futures fall to $2.43, the spread has narrowed to $0.22 and the futures spreader has a $0.03 profit. Should the March futures close at $2.68 and the December futures at $2.40, the spread would widen to $0.28 and the futures spreader loses $0.03. In an example of rising prices, if the March contract rose to $2.80 while the December contract rose to $2.67, the spread would narrow to $0.13. Conversely, if the March futures had closed at $2.92 and the December futures at $2.54, the spread would widen to $0.38.

However, unlike the futures spreader, the farmer is always concerned with the price of one of the legs of the spread—the new crop futures price. Even though the farmer and spreader will be in equal situations on any given spread, if the farmer rolls the contract and the new crop futures price declines more than the spread increases, the farmer will lose part of or all of the spread profit and possibly incur a loss because the farmer must obtain a price on delivery above his production cost to profit. The futures spreader does not face this risk because the spreader has no investment in the underlying crop.

VI. DETERMINING THE THEORETICAL VALUE OF THE HTA CONTRACT

The farmer who sells the Board or enters a cash forward contract knows the futures price received. A farmer who enters an HTA contract receives only a futures reference price that will not become a final futures price until the farmer makes the roll into the delivery futures month. Therefore, with an HTA contract, the best approximation of the value of the HTA contract a farmer can achieve is

37. The short March futures is covered at $2.65 for a $0.07 profit while the long December position is covered at $2.43 for a $0.04 loss.
38. The short March position is covered at $2.80 for a $0.07 loss while the long December position is covered for a $0.20 profit.
to calculate a theoretical futures price. If a farmer entered an HTA contract at the $2.72 March futures price in Price Table 1, the theoretical price of the HTA contract is not $2.72 but, rather, the $2.47 December futures price less any elevator charges. It may seem as if the farmer is selling the crop at the futures reference price, but never does. Assume that when the farmer decides to make the final roll into the delivery month futures, the contract prices are unchanged. The elevator would buy back the short March futures contract at $2.72, sell a December futures contract at $2.47, and subtract its fees.\textsuperscript{39} If the farmer decides not to roll into the delivery month futures contract but elects, instead, for an intermediate roll when the March futures contract is trading at $2.70 while the December futures continue to trade at $2.47, the theoretical price is calculated as follows: The $0.02 profit realized from buying back the March contract at a lower price would be added to the $2.47 December contract price, and the $0.03 in elevator fees would be subtracted, resulting in a theoretical futures price of $2.46, and a current anticipated delivery price of $2.26 at the current basis.\textsuperscript{40} If the March futures contract falls to $2.66 and the December futures contract trades at $2.45, the theoretical futures price is $2.48.\textsuperscript{41} An hour or a minute later the March futures contract could be $2.68 and the December futures at $2.42, realizing a $2.43 theoretical price.\textsuperscript{42} Therefore, regardless of the futures reference price, the value of the HTA contract at any moment in time is the current delivery month futures price plus or minus the profit or loss from previous rolls, and the profit or loss to buy back the current short position, less all accrued and anticipated elevator fees.

Understanding the calculation of the theoretical HTA price exposes the HTA contract as a wholly unsuitable price hedging tool. A farmer with an HTA contract has no more price certainty than the farmer who decides not to hedge at all, but the farmer with the HTA contract has assumed more risk. At worst, the farmer who elects to wait and deliver on the cash market can only lose what he invested in his crop. The farmer with an HTA contract has no theoretical limit on the risk assumed. Rather than merely facing price uncertainty, the farmer with an HTA contract faces price uncertainty and unlimited risk. The calculation of the theoretical HTA contract price also exposes an innate contradiction in attempting

\textsuperscript{39} Elevators often charged an initial HTA fee to cover commissions, loan interest, and some profit. The fee ranged from $0.01 to $0.05 per bushel and from $0.01 to $0.03 per roll. For purposes of the following examples, the fees will be $0.02 to initiate an HTA contract and $0.01 per roll.

\textsuperscript{40} The theoretical value of an HTA contract is always comprised of four components: (1) the current delivery month futures price; (2) the cumulative roll profit or loss to date; (3) the profit or loss that would be realized if the contract were rolled to the delivery month futures contract; and (4) the total accumulated elevator fees plus the fee to roll to the delivery futures contract. Because futures prices seldom have more than two anticipated delivery months (the current new crop year and that for the following year), it is impossible to calculate the theoretical value of the third, fourth and subsequent years of a multi-year flex contract other than to assume that the delivery months in those crop years will have December’s futures price as well.

\textsuperscript{41} This is the case because the $2.45 December futures price plus the $0.06 unrealized profit on the short March futures contract sold at $2.72, less the $0.02 HTA initiation fee and the $0.01 fee that will ultimately be charged for the roll to the December contract.

\textsuperscript{42} The $2.42 December futures price plus the $0.04 profit on the short March futures contract, less the $0.03 in elevator charges, equals a $2.43 theoretical price.
to use the HTA contract as a new crop price hedge. The farmer seeking to hedge price risk is *bearish*. He fears that the price of new crop corn will fall before he can harvest and sell his crop. However, the HTA contract is relatively *bullish* on new crop futures prices. Because the farmer is long the new crop and short the old crop futures, he will break-even or profit from the HTA contract *only* if what he anticipates owning (the new crop harvest) retains more value than that which he does not own (old crop grain). Because a long futures position in a commodity being held for sale cannot hedge against declining prices, an HTA contract cannot be a price hedge.

**VII. THE HTA CONTRACT IN A NEUTRAL MARKET**

If supply and demand, and the costs of money, storage, and handling charges continued unchanged, and no changes occurred in government programs while the weather remained benign, the only material variable in the futures price from near to deferred contract months would be the "futures carry"—the theoretical cost to store grain until the expiration of a futures contract. Because the futures carry reflects the current cost of storing grain over time, it should diminish uniformly from each futures contract in a stable market, giving the classic step-ladder price effect:

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<tbody>
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<td>$2.98</td>
<td>$3.10</td>
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<tr>
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<td>$2.62</td>
<td>$2.74</td>
<td>$2.86</td>
<td>$2.98</td>
</tr>
<tr>
<td>04/28</td>
<td>$2.50</td>
<td>$2.62</td>
<td>$2.74</td>
<td>$2.86</td>
<td>$2.98</td>
</tr>
<tr>
<td>06/30</td>
<td>$2.50</td>
<td>$2.62</td>
<td>$2.74</td>
<td>$2.86</td>
<td>$2.98</td>
</tr>
<tr>
<td>08/31</td>
<td>$2.50</td>
<td>$2.62</td>
<td>$2.74</td>
<td>$2.86</td>
<td>$2.98</td>
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<tr>
<td>11/30</td>
<td>$2.50</td>
<td>$2.62</td>
<td>$2.74</td>
<td>$2.86</td>
<td>$2.98</td>
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On December 31, the market has a $0.48 futures carry ($3.10 less $2.62) that can only be captured with a cash forward at $3.10 or a short sale of the December futures contract.

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43. See CHICAGO BOARD OF TRADE, IMPROVING MARGINS USING BASIS, GRAIN MERCHANDISER SERIES 7-8 (1995). A simple formula for calculating the futures carry is the price of grain multiplied by the current interest rate plus 2% for items such as insurance, handling costs, and elevator profit, plus the basic storage cost for an exchange storage facility. *See id.* at 8. Assuming a price of $2.50 per bushel, a 9% interest rate and 2% for insurance and other costs, the futures carry would be 2.25¢ ($0.0225) (9% plus a 2% charge to cover insurance and other costs gives an 11% annual interest rate, divided by 360 banking days (0.0003) times 30 days equals an interest rate of 0.009 per month, times $2.50 equals 2.25¢ ($0.0225)). *See id.* at 7. If the basic storage rate for an exchange storage facility was 4.75¢ ($0.0475), the full futures carry would be approximately $0.07. *See id.* at 8. Because the futures price rarely reflects more than 80% to 85%, the futures carry in this example would be approximately $0.06 a month. *See id.*

44. Because the only difference between the original HTA contract and a cash forward is that the farmer does not set the local basis at the time the contract is written and pays an HTA initiation fee of a few cents per bushel, only the cash forward contract will be discussed in the price examples. Whatever futures or cash price the farmer receives with a cash forward contract, a farmer with a basic
Farmer A enters into a cash forward contract and is guaranteed a price of $2.90 ($3.10 less the $0.20 local basis). He has price certainty, but if his crop fails he will have insufficient grain to deliver, requiring him to make a cash settlement of the contract with the elevator. Farmer B does nothing. He does not know what price he will receive, but he does not bear more than the normal risk of producing and monitoring the crop. Farmer C enters a HTA contract at a $2.62 March futures price with a theoretical net futures price of $3.07 (the December futures price less the $0.02 HTA initiation fee and the minimum charge of $0.01 for the ultimate roll to the December futures contract). Farmer C bears the same production risk as Farmer A while sharing the same price uncertainty as Farmer B. Farmer C has assumed the worst aspects of the other hedging decisions without receiving any corresponding benefit. Additionally, he has undertaken the spread risk of unlimited loss. Because the futures carry and underlying price remain constant, Farmer C will capture the same $0.48 carry that Farmer A captured with the forward contract but must deduct the elevator’s HTA initiation and roll fees. Therefore, unless the carry fluctuates favorably, the farmer with the HTA contract will always receive a lower price than he would have received if he had entered a cash forward contract.

The futures carry, for the most part is a function of interest rates. Therefore, the futures carry normally does not fluctuate sufficiently in the six to nine months of the old crop year to justify the uncertainty and risks of the HTA contract. If the Federal Reserve suddenly raised interest rates by two percent so that the interest rate in the futures carry formula jumped from nine percent to eleven percent, and the basic storage cost also increased by $0.01 to 5.8¢, the monthly futures carry would only increase to $0.07 per bushel. Assuming that this occurs as the May futures contract expires, the prices would be as follows:

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<tbody>
<tr>
<td>12/31</td>
<td>$2.62</td>
<td>$2.74</td>
<td>$2.86</td>
<td>$2.98</td>
<td>$3.10</td>
</tr>
<tr>
<td>02/28</td>
<td>$2.50</td>
<td>$2.62</td>
<td>$2.74</td>
<td>$2.86</td>
<td>$2.98</td>
</tr>
<tr>
<td>04/28</td>
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<td>$2.64</td>
<td>$2.86</td>
<td>$2.78</td>
<td>$3.92</td>
</tr>
<tr>
<td>06/30</td>
<td></td>
<td>$2.50</td>
<td>$2.64</td>
<td>$2.64</td>
<td>$2.88</td>
</tr>
<tr>
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<tr>
<td>11/30</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>$2.50</td>
</tr>
</tbody>
</table>

HTA contract entered at the same futures price would receive less the elevator’s HTA initiation fee.

45. Farmer B bears a production risk. If his crop fails, he will be unable to cover the costs of planting the crop and operating his farm. Farmer A bears that production risk plus the risk that he may be required to pay the elevator the difference between the cash forward price and any increased price at the time set for delivery on those bushels he cannot deliver.


47. Assuming the same $2.50 per bushel price, the futures carry would be calculated as follows: 13% (11% interest rate plus 2% miscellaneous costs) divided by 360 banking days, times the 30 days in a futures month, times $2.50 equals a futures carry of 2.7¢ ($0.027), which provides a full futures carry of 8.5¢ when added to the basic storage charge ($0.058 or 5.8¢) for an exchange storage facility. Because only 80% to 85% of the full futures carry is present in the futures price, the actual full futures carry is approximately $0.07.
Farmer C now captures two $0.12 carries and two $0.14 carries for $0.52 in roll profits and a resulting final futures price of $3.10 or that which he could have obtained through a normal cash forward contract. Clearly, significant changes in underlying economic factors are insufficient to justify the HTA contract as a viable tool for capturing changes in the futures carry, even assuming a full-carry market. For the carry capture to perform as advertised, the carry must fluctuate favorably between futures months. The carry that the HTA rolling seeks to capture is not the futures carry as defined by interest charges and storage cost. Instead, it is the premium or discount being paid to deliver grain immediately in times of shortage or the current discount to encourage deferred delivery in times of abundance. In other words, in the HTA context the word "carry" is merely a euphemism for futures contract price speculation, and the HTA contract is designed solely to speculate in the inter-crop year spread.

VIII. THE HTA CONTRACT IN A RISING MARKET

In 1995, the corn market experienced continually rising prices from early Spring throughout harvest and delivery.

Price Table 4

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<td>$2.40</td>
<td>$2.44</td>
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</tr>
<tr>
<td>02/28/95</td>
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<td>$2.42</td>
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<td>$2.53</td>
<td>$2.57</td>
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<tr>
<td>04/28/95</td>
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<td>$2.55</td>
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<tr>
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<td></td>
<td></td>
<td></td>
<td></td>
<td>$3.30</td>
</tr>
</tbody>
</table>

Farmer A from the earlier example enters into a forward contract in February and receives a final futures price of $2.57 and an ultimate delivery price of $2.37. Farmer B simply waits. He will ultimately obtain a cash price of $3.10 ($3.30 less the local basis). Farmer C enters into an HTA contract using the $2.48 July future price to set the initial HTA contract price. Farmer C has a theoretical futures price of $2.54 (the December futures price less the HTA fee and at least

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48. The elevator fees remain $0.06, which reduce the roll profits to $0.46. The $0.46 is then added to the $2.64 December futures price.

49. A full-carry market occurs when the cost of storage is the only difference between cash and futures prices. In such a market, the only differential between futures months is the cost of storage. See Robert W. Kolb, Understanding Futures Markets 102-04 (4th ed. 1996). Gold, for example, is a full-carry commodity because each month’s futures price reflects the cash price plus the cost to carry gold until delivery. If the cost of carrying gold is 10% and the March gold contract is $400, the cost to carry gold until the March contract the next year is $40 and the futures price for that contract would be $440. If gold rose to $450, the carrying cost would rise to $45; the price of next year’s March contract would increase to $495 and the spread would widen to $5. Conversely, if the price of gold fell to $350, the carry would fall to $35 and next year’s March contract would be priced at $385, resulting in a $35 carry and a loss of $5 on the spread.

50. Chicago Board of Trade. Closing prices are rounded down. All rolls are made in the last trading day of the month prior to the expiration of the futures contract.
one roll charge). On June 30 the July futures contract is approaching expiration. Farmer C must either roll into the December delivery month contract or execute an intermediate roll into the September futures contract. If Farmer C rolls to the December futures contract, he receives a final futures price of $2.53 and a delivery price of $2.33. Should he elect for an intermediate roll to the September futures contract, he receives a final futures price of $2.49 and a delivery price of $2.29. Farmer C has once more undertaken the identical production risk as Farmer A while sharing the same price uncertainty as Farmer B who simply waited. Farmer C has received the worst price while assuming the risk of unlimited loss. Farmer B incurred neither production risk nor short futures risk and received a price of $2.90 as reward merely for bearing the risk of price uncertainty.

Because the holder of an HTA contract loses money as the short old crop futures contracts rise in price and gains money as the long new crop futures contracts rise, it is difficult for the HTA contract to hold its own in a rising market. First, grain prices have a seasonal tendency to weaken in the new crops futures months on the anticipated availability of more grain. Second, because producers will accumulate most of their short positions in the December futures contract (even the holders of HTA contracts eventually have to sell short the December futures contract), the futures price will have a tendency to be depressed. The rising market situation in which the HTA contract will work and may even show a profit is when new crop prices reflect an expectation of a poor harvest. However, this places the farmer at risk of defaulting and, if he does, the higher HTA price would reflect the increased damages owed to the elevator. Rising markets, especially those that weaken into the new crop futures months, are ill-suited for HTA contracts.

If rising markets are not favorable for HTA contracts, inverted markets are a disaster. The inverted 1996 market looked like this:
On February 29, Farmer A enters into a cash forward contract based on the December 1996 delivery price of $3.15, for a delivery price of $2.95. Farmer B does nothing and ultimately receives a final delivery price of $2.50. Farmer C prices his HTA at $3.95 May futures and has a theoretical price of $3.12 (the December futures less the $0.02 initial HTA fee and the $0.01 fee for the necessary roll into the December contract). On April 30, Farmer C can roll into the December futures and receive a $2.57 futures price and $2.37 at delivery. If Farmer C elects for an intermediate roll into the July contract at $5.16, he has a theoretical futures price of $2.56 which, by June 30 has eroded to $2.26, resulting in an ultimate delivery price of $2.06. If Farmer C elects for an intermediate roll from the May futures contract directly into the September futures contract, he will receive a final futures price of $2.22 because of the relative strengthening of the December futures.

IX. THE ERODING MARKET

The fear of declining prices is the primary reason to hedge an anticipated crop. The following prices reflect a market experiencing a weakening demand:

<table>
<thead>
<tr>
<th>Date</th>
<th>Mar. '96</th>
<th>May '96</th>
<th>July '96</th>
<th>Sept. '96</th>
<th>Dec. '96</th>
</tr>
</thead>
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<tr>
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<td>$2.93</td>
<td>$2.79</td>
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</tr>
<tr>
<td>04/30/96</td>
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<td>$4.52</td>
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<tr>
<td>06/28/96</td>
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<td>$3.97</td>
<td>$3.61</td>
<td></td>
</tr>
<tr>
<td>08/30/96</td>
<td>$3.18</td>
<td></td>
<td>$3.18</td>
<td>$3.02</td>
<td></td>
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<tr>
<td>11/29/96</td>
<td></td>
<td></td>
<td></td>
<td>$2.70</td>
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55. CHICAGO BOARD OF TRADE.

56. The May contract is bought-in at $4.62 for a $0.67 loss which, together with the $0.03 in elevator charges, is subtracted from current $3.27 futures price for a final futures price of $2.57 less the $0.20 basis.

57. The July contract, sold at $4.52, is covered at $5.16 for an additional $0.64 roll loss and a cumulative loss of $1.31, which, together with elevator charges of $0.04, are deducted from the $3.61 December futures price giving a $2.26 final futures price and a delivery price of $2.06.

58. The September contract, sold at $3.97, is covered at $3.18 for a $0.79 profit. While the December contract has fallen $0.59 to $3.02, it actually strengthened in relation to the September futures contract by $0.20, yielding a final futures price of $2.20. If Farmer C had priced his HTA contract with the July futures contract on February 29, held it to expiration and rolled in the December futures contract at $3.61, he would have suffered $1.27 in roll losses, incurred $0.03 in elevator charges, realized a final futures price of $2.21 and a $2.01 delivery price.
On February 28, Farmer A enters into a cash forward contract at $2.90 and receives a final delivery price of $2.70. Farmer B again does nothing. The price risk Farmer B accepted materializes and he receives a delivery price of $2.02. Farmer C enters an HTA contract using the July futures as the initial futures month and receives an initial contract price of $2.61 and a theoretical final futures price of $2.87 (the $2.90 December futures less minimum elevator charges). If Farmer C rolls into the delivery month futures contract on July 30, he realizes a final futures price of $2.75 and a $2.55 delivery price.\textsuperscript{59} An intermediate roll into the September futures contract produces a final futures price of $2.49.\textsuperscript{60} While the HTA contract provides a better result than simply delivering on the cash market, it again performs below the level of the cash forward contract which provided price certainty and did not expose Farmer A to the inherent risk of an unlimited short position. Had new crop prices not weakened quite so much, relative to the old crop futures prices, Farmer C would have received a proportionally higher price, but still less than Farmer A who used the traditional cash forward contract.

If crop prices rose, inverted, or declined (markets shown in Price Tables 6 through 8), perhaps the futility of the HTA contract would have been exposed before disaster struck. However, fate was not so kind. The year 1993 gave the appearance that the HTA concept worked. The 1993 crop prices appeared as follows:

### Price Table 6

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<tbody>
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<td>11/30</td>
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<td>$2.22</td>
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</tr>
</tbody>
</table>

59. The July futures contract is covered at $2.46 for a $0.15 roll profit (reduced to $0.12 by the elevator charges) and is added to the $2.63 December futures price.

60. The September futures contract, sold for $2.51, realizes a $0.13 roll profit for a cumulative roll profit of $0.28 (reduced by $0.04 in elevator charges) and added to the $2.25 December futures price, which has weakened an additional $0.38.

61. \textsc{Chicago Board of Trade.}
futures price of $2.39 and a final delivery price of $2.19. Farmer B who does not hedge eventually receives a $2.59 delivery price. Farmer C enters an HTA with a July futures price of $2.25 and a theoretical price of $2.36. On June 30, Farmer C would now realize a final futures price of $2.38 if he rolled directly into the December futures contract.\textsuperscript{62} If Farmer C makes an intermediate roll into the September futures contract at $2.29, he would also receive a $2.36 futures price because this futures contract expires at $2.29.\textsuperscript{63} In either instance the HTA contract gives the appearance of doing precisely as promised, enhancing the farmer’s price by a modest capture of the carry of $0.11 in one instance and $0.13 in the other. In actuality, however, the HTA contract accomplished nothing of the sort, but instead provides the same or $0.02 less than a cash forward contract would realize. But, for farmers who believed that they had sold their corn for $2.25 in February and that they could “save” their $2.36 or $2.38 HTA price for their 1994 crop and deliver at the high cash market price in November or December, the HTA seemed to offer the answer to their hedging quandary—a locked-in price that could be increased by the carry with the flexibility to capture a rise in the cash market. In retrospect, 1993 was a very bad year for these farmers. Convinced that the new HTA contracts worked, they were ready to go full steam ahead in 1994 and their skeptical neighbors were now ready to test the HTA contract with part of their 1994 crop.

The 1994 prices were as follows:

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</tr>
<tr>
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<td></td>
<td></td>
<td></td>
<td>$2.13</td>
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</tbody>
</table>

Farmer A enters into a cash forward contract on February 28 and receives a delivery price of $2.53. The price risk that Farmer B has accepted by deciding not to hedge has materialized and he receives a delivery price of $1.93. Farmer C enters an HTA contract at the initial July futures price of $2.81 but has a theoretical price of $2.74 (the December futures price less $0.03 in elevator fees). If Farmer C rolls into the December futures contract on June 30, 1994, he obtains a final futures price of $2.71.\textsuperscript{65} He has received approximately the same futures price as the farmer who cash forwarded, the only difference being the HTA fees. If Farmer C decides upon an intermediate roll into the September futures, he

\textsuperscript{62} The short July contract is covered for a $0.03 roll profit which is cancelled by the $0.03 in elevator charges.

\textsuperscript{63} The $0.01 reduction in the December futures contract is offset by the additional roll charge.

\textsuperscript{64} Chicago Board of Trade.

\textsuperscript{65} The short July futures contract is covered at $2.49 for a $0.32 profit, which, less the $0.03 in HTA fees, is added to the $2.42 December futures price.
ultimately receives a final futures price of $2.74, which is $0.01 higher than the price received by Farmer A with his cash forward contract. 66

For those farmers who believed that they could save their HTA price for the next year’s harvest, the HTA had performed as promised for a second year. The proof was in the pudding. They had “locked-in” an acceptable price, delivered on the cash market at a higher price and still had the HTA contract’s price for use next year. While 1993 seemed to confirm that the HTA contract could take the risks out of farming, 1994 only further strengthened that fallacy.

Farmer C’s futures price of $2.32 as of November 30, 1993, which he had “saved” for 1994, fared very well. Had the farmer delivered instead on the cash market, he would have received a $2.59 delivery price (the $2.79 December futures price less the basis) and would have rolled this HTA contract forward into 1994. The roll into the March futures contract at its November 30, 1993 price of $2.85 would have resulted in a theoretical price of $2.03. 67 This is obviously a bad decision for any farmer who understands how HTA contracts actually function, and underscores the reality that it is impossible to improve a poor HTA contract, which is ready for delivery, by rolling the HTA contract and delivering on the cash market. Unless something fortuitous occurs in the market, the profits obtained by selling on the higher cash market in 1993 will be lost in 1994. 68 With the specter of unlimited loss haunting him from day to day, disaster lurked behind every futures market opening. But, for the farmer who believed he had locked-in a price of approximately $2.32, it is a very reasonable, if not the only, decision.

After the 1993 HTA contract is rolled into the March 1994 contract, on February 28, 1994, it is then rolled into the May futures contract at $2.96 producing a theoretical futures price of $2.09. 69 The roll into the July futures on April 29 occasions a $0.02 profit but, even more importantly, the new crop 1994 futures have strengthened relative to the old 1993 crop futures prices because they declined only $0.15. The theoretical futures price on April 29 has, therefore,

66. The short September futures contract is covered at $2.20 for a $0.24 profit, which brings the cumulative roll profits to $0.56, from which the $0.04 in HTA fees are deducted and the total is added to the $2.22 December futures price.

67. The December 1993 futures contract, sold at $2.37, is covered at $2.85 for a $0.48 loss which, with the $0.01 loss from the July futures roll, brings cumulative roll losses to $0.49. The elevator charges are now $0.05 bringing the loss to $0.54. Assuming the farmer were to roll directly into the delivery futures month when he will next have crop (December 1994 which was priced at $2.58 on November 1993 according to the Board records), adding the additional $0.01 fee for that roll brings the roll losses to $0.55 giving the farmer a price of $2.03 for his 1994 production.

68. The NGFA warned elevators of this reality, cautioning them that allowing farmers to roll low-priced HTA contracts and delivering on the cash market only sweeps the problem under the rug for a year. See DIANA KLEMM, 24TH ANN. COUNTRY ELEVATOR COUNCIL MEETING, NATIONAL GRAIN & FEED ASS’N, CASH MARKET STRATEGIES PANEL DISCUSSION 15-18 (1995). In fact, it cautioned elevators to tell farmers that “rolling a low-priced contract ahead won’t add anything to your [the farmer’s] bottom line. This isn’t a good strategy for you, nor for us.” Id. at 18.

69. The March 1994 futures contract is covered at $2.93 for an $0.08 loss ($2.93 less the $2.85 March 1993 futures contract price for November 30, 1993), bringing cumulative roll losses to $0.57. The elevator fees have increased $0.01 to $0.07 which, together with the cumulative roll losses, are deducted from the $2.73 December futures.
increased to $2.20. The 1994 crop futures prices continued to strengthen relative to old crop 1993 prices, and the roll into the September futures contract realizes a $0.33 profit while new crop prices fall only $0.15. The farmer’s theoretical futures price has increased to $2.36. The roll into the December futures realizes a roll profit of $0.24, while new crop prices decline only $0.16, producing a final futures price of $2.43.

Just as in 1993, the HTA gives the farmer the appearance that it has done precisely what it was intended to accomplish and captured a modest $0.11 carry during the year. If a farmer does not understand the mechanics of the HTA rolls and believes he originally locked-in a $2.25 price in February 1993, the HTA appears to have captured a modest $0.17 carry over the eighteen month period while permitting him to enjoy a $0.40 profit by delivering on the cash market in 1993. In November 1994 it gets even better. While the futures price has plummeted to $2.13, the farmer delivers on his 1993 contract at a $2.43 futures price and puts his 1994 HTA contract “in the bank” for use in 1995 or some other crop year when prices have deteriorated. In November 1994, when the price for the December futures contract has slipped to $2.13, the farmer delivers and receives $2.43 on his 1993 HTA contract and saves his 1994 HTA contract for another year. But the HTA contract has not captured a steadily increasing but smaller carry. Instead, futures price movements have turned a significant loss into a fair profit. Appearance, however, is everything. For two consecutive years the HTA contracts had performed just as the elevators and agricultural consultants had represented. The farmers that had profited in 1993 and 1994 were now ready to market three, four, or five years of crop using HTA contracts. The farmers that had stood aside were now convinced that they would miss the HTA ship unless they too jumped aboard. Viewing the losses that would ultimately be suffered as a result of this false confidence, the year 1994 could not have been worse for these farmers if 1994 had been a time of flood or drought. Prices had acted in the only manner in which the HTA concept works—a relative strengthening of new crop prices versus old crop prices, while the price of new crop corn futures plummets. In this instance, new crop prices fell from $2.70 on January 3 to $2.13 on November 30. The HTA contracts convinced many farmers that only smooth sailing lay ahead, with price risks tamed. Instead, the HTA ship was headed for the shores of an inverted market.

70. The $0.27 profit on the roll out of the May futures contracts reduces the cumulative roll losses to $0.30 and the elevator charges (now $0.08) are subtracted from the $2.58 December futures price.

71. The $0.33 roll profit realized from covering the May futures at $2.49 gives the farmer a cumulative roll profit of $0.03. Because the HTA charges are now $0.09, the HTA contract is only $0.06 lower than the December futures price.

72. The roll profits now total $0.27 and the HTA fees total $0.10, leaving $0.17 to be added to the $2.26 December futures price.

73. The HTA concept, as explained to the farmers, was not a get-rich-quick scheme, but merely a method to capture the futures carry of possibly $0.01, maybe 1 1/2¢, a month. The most salient feature of the HTA contract for the farmer was not the capture of this carry, but the ability to deliver on the cash market if prices rose and to roll the HTA contract forward. The 1993 price movement enabled farmers to capture a $0.40 price increase by doing just that, demonstrating the central importance of the ability to roll the HTA.
X. THE PURPOSE OF THE HTA CONTRACT IS PRICE SPECULATION

As these examples demonstrate, the HTA contract can never effectively hedge price risk because price is not certain until it is rolled into the futures delivery month. Until that time, the holder of the HTA is actually betting against himself. He has entered the HTA contract, at least ostensibly, to hedge all or a portion of his crop against price decline, but will lose money if the new crop prices weaken as he expects. The HTA contract serves no legitimate hedging function because it fails to reduce either price uncertainty or production risk. If the HTA contract is not a hedge, then it serves only one function—speculation. 74


The flex contract's multi-year rolling provision precipitated the present crisis. The ability to roll the delivery obligation forward, sometimes indefinitely, enabled agricultural consultants and elevator managers to persuade farmers to sell not only 100% of one crop year's production, but 100% of multiple years of anticipated production.75 The "programs" advanced by some elevators and agricultural consultants bordered on lunacy. Some farmers, for example, were advised to sell a percentage of their crop (generally twenty-five percent) every time corn prices advanced $0.02 to $0.03 per bushel. The farmers followed this advice until they had hedged their entire expected production from one to six crop years.76 The farmers with previous HTA experience used old crop reference months to initially price, while many of the farmers new to the HTA concept priced their contracts using the delivery month futures contract. The two strategies produced only a relatively minor difference, therefore, the HTA contracts will be assumed to have been initially priced in the December 1995 futures price.77 The prices were as follows:

74. The only reason to use old crop futures in attempting to price new crop grain, is to speculate on the direction of the old crop/new crop futures price spread. See WHITE PAPER, supra note 1, at 13; see also CFTC v. Standard Forex, Inc., [Current Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 26,786 (E.D.N.Y. July 25, 1996) (stating that the futures market enables persons to either assume (speculate) or shift (hedge) price risk); Cargill v. Hardin, 452 F.2d 1154, 1158 (8th Cir. 1971) (explaining that the purpose of a futures market hedge is protection against adverse price fluctuations).

75. See, e.g., Complaint, Gunderson v. ADM Investor Servs., Inc., No. 96C-3382 (N.D. Ill. filed June 5, 1996) (stating 54 farmers had 8,353,000 bushels of corn committed to flex contracts even though their combined yearly production total was only 3,579,000 bushels).


As corn prices rose into harvest, 1994 seemed like a replay of 1993. Farmers who had been led to believe that they owned flex contracts valued at the original futures reference price, decided (often upon suggestion of the elevators and agricultural consultants) to take advantage of the roll provision of their flex contracts and roll their $2.70 HTA contracts forward for use in another crop year. A farmer who sold his crop for a $2.62 futures price ($2.42 delivery price) had little to gain by electing to roll into the March 1996 contract on November 30 because his theoretical futures price would only be $2.66.

78. CHICAGO BOARD OF TRADE.
79. In Gunderson for example, farmers were presented with the following marketing material:

What is a hedge to arrive contract?
1. It is an elevator contract.
2. The contract is a Chicago Futures contract not a cash contract.
3. The elevator sells a futures contract in the month and price you select.
4. The elevator pays the margin call if the price continues higher against the contract.
5. No matter what the price does up or down, you receive the contract price minus the basis.
6. The basis, the difference between Chicago price and cash, will be set at a later date.

Complaint at exhibit N, Gunderson v. ADM Investor Servs., Inc., No. 96C-3382 (N.D. Ill. filed June 5, 1996) (underlining and bold omitted) (emphasis added). The representation that the farmer will receive the contract price no matter what price movement occurs is an obvious misrepresentation. Attempting to defend this contract as a cash contract would seem to present a Herculean task because it is presented as a futures contract rather than a cash contract.

80. The $2.62 contract is covered at $3.30 for a $0.68 loss. The roll loss plus the $0.03 in elevator fees is deducted from the $3.37 March 1996 price.
Likewise, those farmers who understood the HTA pricing mechanism were unconcerned because the unlimited rolling features of their HTA contracts meant that they could either wait for the market to cure the situation or simply roll them from crop year to crop year at a cent or two per bushel. Unless the farmer believed that he could save his HTA price for a harvest when prices were lower or roll the HTA contract indefinitely, it makes absolutely no sense to assume a year of price uncertainty and unlimited loss potential for $0.04 per bushel. And that is precisely what many of these farmers did. Most of them were unaware that they actually had suffered an unrealized loss of $0.68 per bushel, not merely on one crop year’s production, but on each year’s production that had been committed to a flex contract.

Prices then began to soar as follows:

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<th>Sept. '96</th>
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<td>$3.58</td>
<td>$3.58</td>
<td>$3.27</td>
</tr>
</tbody>
</table>

In February 1996, the farmer was forced to roll into the May 1996 futures contract at a $0.54 roll loss (the $3.37 March futures contract is covered at $3.91) for a total of $1.22 cumulative roll losses, giving the farmer a theoretical futures price of $1.91 (the delivery month futures price of $3.17 less $1.22 less $0.04 in elevator charges). Farmers who had sold multiple years of crop had incurred huge losses. A farmer who sold three years of production totaling 150,000 bushels had experienced almost $185,000 in unrealized spread losses. Margin calls for the elevators were becoming unmanageable. On March 29, 1996, the

81. Unless, of course, the farmer, elevator, or both had been told by the commodity brokers and agricultural consultants that the inverse spread between old crop and new crop “always” disappears. Then, of course, one would be anxious to sell more grain using old crop futures months as reference months because the more the spread expanded, the more it would eventually close. However, the NGFA warned elevators of the complete folly of such a strategy at the beginning of December 1995 at a time when the problem was manageable. “[T]he logic that old crop/new crop inverses ‘always disappear’ simply isn’t true. History does not bear this out. Therefore, this strategy isn’t even a good speculative bet.” DIANA KLEEME, 24TH ANN. COUNTRY ELEVATOR COUNCIL MEETING, NATIONAL GRAIN & FEED ASS’N, CASH MARKET STRATEGIES PANEL DISCussion 11 (1995) (emphasis added). In fact, elevators were provided the following response to give producers on December 4, 1995:

1995 crop prices are higher because old crop is in short supply. Prices may drop as demand begins to cut back, but history does NOT show that the premium of old crop over new crop always disappears. It DOESN’T. Sometimes it drops a little, sometimes it doesn’t, sometimes the inverse worsens. But in any case, it’s speculative to sell any price that represents a time period earlier than you can deliver your production against. Betting on old crop/new crop spread relationships isn’t even a good speculative bet! You’re in the business of farming, not speculation. If you believe speculating in futures is a sure way to make money, think about renting out the farm and trading futures full time!

Id. at 19 (underlining omitted).

82. CHICAGO BOARD OF TRADE.
theoretical price on the 1996 harvest had declined to $1.74 (the previous $1.22 in roll losses plus the $0.20 plus $0.05 in elevator charges are subtracted from the $3.21 December futures price). With margin calls increasing and no relief in sight in the form of lower prices before additional roll losses were incurred, elevators began making demands for security and, in some cases, for cash. On April 30, the May futures contract had risen another $0.53 so that when the actual buy back was executed the cumulative roll losses now totaled $1.97 and the elevator charges totaled $0.06 plus $0.01 for the ultimate roll to the December contract for a theoretical price of $1.23. The farmer who produced 50,000 bushels and sold three years production had incurred spread losses and elevator fees totaling almost $300,000. The increased margin requirements on the elevators caused them to attempt to obtain margin from the farmers or demand immediate delivery of grain that they knew the farmers did not have (and could not have for a number of years). This was in direct contradiction of the terms of the HTA contracts, which in turn caused the farmers to begin questioning the validity of the contracts.

XII. IS THE HTA CONTRACT A FUTURES CONTRACT?

The point at which a cash forward contract evolves into an illegal futures contract or prohibited trade option is a factual question that frequently depends on the course of dealing between the parties. No specific formula is available for making this determination and, unfortunately, the determination cannot be made across the board. Additionally, the HTA contracts and the marketing statements varied from one locale, if not one elevator, to the next. Therefore, the inquiry into the validity of HTA contracts must proceed on an elevator by elevator process or, at best, by groupings of elevators that share common HTA contract provisions and marketing practices. While class action litigation may

83. Pricing the flex contracts with the May, July, or September futures would add $0.10-$0.15 to the roll losses.

84. The rule of law was best stated by a circuit court over one hundred years ago in a case concerning a contract to buy rye:

In seeking to ascertain the intentions of parties to such transactions as the one under consideration, it is evident that it will not do to place any great stress upon the mere terms of their contract, or upon their own declarations, whether under oath or not. Parties to such contracts will always seek to give them the form and semblance of legality, and all our experience admonishes us to receive with extreme caution, if not absolute distrust, what parties charged with transactions apparently illegal say respecting the innocency of their own intentions. . . . We must look at the actions of interested or accused parties, rather than their mere words, to ascertain their real intentions. We must consider what they have done, rather than what they have said, when called to account for their actions. We can best learn what interpretation the parties themselves have put upon their own contract, by considering what they have done under and in pursuance of it, with a view to its settlement or fulfillment.


be viable for trading advisors and commodity firms that advocated the use of HTA contracts throughout a state or group of states, the particular issues pertaining to a given elevator severely limit the use of a class action to interpret the validity of HTA contracts on a broad scale.

The issue is not the contract name, but instead what the parties intended it to accomplish.86 Did the parties intend the HTA contract as a mechanism for transferring title or merely as a vehicle to either hedge risk or to engage in price speculation?87 The CFTC has held steadfast to the position that the dual delivery obligation (of the farmer to make delivery and the elevator to accept) lies at the legal heart of a cash forward contract. When this dual delivery obligation is present, the contract is generally seen to fall within the cash forward contract exemption of the CEA.88 Some new HTA contracts, in their purest form, while permitting one or more intermediate rolls up to, but not past, the delivery month, still obligate the farmer to deliver in the delivery month.89 That delivery


87. As the Melchert Court stated over a century ago in assessing intent to deliver, "the subsequent conduct of the parties in dealing with the contract—in adjusting, settling, or fulfilling it—may often, as evidence, cast strong reflected light upon their original intentions in making it." Melchert v. American Union Tel. Co., 11 F. 193, 195 (C.C.D. Iowa 1882).


89. See, e.g., Complaint, Hodge Bros. v. DeLong Co., No. 96-C-0543-C (W.D. Wis. filed June 26, 1996). This case involved these types of HTA contracts as well as traditional cash forward contracts and the new flex-hedge contracts. The Hodge plaintiff had old crop grain in storage and had entered into HTA contracts using old crop reference months that may or may not have been for this old crop grain. He also sold new crop grain on a traditional cash forward basis. What grain pertained to which type of contract was a matter of active dispute between the parties. Wisconsin, however, has a unique statute that entitles an elevator to injunctive relief whenever a farmer fails to deliver under a cash grain contract. Wis. STAT. ANN. § 127.17(3) (West 1986 & Supp. 1997). Pursuant to this statute the court ordered the proceeds of the cash sale escrowed and the parties finally settled their dispute after the Hodge plaintiff sought bankruptcy protection. See Complaint, Hodge Bros. v. DeLong Co., No. 96-C-0543-C (W.D. Wis. filed June 26, 1996).
obligation is what *compels* the farmer to roll the underlying futures contract from the futures reference month to the delivery futures month. While the use of an HTA contract as a price hedging tool may be ill-conceived, even foolish, the CEA does not protect an individual from the consequences of improvident contracts, only from illegal ones. Farmers and elevators are free to select any pricing mechanism, regardless of how inane, to set the contract price on a cash forward contract. If the HTA contract is ultimately viewed as an unwise but unified transaction intended to deliver a specific crop of grain, it would appear to fall within the CEA’s cash forward exception. If the HTA contract, however, is perceived as an unpriced contract that acts as the margin security for commodity futures price speculation through the elevator’s hedging account, then the HTA contract would violate the CEA. Two factors militate toward this result. First, while the purchase of a limited risk vehicle such as a call option to enhance the ultimate price may be viewed as merely incidental to the cash forward contract, the futures element of the HTA contract entails risk that can easily consume the cash forward element of the contract. Second, the HTA contract involves an old crop/new crop spread, which, as discussed above, is a purely speculative vehicle that cannot shift price risk. These two factors alone might be insufficient to render the HTA contract illegal, but the presence of one or more additional factors could easily do so.

The determination of whether the HTA contract violates the CEA will ultimately depend on the wording of the contract and the dealings between the parties. The term “parties” means more than simply a specific farmer

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91. See In re Bucyrus Grain Co., Inc., 127 B.R. 45 (D. Kan. 1988), appeal dismissed, 905 F.2d 1362 (10th Cir. 1990) (finding a grain elevator that entered trades for customer in the elevator’s commodity account acted as a futures commission merchant (FCM)); see also Complaint and Notice of Hearing at 7, In re Southern Thumb Coop., Inc., No. 97-3 (C.F.T.C. filed Nov. 13, 1996) (C.F.T.C. enforcement action). The NGFA cautioned elevators that “[a]llowing a customer to just ‘trade’ futures through you with no intent to ever deliver the cash grain is illegal. (You would be functioning as an unlicensed broker, and possibly operating a ‘bucket shop’).” DIANA KLEMME, 24TH ANN. COUNTRY ELEVATOR COUNCIL MEETING, NATIONAL GRAIN & FEED ASS’N, CASH MARKET STRATEGIES PANEL DISCUSSION 5 (1995).

92. When an option is *purchased* only the premium is at risk and the profit, if any, is added to the final contract price. With the purchase of a call option the farmer is still acting as a legitimate hedger. Assuming that a farmer has entered into a traditional cash forward contract or original HTA contract, thereby reducing future price risk, he has increased his production risk in that he may not have sufficient crop to deliver against these cash contracts. The call option reduces this production risk by setting an upper limit on the price (hence the damages) that he must pay the elevator if he is unable to fulfill his delivery obligation. The CFTC has therefore considered the purchase of call options as merely incidental to the cash forward contract. See Characteristics Distinguishing Cash Forward Contracts and “Trade” Options, 50 Fed. Reg. 39,656, 39,660 (1985) (interpreting 17 C.F.R. ch. I); CFTC Interpretative Letter No. 96-23, [1994-1996 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 26,646 (Mar. 14, 1996). However, the sale of put options as part of an HTA or flex contract by a farmer may be a violation of the CEA. See Complaint and Notice of Hearing at 14-15, In re Wright, No. 97-2 (C.F.T.C. filed Nov. 13, 1996); Complaint and Notice of Hearing at 7, In re Southern Thumb Coop., Inc., No. 97-3 (C.F.T.C. filed Nov. 13, 1996) (stating elevators’ short put and call options program are not an integral part of a cash contract).

93. The prior dealings of the parties in their HTA relationship cannot be over emphasized in
challenging liability under an HTA contract, but includes the elevator's dealings with all its customers (i.e., the elevator's HTA contract policies and procedures). If, for example, an elevator is writing HTA contracts for farmers located one or two hundred miles from the elevator, ostensibly for delivery during harvest, then a question of intent to deliver arises. Or, if an elevator writes HTA contracts with a piano teacher or a garage mechanic, then it would tend to prove that the purpose of that elevator's HTA contracts is to engage in commodity futures price speculation. While that type of activity (as well as transfers of contracts between producers much like security transactions) may have occasionally occurred, the more likely situation involves farmers hedging their seed corn or, as in the two recent CFTC enforcement actions, elevators writing HTA contracts for farmers who feed their crop to their livestock.94

Some elevators permitted farmers to unhedge or "lift" the underlying futures hedge.95 The farmer could simply cash-out of the futures portion of the making this determination. This has been demonstrated by two recent cases finding that the specific HTA contracts at issue before the respective courts fell within the cash contract exception to the CEA. In the case of In re Grain Land Coop. Cases, [New Developments] Comm. Fut. L. Rep. (CCH) ¶ 27,164, at 45,550 (D. Minn. Sept. 25, 1997), the key to the district court's ruling that the specific HTA contracts at issue fell within the cash forward exception was that the prior dealing of the farmers and elevator as it related to HTA contracts, involved the delivery of "millions of bushels" of grain which established to the court's satisfaction that delivery was indeed intended by both sides. See id. at 45,554. Bunker v. Farmers Elevator Co., Case No. 97-0137-CV-W-SOW (W.D. Mo. Sept. 18, 1997), is a curious case in which the court found that neither corn nor soybeans were a "speculative product." Id. at 12. Copper, gold, or Treasury Bills or any other commodity on the futures market has value and is not "speculative;" it is the future delivery together with the margin leverage and the possibility of price fluctuation that makes the futures contract speculative unless used as a hedge for the actual commodity. In any event the court found that the "parties fully expected delivery." Id. at 13.

The Grain Land case could result in two diametrically opposed decisions involving the same contracts because the CFTC has an enforcement action against the cooperative pending before a CFTC administrative law judge, alleging the same HTA contracts violate the CEA. The administrative law judge, based on the evidence and arguments presented by the CFTC, could very well conclude that the same HTA contracts, ruled to be cash forward contracts by the district court judge in Minnesota, are illegal futures contracts that violate the CEA and, therefore, sanction the cooperative.

94. See Complaint and Notice of Hearing at 1, 6-7, In re Grain Land Coop., No. 97-1 (C.F.T.C. filed Nov. 13, 1996) (alleging that the elevator wrote HTA and flex contracts for producers who grew grain to feed their hogs); Complaint and Notice of Hearing at 12-13, In re Wright, No. 97-2 (C.F.T.C. filed Nov. 13, 1996).

95. See, e.g., Complaint at exhibit B, Heitoff v. Cargill, Inc., No. 4: 96 CV 337 (D. Neb. filed June 11, 1996) (stating "[i]f you feel that the futures are going higher, lift your hedge, then when you feel the futures are at a level you want to lock in again, call us and reset your hedge. You can also take advantage of a temporary dip in the futures to add to your position."); Plaintiff's Complaint for Declaratory Relief at exhibit G & exhibit D, Hazlett v. Andersons, Inc., No. IP97-0346 CD/F (S.D. Ind. filed Mar. 4, 1997) ("Futures Features Lift 2¢"; "Crop Year Change 3¢"; "Grain Type Change 3¢"; and "Convertible Re-hedge 1¢") ("Ability to 'price' and 'lift' futures prices"); Complaint and Notice of Hearing at 4-5, In re Southern Thumb Coop., Inc., No. 97-3 (C.F.T.C. filed Nov. 13, 1996). The NGFA cautioned members that allowing farmers to "unprice" and "reprice" HTA contracts increases the likelihood of a claim of illegal futures trading. DIANA KLEMME, 24TH ANN. COUNTRY ELEVATOR COUNCIL MEETING, NATIONAL GRAIN & FEED ASS'N, CASH MARKET STRATEGIES PANEL DISCUSSION 5 (1995).
HTA contract and later go short again or simply stand aside. Little difference exists between a farmer who pledges an anticipated crop as security to engage in such in-and-out futures trading and the public customer who deposits a treasury bond or cash with a commodity brokerage firm in a regulated commodity account.\textsuperscript{96} This would also hold true for those elevators that permitted farmers to roll backwards out of the delivery month futures contract to an old crop futures month.\textsuperscript{97} Rolling backward, especially out of the futures delivery month, is an inherently bullish speculation. The farmer has previously rolled into the delivery month futures contract to protect against further weakness in new crop prices. A backwards roll is executed for only one reason—to take a bullish or long position in new crop futures prices versus the old crop futures rolled backwards—which may be seen as nothing more than trading long futures through the elevator's hedge account.

Some elevators also knowingly permitted farmers to enter into HTA contracts for more grain than could be produced in a single crop year. Because neither the elevator nor farmer contemplated delivery for at least that portion of the HTA contract for bushels in excess of the farmers production capability,\textsuperscript{98} such a course of conduct raises an inference that neither party intended that actual delivery occur.\textsuperscript{99} Certain HTA contracts also contain language that violates the CFTC's requirement that the underlying futures contract be initiated for the elevator's risk\textsuperscript{100} by clearly stating that the futures contract was initiated for the

\textsuperscript{96} If the elevator sends a check to the farmer for realized profits or applies the profits to outstanding seed or chemical bills owed to the elevator, then it would certainly seem to indicate that the farmer had engaged in two severable transactions.

\textsuperscript{97} Under the terms of some HTA contracts, the farmer has the right to unlimited rolls until one of two conditions occur—the farmer sets the basis, converting the HTA to a cash forward contract, or the old crop futures contracts expire. Under the flex contracts, even after the old crop futures contracts expire, the farmer can continue to roll forward, and then backward.


\textsuperscript{99} See Complaint and Notice of Hearing at 5-7, \textit{In re} Grain Land Coop., No. 97-1 (C.F.T.C. filed Nov. 13, 1996); Complaint and Notice of Hearing at 12, \textit{In re} Wright, No. 97-2 (C.F.T.C. filed Nov. 13, 1996). In \textit{Plaintiff's Complaint for Declaratory Relief at exhibit C, Hazlett v. Andersons, Inc.,} No. IP97-0346 CD/F (S.D. Ind. filed Mar. 4, 1997) farmers were permitted to write contracts for 180% of production, and "[a]llow[ed] . . . to hedge an attractive futures price on bushels unable to be delivered to The Andersons." A variation that permitted a farmer to write an HTA contract for more than the farmer's anticipated production was used in \textit{Complaint, Harris Farms v. Continental Grain Co.}, No. 96C 4269 (N.D. Ill. filed July 15, 1996), where the farmer entered an HTA contract at $2.55 in May 1995 for January 1996 and sold a call option as part of the contract for three times the amount of bushels at $3.20 if the March 1996 futures traded at or above that price on February 16, 1996. The farmer could roll the HTA contract until December 1999. \textit{See} Complaint at exhibit A-2, \textit{Harris Farms} (No. 96C 4269); Complaint and Notice of Hearing at 3-4, \textit{In re} Southern Thumb Coop., Inc., No. 97-3 (C.F.T.C. filed Nov. 13, 1996); \textit{Complaint and Notice of Hearing at 8, In re} Wright, No. 97-2 (C.F.T.C. filed Nov. 13, 1996). The NGFA warned elevators that because the farmer retains the premium if the "strike price" of this option is not reached, such a mechanism may constitute an illegal trade option. DIANA KLEMME, 24th ANN. COUNTRY ELEVATOR COUNCIL MEETING, NATIONAL GRAIN & FEED ASS'N, CASH MARKET STRATEGIES PANEL DISCUSSION 7 (1995).

farmer. Such a contractual provision would seem to place the elevator in the position of acting like a Futures Commission Merchant (FCM)—accepting orders for commodity futures contracts and extending credit. Another important, if not a determinative factor, is the farmer’s ability to roll the HTA contract into another crop year. This Article includes the effect of this modification on the HTA contracts in the discussion of flex contracts.

Finally, if the HTA contract contains a cash buy-out provision included as “an integral part of the contract,” there would be little doubt that the HTA contract was nothing but a mechanism to trade futures contracts through the elevator. The farmer can buy-out of the HTA contract at any time and, once he does, is no longer under an obligation to deliver. Thus, the mutual obligation to make and take delivery, so essential to the cash forward contract, no longer exists. These buy-out clauses are affected in one of two ways. Sometimes the elevator deducted buy-out charges from the initial HTA contract price. In such situations it is impossible to distinguish the HTA contract from an illegal off-
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exchange option contract or trade option in which the farmer has sold a call to the elevator. Other elevators only charge the buy-out fee if the farmer elects to exercise it, in which case the elevator has essentially sold the farmer a put option. 105 While a standard buy-out provision may be sufficient to establish an HTA contract as an illegal futures contract, the converse is not true. If the HTA contract lacks a buy-out clause, and even if the contract specifically states that delivery is required, should the elevator's past practice reveal a tacit agreement to permit a buy-out, then the HTA contract may be viewed as an illegal futures contract. 106

When all these factors are present and the farmer has the ability to roll backwards, lift a hedge, reinstitute the hedge, average down by selling more crop than can be produced and buy-out of the HTA contract, it is impossible to come to any conclusion other than that the farmer is engaged in speculating in futures contracts using the elevator's hedge account. How many of these factors must be present to transform an HTA contract into an illegal futures contract or trade option is a mixed question of law and fact.

XIII. THE FLEX-HEDGE AND CONVERTIBLE-HEDGE CONTRACTS

The most significant event precipitating the HTA controversy was the introduction of flex contracts. The use of flex contracts to hedge multiple crop years led to the depth of the current crisis. The primary feature of the flex-hedge and convertible hedge contracts (collectively called flex contracts) is the ability to roll the contract into one or more subsequent crop years. The ability to roll the flex contract into another crop year so fundamentally altered the nature of the farmer's obligation to the elevator that the flex contract loses any claim of legitimacy as a cash forward contract. 107 A flex contract gives the farmer the

105. This is actually the more cost effective method if the farmer does not default. Should an elevator enter an HTA contract with a farmer for $2.50 in the delivery month futures and subtract the $0.05 buy-out fee from the HTA price, the farmer has sold his grain for $2.45, which will translate to $2.25 after the hypothetical local basis is subtracted. If the price of corn at delivery is $2.25 1/4 or higher the farmer will elect to deliver on the cash market. However, if the elevator sets the delivery month futures price at $2.50 and assesses the charge only if the farmer elects to exercise the buy-out option, the farmer now will only decide to deliver on the cash market if the price is $2.35 1/4 or better. By doing this, the elevator has saved the overhead of canceling and rewriting contracts in this $0.10 window.


107. A spread that crosses an indefinite number of crop years increases the risk immeasurably. The White Paper states, in relation to this new multi-year contract, that "using this strategy requires a thorough understanding by both the buyer and the seller of how futures spreads function." WHITE PAPER, supra note 1, at 15 (emphasis in original). However, any farmer or elevator who understood the spread risk would never enter into a multi-year flex contract, especially for crop years for which no futures months yet exist, unless they believed that the contracts could be rolled indefinitely. Without futures contracts for the delivery months, the farmer cannot even place a theoretical value on the flex contract because the current spread to an anticipated delivery month cannot be calculated.
option of either delivering the grain pursuant to the contract or rolling the flex contract and delivering the grain on the cash market. The flex contract, therefore, cannot be intended to transfer title to grain under the HTA contract because the farmer is not obligated to deliver.\textsuperscript{108} The real purpose of the flex contract is to hedge prices, production risks, or both.\textsuperscript{109} While ill-suited to effectively perform the first function, the flex contract succeeds admirably in performing the second.

If the cash price at delivery exceeds the price due under the flex contract, the farmer can simply roll the flex contract and deliver on the cash market at the higher price. In this situation, the flex contract offers the same price protection, similar to a short sale of a futures contract, and is acting as a price hedge, \textit{albeit a poor one}. On a macro level, the flex contract might work as a price hedge. For example, if the Brazilian soybean crop was forecasted as failing and the price of soybeans suddenly rose sharply, the farmer could increase his soybean acreage (presumably on a flex contract of his own) and roll the resulting shortage of corn committed to the flex contract to another crop year, thereby assuring the best "price" for his acreage. There will be occasions in which the inter-crop year fluctuations would move in the farmer's favor, providing him with a higher flex contract price than the cash market offers. Or, if the cash price collapses after the farmer rolls the flex contract into the delivery month futures contract, the flex contract price would be advantageous.

Like Sybil, the flex contract has another face. Unlike the cash forward contract that increases the farmer's production risk, the flex contract, while supposedly providing price protection, incurs no additional production risk (such as inability to meet contractual obligations of forward grain contracts) because the roll provision places the farmer in an analogous position to the farmer who elects not to cash forward any of his crop and instead deliver on the cash market. If the price under the flex contract is attractive but the farmer's production fails to meet expectations for any number of reasons, the farmer merely rolls the flex contract forward in an amount equal to the corresponding shortage and delivers what he has. In this situation the flex contract offers the same protection as a long position on the futures market.\textsuperscript{110} Why, one is compelled to ask, would a farmer use the sale of futures contracts on a regulated exchange to hedge price risk, production risk, or both?\textsuperscript{111} Not only does the elevator pay the margin for the

\textsuperscript{108} Unlike forward contracts, futures contracts do not require a delivery date and may be of indefinite duration. See Chicago Mercantile Exch. v. SEC, 883 F.2d 537, 546 (7th Cir. 1989); CFTC v. Standard Forex Inc., No. CV-93-0088, 1996 WL 435440, at *9 (E.D.N.Y. July 25, 1996). Many flex contracts lack a delivery period. Flex contracts that do contain a delivery date or period may have been frequently amended with each roll (sometimes through scratch-outs and handwritten notes on the face of the contract).

\textsuperscript{109} See Plaintiff's Complaint for Declaratory Relief at exhibit D, Hazlett v. Andersons, Inc., No. IP97-0346 CD/F (S.D. Ind. filed Mar. 4, 1997) (describing the features and advantages of the flex contract as follows: "ALLSWS FOR THE ADJUSTMENT OF CONTRACTUAL OBLIGATIONS TO SUIT HARVEST, STORAGE, WEATHER AND MANPOWER CONSTRAINTS.").

\textsuperscript{110} The farmer may have to purchase corn at the prevailing price to meet his obligations. If so, he can stand for delivery of the futures contract or, if the price has risen, sell the futures contract and use the proceeds to fulfill his obligation.

\textsuperscript{111} At least one agricultural consultant represented that if prices went down the farmer would receive higher prices, and if the price went up the farmer would also receive higher prices. See Complaint and Notice of Hearing at 8, In re Wright, No. 97-2 (C.F.T.C. filed Nov. 13, 1996).
The flex contract but, unlike hedging through a regulated futures exchange where the farmer must decide to be long and hedge production risks or be short to hedge price risks, the flex-hedge enables the farmer to hedge both risks simultaneously and to use the elevator's money to do it. Like an elementary quantum particle possessing both wave and particle characteristics that only show their final state upon observation, the flex contract is both a price and a production hedge that only reveals its true nature after the farmer decides whether and how much to deliver.

In summary, the flex-hedge purported to finally eliminate the risks of farming for the price of a few pennies per roll. In actuality, the flex contract offered nothing but a price speculation vehicle that proved the predicate for disaster. The farmers believed that they were buying insurance when, in fact, they were playing roulette and finally the market broke the bank—the elevators and their lenders.

Some elevators have contended that extended or unlimited rolling of the flex contract does not vitiate the delivery obligation of the farmer and that the flex contract, therefore, still falls within the cash forward contract exemption. The farmer, these elevators argue, intends to deliver his grain to the elevator, and may well be obligated to do so under the terms of the flex contract, even if he elects to roll the flex contract and deliver on the cash market. This argument begs the issue. It is not the intention to deliver but the obligation to deliver under the contract that is determinative.

The elevator may, indeed, require the farmer to deliver the available current crop to its facility for the current cash price. However, because the flex contract gives the farmer the right to roll the contract forward, the elevator cannot demand

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112. Through the use of options and futures contracts it is possible to hedge both risks simultaneously but it is a complicated and costly process that could never be as effective as what the flex contract promised to accomplish for the farmer. Also, understanding the features of the flex contract as represented to the farmer provides a frame of reference for the breach of contract claims filed by farmers. Because the unlimited roll provision is the key element of the flex contract, an elevator's refusal either to permit future rolling or to materially limit it would seem to constitute a material breach of the contract. Similarly, because the flex contracts require the elevator to pay the margin on the underlying futures contracts, demanding that the farmer pay all or part of the margin debit or provide security for it may constitute a material breach of the contract.

113. Some farmers have advanced the argument that the unlimited roll provision renders the contract illusory and, therefore, unenforceable. This argument misconstrues the nature of price and production hedging. The farmer is obligated to pay the roll fees, and the elevators, in return, are obligated to margin the underlying futures position or to take delivery of the grain if the farmer sets the basis. There is no illusion. See Chicago Mercantile Exch. v. SEC, 883 F.2d 537, 546 (7th Cir. 1989) (stating futures contracts do not necessarily require a specific delivery date and may be of infinite duration); CFTC v. Standard Forex, Inc., No. CV-93-0088, 1996 WL 435440, at *10 (E.D.N.Y. July 25, 1996).

114. It is extremely doubtful that the elevators appreciated the risk. Who would guarantee to pay the margin indefinitely for a short position that was four, five or six times a farmer's annual production?

115. Each year an admittedly small number of farmers who sell futures contracts intend to deliver on the futures contract and do so. The fact that the farmer intends to deliver on the futures contract he has sold on an exchange does not transform that futures contract into a cash forward contract. It remains a futures contract and it does so because the farmer is free to change his intention, liquidate the futures contract and sell the grain on the cash market.
that the farmer deliver at the flex contract price for the flex contract bushels. In this instance the alleged obligation to deliver is nothing more than margin for the new crop/old crop futures price speculation inherent in the decision to roll the flex contract forward to another crop year rather than to set the basis and deliver for the flex contract price. The elevator only acquires a right to demand delivery under the flex contract when and if the farmer sets the basis. Until the basis is set, the farmer has the freedom of choice. And, as noted previously, many of the flex contracts entered into during 1995 and rolled into 1996 were priced in the December 1996 delivery month futures contract. Yet, these flex contracts contained roll provisions and charges that would seemingly provide prima facie evidence of the parties' intention to provide the producer with the option, rather than the obligation, to deliver.

The farmer's right to roll the flex contract forward indefinitely is just as definitive as the cash buy-out provision in determining that the contract is an illegal futures contract. The ability to roll the flex contract forward indefinitely is certainly a centerpiece of the two recent enforcement actions brought by the CFTC concerning flex contracts. A flex contract that provides a standard buy-out provision and permits indefinite rolling would certainly seem to violate the CEA's prohibition against off-exchange futures contracts.

XIV. VIOLATIONS OF THE COMMODITY EXCHANGE ACT

The determination of whether HTA or flex contracts are futures contracts solicited in violation of the CEA's prohibition against off-exchange contracts may be more of an academic exercise than of practical significance. The CFTC has consistently maintained the position that the language of the CEA's anti-fraud provision, which prohibits misrepresentations, deception or fraud "in connection with any order for commodity futures contracts," is to be broadly construed and reaches off-exchange sales and solicitations. The futures

116. In fact, most flex-hedge contracts provide that if the farmer has not set the basis and fails to instruct the elevator to roll the flex contract, the elevator automatically must roll the contract. Therefore, by inaction, such as not setting the basis, the farmer has made his election.

117. Some elevators do not require that the farmer make delivery to them on the cash market and leave the farmer free to deliver to another elevator if the flex-hedge is rolled forward.


120. The White Paper contains a table of "Contract Risk Comparison" setting forth the amount of risk as per different types of contracts. WHITE PAPER, supra note 1, at 27. For HTA or flex contracts that are rolled and that involve multiple crop years, the table indicates that the selling farmers bear market risks from both fluctuations in spread and yield. The table also advises that for such contracts, the elevator bears legal risks of 8-10 on a scale of 1 to 10. Id.


contracts underlying the HTA contracts would certainly seem to fall within that broad definition and meet the requirement that the sales be used "for hedging any transaction"124 or for "determining the price basis of any transaction in interstate commerce" in the commodity.125 Because the CEA prohibits "any person" from engaging in such fraud, whether the elevator or grain merchandiser is registered with the CFTC is irrelevant to the section’s application.126 The elevators and grain merchandisers, for the most part, are exempt from registering as commodity trading advisors.127 However, the elevators and merchandisers are still bound by the anti-fraud provisions of the CEA,128 which in addition to the general anti-fraud provision, include specific CFTC regulations mandating adequate risk disclosure129 and prohibiting guarantees against loss.130 Another issue is the measure of damages under the CEA. In the case of illegal off-exchange contracts, the CFTC has imposed benefit-of-the-bargain losses.131 Therefore, those farmers who reasonably believed that they were selling their corn for the initial futures reference price may have a cause of action under the CEA for the difference between the prices they received for their crops and that shown as the initial futures reference price. Also, if the farmers refrained from cash forwarding contracts their crop at higher prices than they ultimately received in reliance on the HTA contracts, they may have a claim for the difference. Damages under the CEA may extend even to impairment of the farmer’s credit.132

130. See 17 C.F.R. § 1.56 (1997).
XV. COMMON LAW REMEDIES

The fact that a particular HTA or flex contract does not give rise to a violation of the CEA does not mean that the farmer is without a remedy. In fact, while the traditional common law remedies may lack the glamour associated with the question of whether the HTA and flex contracts are off-exchange commodity contracts, common law actions for breach of contract, fraud, mistake, breach of fiduciary duty and negligence may offer the farmer the easiest path to recovery and provide the highest level of recovery. The predominant issue is risk disclosure. Clearly, the elevators and agricultural consultants had the responsibility to disclose the unlimited risk inherent in the HTA and flex contracts. If the elevators and agricultural consultants failed to adequately disclose the risks of the HTA and flex contracts, they may be liable for any losses sustained as a result of the realization of that risk. The fact that the farmer may have later learned that the HTA or flex contract entailed more risk than he previously believed, but nevertheless decided to continue rolling the contracts, does not relieve the elevator of liability unless all the taint from previous representations of safety have dissipated. And, after the risk materializes, if the contracts were rolled in an attempt to mitigate damages, the elevators will probably also be liable for these additional losses.

The elevators and agricultural consultants allegedly conducted studies of

26,962, at 44,664 n.6 (C.F.T.C. Feb. 27, 1997).

133. The White Paper states that the responsibility is imposed on the elevator to disclose risks and to insure that the strategy is suitable for the farmer. White Paper, supra note 1, at 49-50. See also Complaint and Notice of Hearing, In re Southern Thumb Coop., Inc., No. 97-3 (C.F.T.C. filed Nov. 13, 1996), for the option risks that must be disclosed.

134. See, e.g., Knight v. First Commercial Fin. Group, Inc. [Current Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 26,942 at 44,555 (C.F.T.C. Jan. 14, 1997) (stating inadequate or misstated risk disclosure subjects the FCM to liability for subsequent losses as a result of the realization of that risk); Bruschi v. Brown, 876 F.2d 1526, 1531 (11th Cir. 1989) (holding liability attaches if "a defendant induces a plaintiff to enter into a risky transaction by misrepresenting it as safe and the plaintiff suffers a loss resulting from the risky nature of the investment."); Bastian v. Petren Resources Corp., 892 F.2d 1312, 1320 (7th Cir. 1989) (holding that creating a false impression of exceptional competence, on the one hand, and of limited risk and security in a very risky area, on the other hand, constitutes fraud); Restatement (Second) of Agency § 425 (1958) (stating agents paid to make, manage or advise on investments have fiduciary obligations). The NGFA agreed that the elevator was obligated to inform the farmer of the spread risks inherent in the HTA. See White Paper, supra note 1, at 48-49. Indiana has subsequently codified the risk disclosure requirement and has required elevators that write HTA contracts to register as commodity firms and to have their personnel attend classes on commodity futures. See IND. CODE §§ 26-3-7-3 (1997).

135. See Reed v. Sage Group, Inc., [1987-1990 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 23,943, at 34,299 (C.F.T.C. Oct. 14, 1987) (stating that "[h]aving injected false information into the customer's decision-making process, respondents must demonstrate not only that the customer received accurate information but that such information has dissipated the taint from the earlier misrepresentation"); Clayton Brokerage Co. v. CFTC, 794 F.2d 573, 578 (11th Cir. 1986); McAnally v. Gildersleeve, 16 F.3d 1493, 1498 (8th Cir. 1994).

136. See Clayton Brokerage Co. v. CFTC, 794 F.2d 573, 580 n.6 (11th Cir. 1986).
historical price activity and the HTA contract's viability. They also had access to the market information, including margin calls, necessary to assess and monitor the farmer's risk exposure. 137 Having this information placed them in a superior position to that of many of the farmers and, therefore, may have placed them in the position of a fiduciary which, at a minimum, obligated the elevator to timely inform the farmer of current or increasing margin liability. 138 The inherent inability of the HTA and flex contracts to hedge price risk raises the issue of whether the elevators and agricultural consultants performed adequate due diligence to determine the viability of the concept they intended to offer to the farmer. 139 Elevators and agricultural consultants will bear the ultimate burden of

137. The NGFA determined that elevators needed to provide special attention to the margin requirements of the farmer. “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.” WHITE PAPER, supra note I, at 40 (emphasis omitted). Concerning the issue of internal systems and controls that should have been put into place by the elevator, the NGFA warned:

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.

id. at 39 (emphasis omitted). Because it is written by the association for elevators and dealers, the White Paper will undoubtedly be cited as providing the standard of care owed by elevators regarding risk disclosure and risk management. If used as the standard, the White Paper may, more than anything else, be the factor that renders the elevator liable. The standards are high and the necessary reports and procedures are complicated. While it may, on the one hand, seem unfair to hold cooperatives and small elevators to the standards suggested in the White Paper, on the other hand, it is a little like handling dynamite—those who do not understand it should have avoided it. See id. And, if the White Paper's effectiveness on the issue is lessened by the fact that it was published after losses were incurred, the same warnings were given in a more vivid context in DIANA KLEMME, 24TH ANN. COUNTY ELEVATOR COUNCIL MEETING, NATIONAL GRAIN & FEED ASS'N, CASH MARKET STRATEGIES PANEL DISCUSSION (1995), published before the inverse reached crisis proportions and while elevators were permitting (and sometimes encouraging) farmers to deliver on the cash market and either roll their HTAs into a new crop year or write new HTA contracts, or both.

138. Occupying a position of superior knowledge is sufficient to establish a confidential relationship. See Roberts v. Sears, Roebuck and Co., 573 F.2d 976, 983 (7th Cir. 1978) (applying Illinois law); Martin v. Heinold Commodities, Inc., 643 N.E.2d 734, 740-42 (Ill. 1994) (holding fiduciary relationship can arise in what otherwise might be an arm's length relationship if one side possesses information that should be disclosed). The fact that the farmer may have been receiving advice from an agricultural consultant complicates, but does not end the inquiry. See Roberts, 573 F.2d at 984 (concluding that both sides in negotiations availing themselves of legal representation does not preclude the existence of a confidential relationship). And, depending on the particular facts, the agricultural consultant, though paid by the farmer, might, in some instances, be seen as the elevator's agent, especially if the elevator sponsored a seminar or otherwise introduced the farmer to the advisor. See Knight v. First Commercial Fin. Group, Inc., [Current Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 26,942, at 44,556 (C.F.T.C. Jan. 14, 1997) (holding customer's consultant to be FCM's agent for purposes of risk disclosure even though not employed by, or receiving commissions from, the broker).

proof as to what steps they should reasonably have taken to determine whether the HTA and flex contracts could act as a legitimate hedge and, possibly, the amount of risk the farmers would theoretically be accepting in acting on their advice.

Another issue concerns what duties the elevators and agricultural consultants owed the farmer once he had entered into the HTA or flex contract. If the elevators (and certainly the agricultural consultants) held themselves out as possessing expertise in spreads and hedging necessary to initiate and monitor an HTA program, they will probably be held to the standards of those who, in fact, possess just such an expertise. While, at first, it may seem harsh to impose such sophisticated requirements on local cooperatives, the fact is that the HTA program is complicated and carries high risks and, if the elevator and farmer both operated out of various degrees of ignorance, the legal liability should (and probably will) fall on those who introduced the concept and undertook to monitor it.

Finally, there is the question of the relationship between the agricultural consultant (the farmer’s agent) and the elevator. In at least one CFTC enforcement action, it is alleged that the consultant was receiving undisclosed payments from the elevator, which could render both liable for breach of the agricultural consultant’s fiduciary duty to the farmer.
XVI. THE NUMBERS BEHIND THE CONTROVERSY

The economics of the futures trading and elevator charges occasioned by the flex and the flex contracts is startling. Many farmers never forward contracted any portion of their crop, seeing it as too risky to sell that which they had not yet harvested. And, those farmers who did forward contract did so for only a portion of their expected crop.\(^{145}\) For example, a farmer with an annual corn production of 50,000 bushels might forward contract 25,000 bushels or five futures contracts in a given year. Having been told that the flex contract provided an absolute price floor and posed no risk due to the ability to roll the obligation indefinitely, the farmer now hedged his entire crop or ten futures contracts, a 100% increase.\(^{146}\) And, while the traditional forward contract and original HTA sold only the futures contract that most closely corresponded with the delivery month, the flex contracts required a minimum of one futures roll and contemplated more. With a ten contract futures position to hedge his entire crop and two intermediate rolls a year, the flex contracts would generate thirty futures contracts per year or a 600% increase. With the multi-year flex contracts, the farmer hedged three to five years of crop or 90 to 150 futures contracts for an increase in commodity contracts ranging from 1800% to 3000%.\(^{147}\) Assuming twenty dollars per contract brokerage fees paid by the elevators, the commodity commissions rose from $100 on a normal cash forward contract for that farmer’s production to $1800 to $3000 per year with the multi-year flex contracts. Assuming a thousand farmers followed such HTA programs, the brokerage...

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\(^{145}\) The farmers this author has interviewed have split 50-50 in using forward contracts to some extent prior to their use of the HTA and flex-hedge contracts. Of the half who did, most forward contracted a small percentage after the crop was in the ground and sold additional percentages as the crop matured, usually reaching 50% just prior to harvest. A few of the more aggressive farmers might forward contract 70% of their crop.

\(^{146}\) In Gunderson, one of the trading advisors provided the following promotional material to farmers concerning HTA contracts:

Why should I use a hedge to arrive contract?
1. The contract is not an obligation to deliver the product this year.
2. The contract can be bought back at a profit if the price is lower than what the contract was made out for.
3. The contract can be rolled out to next year and delivered upon next year.
4. Sales can be 100% of production because of number 1.
5. If price moves to next level you can sell next year’s crop.


\(^{147}\) A number of advisors succeeded in convincing farmers to open regulated futures accounts with their brokerage firm to further enhance the value of their crop through a bearish old-crop/new-crop spread. See Complaint, Gunderson v. ADM Investor Servs., Inc., No. 96C-3382 (N.D. Ill. filed June 5, 1996); Complaint, Nagel v. ADM Investor Servs., Inc., No. 96C 2675 (N.D. Ill. filed May 20, 1996). Therefore, the number of futures contracts traded was materially higher. The consultants tried to guess the top of the price rise based on “historical” experience. When the price of corn rocketed beyond their “historical” experience, the farmers suffered additional losses on the bear spreads in their futures accounts.
commissions increased from $100,000 to as much as $3 million.\textsuperscript{148} When the number of farmers who never forward contracted or wrote an original HTA but who were convinced to use the HTA and multi-year flex contracts is added, both the percentages and the dollar amount of commissions explode.\textsuperscript{149}

Similarly, if the elevator charged a $0.02 per bushel HTA or flex contract fee to initiate the contract, it would receive $3500 in fees from the farmer who sold three years production of 50,000 bushels a year. Rolls charged at the rate of $0.01 would generate another $1500 in fees. Therefore, with only a single roll, the elevator realizes $5000 a year in HTA fees per farmer. Assuming a $20 round-turn commission, the elevator would have paid the commodity brokerage firm $1200 ($600 for the initial position and $600 for the roll), leaving $3800 to cover the cost of borrowing any margin funds and for additional overhead costs. Each additional roll would net the elevator $900 at a $0.01 roll fee ($1500 less $600 in brokerage commissions) and $2400 at a $0.02 roll charge.\textsuperscript{150} Clearly the elevator’s incentive was to engage in as many intermediate rolls as possible. And, in fact, certain elevators required the farmers to engage in a minimum number of rolls per year as a price for participating in an HTA program. Fifty farmers would generate $250,000 a year to the elevator and a thousand farmers would generate $5 million in fees to various elevators. As roll charges increased to $0.02 and even $0.03 per bushel and the number of intermediate rolls increased, the gross fees due the elevators doubled or tripled.

\textbf{XVII. CONCLUSION}

With the anticipated demise of federal farm programs, farmers were told that they had to find new means to market their crops. Perhaps farmers were naive to believe promises that the HTA and flex contracts were the answers to obtaining good prices over the long term with little or no risk. But that does not make them fair game for misrepresentations made by people who they trusted and on whom they had the right to rely. Maybe the elevators were also naive and misled by agricultural consultants and commodity brokerage firms who, as commodity brokers also operated commodity or agricultural consulting firms, which, in turn, charged the farmers a yearly fee of $1000 to $3000 a year based on acreage plus a fee of $0.01 to $0.02 for each of the flex-hedge bushels ($1000 to $2000). If only half the farmers had consulting contracts, the consultants realized $500,000 to $1.5 million in consulting fees and $500,000 to $1 million in roll fees.

\textsuperscript{148} Likewise, the farmer who engaged in writing the HTA contracts for the 50,000 bushels with an original futures reference month and three rolls at only $0.01 per bushel generated $2000 in fees to the elevator. By engaging in multi-year marketing through the flex-hedge, the farmer in the example in the text would generate $8000 in fees to the elevator. An elevator with 100 such farmers would realize revenue of $800,000 a year from such fees. Using the costs to the elevator as discussed above, the elevator would experience $500 in interest for the cost of the money necessary to post as margin (none if marked to the market) and $800 in commissions, for a total of $1300 per 50,000 bushels (the equivalent of 10 futures contracts) for a crop year or a $700 gross profit on a single year HTA and $2800 for four crop years or $280,000 (35\%) of the $800,000 in gross revenue.

\textsuperscript{150} Many, if not most, elevators were permitted to mark-to-the market \textit{(i.e.,} each day paying only the amount lost by the previous day’s adverse price movement), so that the cost of money was negligible until the corn price began to rise dramatically.
professionals, presumably were aware of both the risks and the fallacies of the HTA program. In the final analysis, however, as between the farmers and the elevators, the elevators offered programs they did not understand and now, along with the brokerage firms and trading advisors, bear the responsibility for the programs’ failures.

One major unanswered question is where was the Board and CFTC during this time? On February 1, 1995, the open interest for corn futures totaled 298,405 bushels and volume totaled 35,886. One year later, on February 1, 1996, open interest had increased to 498,940 and volume had increased to 65,098. Meanwhile the options open interest proceeded to surpass the futures open interest in corn. A good portion of the surge in open interest may have been attributable to increased speculation, but a 165% increase should have caught the attention of the CFTC before the situation reached crisis proportions, especially because a review of all short hedge positions had to show an increase out of all proportion to available old crop supplies and any anticipated new crop harvest.

In the final analysis, whether HTA and flex contracts violated the CEA, whether risks were adequately disclosed, and whether elevators negligently administered programs are questions that will occupy courts for a number of years.

151. CHICAGO BOARD OF TRADE. Open interest is the number of open futures contracts obligated for delivery at any time. See ROBERT W. KOLB, UNDERSTANDING FUTURES MARKETS 3 (4th ed. 1996). Few of these contracts will actually result in delivery because longs and shorts will tend to cover their positions as the time for delivery approaches. See id. at 73-75.