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An Agricultural Law Research Article

## **Federal Regulation of Agricultural Trade Options**

by

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# FEDERAL REGULATION OF AGRICULTURAL TRADE OPTIONS

*Michael S. Sackheim\**

I.	Introduction.....	443
II.	Regulation of Deferred Delivery Commodity Transactions.....	445
III.	Economic Characteristics of Commodity Options .....	446
IV.	Regulation of Commodity Options.....	448
V.	Pilot Program for Agricultural Trade Options.....	451
	A. Registration of Agricultural Trade Option Merchants.....	452
	B. Disclosure.....	452
	C. Financial Safeguards .....	453
	D. Recordkeeping and Reporting.....	454
	E. Physical Delivery Requirement.....	454
	F. Persons Exempt from ATOM Registration.....	457
VI.	Conclusion .....	457

## I. INTRODUCTION

To manage the risks of fluctuations in commodity prices, various forms of hedging devices have been developed, including deliverable forward contracts, risk-shifting exchange-traded futures contracts and commodity options. Agricultural prices are often subject to greater volatility and uncertainty than prices for other commodities.<sup>1</sup> Option contracts, which offer a financial hedging mechanism with a fixed and known cost, may be customized to meet particular needs.<sup>2</sup> However, subject to limited exceptions, the offer and sale of commodity options is prohibited unless the option is transacted on a futures exchange regulated by the Commodity Futures Trading Commission (“Commission”), an independent federal agency which administers the federal Commodity Exchange Act of 1994, as amended (“CEA”).<sup>3</sup>

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1. See 7 U.S.C. § 5 (1994). See, e.g., DIVISION OF ECONOMIC ANALYSIS, CFTC, POLICY ALTERNATIVES RELATING TO AGRICULTURAL TRADE OPTIONS AND OTHER AGRICULTURAL RISK-SHIFTING CONTRACTS at 7 (1997).

2. See DIVISION OF ECONOMIC ANALYSIS, *supra* note 1, at 2, 17-18.

3. See 7 U.S.C. §§ 1-26 (1994). Prior to the establishment of the commission, the CEA was administered by the Secretary of Agriculture. See Grain Futures Act, Pub. L. No. 67-331, 42 Stat. 998, 1000 (1922) (codified as amended in scattered sections of 7 U.S.C. §§ 1-26 (1994)). Section 2(i) of the

One important exemption to the options ban is the exemption for "trade options" which, as set forth in Commission Rule 32.4(a), requires that the option must be offered to a person or entity which is a commercial user of the underlying commodity and which "enters into the commodity option transaction solely for purposes related to its business as such."<sup>4</sup> Trade options on agricultural commodities had been in use since the Civil War<sup>5</sup> but were banned by Congress in 1936 due to pervasive fraud.<sup>6</sup> Trade options were not permitted with respect to the agricultural commodities enumerated in Section 1a(3) of the CEA, until April 16, 1998, when the Commission adopted interim rules pursuant to a three-year pilot program permitting agricultural trade options, but only if they satisfied certain criteria.<sup>7</sup> The criteria set forth require that: (1) the option may only be marketed by a new class of product-specific Commission registrants, and pending the adoption of a recent proposal to permit cash-settlement; and (2) if the option is exercised, the option must result in physical delivery.<sup>8</sup> This article examines the pilot program for agricultural trade options.<sup>9</sup>

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CEA grants to the Commission:

[E]xclusive jurisdiction [over] . . . accounts, agreements (including any transaction which is of the character of, or is commonly known to the trade as, an 'option,' 'privilege,' 'indemnity,' 'bid,' 'offer,' 'put,' 'call,' 'advance guaranty,' or 'decline guaranty'), and transactions involving contracts of sale of a commodity for future delivery, traded or executed on a contract market . . . or any other board of trade, exchange or market . . .

7 U.S.C. § 2(i) (1994). Although a security may be treated as a commodity for certain purposes, Section 2(i) excludes the coverage of the CEA options directly on one or more securities, including any group or index of securities, or any interests therein or based on the value thereof. *See id.*

4. 17 C.F.R. § 32.4(a) (1999).

5. *See* S. REP. NO. 93-1131, at 10 (1974), *reprinted in* 1974 U.S.C.C.A.N. 5843, 5853. During the Civil War, the Confederate States of America issued bonds that allowed speculators to bet on the fluctuating price of cotton. *See* SHELBY FOOTE, *THE CIVIL WAR: A NARRATIVE, FREDERICKSBURG TO MERIDIAN* 156 (Random House 1974). Eventually, Congress turned its attention to the regulation of speculative trading in commodities by making futures speculation in cotton prohibitively expensive unless engaged in pursuant to specific requirements or for actual forward delivery. *See* United States Cotton Futures Act, Pub. L. No. 64-190, § 6, 39 Stat. 476, 478 (1916) (current version at 7 U.S.C. § 15b (1994)). The debate over the social benefits and potential dangers of various forms of derivative transactions has continued throughout the 1990's. *See* Adam R. Waldman, *OTC Derivatives & Systemic Risk: Innovative Finance or the Dance Into the Abyss?*, 43 AM. U. L. REV. 1023, 1034-38 (1994).

6. *See* S. REP. NO. 93-1131, at 12.

7. *See* CFTC Trade Options on the Enumerated Agricultural Commodities, 63 Fed. Reg. 18,821, 18,821-25 (1998) (to be codified at 17 C.F.R. pts. 3, 32, 33) (interim final rules Apr. 16, 1998).

8. *See id.*

9. The Commission's new interim pilot program requirements are set forth at Commission Rules 3.13-14 and 32.13. *See id.* at 18,822. In August 1999, the Commission requested public comments on a proposal to revise the interim rules permitting the cash-settlement of agricultural trade options, among other changes. *See* CFTC Trade Options on the Enumerated Agricultural Commodities, 64 Fed. Reg. 47,452, 47,455 (1999) (to be codified at 17 C.F.R. pts. 3, 32) (proposed Aug. 31, 1999).

## II. REGULATION OF DEFERRED DELIVERY COMMODITY TRANSACTIONS

Futures contracts and commodity options are regulated under the CEA, subject to a trading prohibition requiring that they either be conducted on or through a board of trade designated as a "contract market" whose rules and activities are subject to oversight by the Commission, or whose rules and activities qualify for at least one exemption adopted by the Commission.<sup>10</sup> The purpose of the CEA is "to ensure fair practices and honest dealing . . . and to control manipulative activity and speculative excesses that undermine the markets."<sup>11</sup> To accomplish this, the CEA provides the Commission with exclusive jurisdiction over commodity sales contracts for future delivery and commodity options.<sup>12</sup>

Section 1a(11) of the CEA defining "future delivery" does not include "any sale of any cash commodity for deferred shipment or delivery."<sup>13</sup> This exclusion, involving transactions commonly referred to as "forward contracts," has been interpreted by both the Commission and the Courts to exclude from the Commission's jurisdiction and its regulations, commercial transactions requiring physical delivery entered into by merchants, processors, commercial users or producers of the underlying commodity.<sup>14</sup>

The forward contract exclusion was created in the Future Trading Act,<sup>15</sup> the first statute passed by Congress to regulate boards of trade engaged in futures trading.<sup>16</sup> Congress utilized its taxing power to enact a prohibitive tax on all futures

The commodities enumerated in Section 1a(3) of the CEA and covered by the Commission's interim rules for agricultural trade options are: wheat, cotton, rice, corn, oats, barley, rye, flaxseed, grain sorghums, mill feeds, butter, eggs, Irish potatoes, wool, wool tops, fats and oils, cottonseed meal, cottonseed, peanuts, soybeans, soybean meal, livestock, livestock products, and frozen concentrated orange juice. See 7 U.S.C. § 1a(3) (1994); CFTC Trade Options on the Enumerated Agricultural Commodities, 63 Fed. Reg. at 18,830.

10. See *Salomon Forex, Inc. v. Tauber*, 8 F.3d 966, 970 (4th Cir. 1993). See also CFTC Characteristics Distinguishing Cash and Forward Contracts and "Trade" Options, 50 Fed. Reg. 39,656, 39,657 (1985) (to be codified at 17 C.F.R. ch. 1).

11. *NRT Metals, Inc. v. Manhattan Metals (Non-Ferrous) Ltd.*, 576 F. Supp. 1046, 1050 (S.D.N.Y. 1983) (citing S. REP. NO. 95-850, at 12 (1978), reprinted in 1978 U.S.C.C.A.N. 2087, 2100).

12. See 7 U.S.C. § 2a(ii) (1994).

13. *Id.* § 1a(11).

14. See *CFTC v. Co Petro Mktg. Group, Inc.*, 680 F.2d 573, 579 (9th Cir. 1982) (holding the exclusion "is unavailable to contracts of sale of commodities which are sold merely for speculative purposes and which are not predicated upon the expectation that delivery . . . will occur in the future."); CFTC Statutory Interpretation Concerning Forward Transactions, 55 Fed. Reg. 39,188, 39,190 (1990).

15. See Future Trading Act, Pub. L. No. 67-66, 42 Stat. 187 (1921) (superseded by Commodity Exchange Act, 7 U.S.C. §§ 1-26 (1994)).

16. See *Co Petro Mktg. Group, Inc.*, 680 F.2d at 577 (looking to legislative history to interpret a statute ambiguous on its face). Two thorough summaries of the history of commodities regulation in the United States are: Glenn Willett Clark, *Genealogy and Genetics of "Contract of Sale of a Commodity for Future Delivery" in the Commodity Exchange Act*, 27 EMORY L.J. 1175 (1978) and

contracts unless these contracts were traded on regulated contract markets.<sup>17</sup> Excluded from this tax, by direct exclusion from the term future delivery, was "any sale of cash grain for deferred shipment."<sup>18</sup> The Futures Trading Act was declared unconstitutional as an improper tax.<sup>19</sup> It was succeeded by the Grain Futures Act of 1922,<sup>20</sup> which utilized the Commerce Clause as a means to the same regulatory ends.<sup>21</sup> The future delivery exclusion remained unchanged and the Grain Futures Act was upheld as constitutional.<sup>22</sup>

The cash forward contract exclusion, found in both the Futures Trading Act of 1921 and the Grain Futures Act of 1922, was intended to ensure that the new regulatory scheme would not interfere with "the owners and growers of grain who merchandised the physical commodity."<sup>23</sup> The Grain Futures Act was followed by the Commodity Exchange Act of 1936,<sup>24</sup> the current forerunner of the CEA, in which the future delivery exclusion was redefined as any cash commodity for deferred shipment or delivery.<sup>25</sup> The "future delivery" exclusion has not been altered in substance since the 1994 amendment and is currently set forth in Section 1a(11) of the CEA.<sup>26</sup>

### III. ECONOMIC CHARACTERISTICS OF COMMODITY OPTIONS

An option, although not defined in the CEA, is essentially a contract giving the purchaser of the option the right, but not the obligation, to make or take delivery of a specific commodity at a specified price (the strike price) within a specific time

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John V. Rainbolt II, *Symposium on Commodity Futures Regulation: Regulating the Grain Gambler and His Successors*, 6 HOFSTRA L.J. 1 (1977).

17. See *Salomon Forex, Inc. v. Tauber*, 8 F.3d 966, 970 (4th Cir. 1993); *In re Stovall*, CFTC Docket No. 75-7 [1977-1980 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,491, at 23,780 (Dec. 6, 1979) [hereinafter *In re Stovall - CFTC Decision* ¶ 20,491].

18. *Co Petro Mktg. Group, Inc.*, 680 F.2d at 577 (citing S. REP. NO. 67-212, at 1 (1921)). See also *In re Stovall - CFTC Decision* ¶ 20,491 at 23,780.

19. *Id.* at 23,781; *Tauber*, 8 F.3d at 970.

20. See Grain Futures Act, Pub. L. No. 67-331, 42 Stat. 998 (1922) (codified as amended in scattered sections of 7 U.S.C. §§ 1-26 (1994)).

21. See *Tauber*, 8 F.3d at 970 (citing *Hill v. Wallace*, 259 U.S. 44 (1922)); *In re Stovall - CFTC Decision* ¶ 20,491 at 23,781;

22. See *Chicago Board of Trade v. Olsen*, 262 U.S. 1, 42-3 (1923).

23. *In re Stovall - CFTC Decision* ¶ 20,491 at 23,780. See also *Co Petro Mktg. Group, Inc.*, 680 F.2d at 577 (finding that "[t]here is no indication that Congress drew this exclusion otherwise than to meet a particular need such as that of a farmer to sell part of next season's harvest at a set price to a grain elevator or miller"). "A cash forward contract . . . guarantees . . . a price but allows delivery to be deferred 'until such time as he could process the wheat.'" *Co Petro Mktg. Group, Inc.*, 680 F.2d at 578 (quoting H.R. REP. NO. 93-975, at 129 (1974)).

24. See Commodity Exchange Act, Pub. L. No. 74-675, 49 Stat. 1491, 1491 (1936) (codified as amended in scattered sections of 7 U.S.C. §§ 1-26 (1994)).

25. See *id.* Accord Grain Futures Act, Pub. L. No. 67-331, 42 Stat. 998, 998 (1922) (codified as amended in scattered sections of 7 U.S.C. §§ 1-26 (1994)).

26. See 7 U.S.C. § 1a(11) (1994).

period.<sup>27</sup> The option purchaser pays the option seller (or grantor) for this right of purchase.<sup>28</sup> The cost of purchasing an option is known as the "premium."<sup>29</sup> The commodity option buyer's profit is determined by the extent to which any change in price of the commodity exceeds the cost of the premium and any related charges, while the loss is limited to the amount of the premium and such charges.<sup>30</sup>

Option contracts allow option purchasers to protect themselves, for the cost of the option premium and related charges, against adverse price movements while maintaining an upside profit potential.<sup>31</sup> For example, a wheat producer can protect against lower harvest time prices by purchasing put options with a given strike price.<sup>32</sup> If the price of wheat at harvest time is below the strike price, the producer can elect to exercise the option and earn the strike price on the sale of the wheat.<sup>33</sup> If prices are higher at harvest time, the producer can choose to allow the option to expire and sell the wheat at the higher spot price.<sup>34</sup> Although options can be effective risk management tools to protect against rising or falling commodity prices, generally they cannot be used to enhance the sale price of a commodity or to lower the cost of obtaining it.<sup>35</sup>

The ability of the producer to lock in a given price for wheat (e.g., the cost of production) using an option will depend on the availability of options with such a strike price, taking into account the cost of the option.<sup>36</sup> The availability of these options depends upon the current market price of wheat as reflected by the supply and demand conditions for the commodity.<sup>37</sup> If the supply of wheat is high and/or the demand for wheat is low, producers will only be able to obtain options with relatively low strike prices (or to the extent that high strike price options are available, they will pay concomitantly high premiums).<sup>38</sup> Thus, depending on supply and demand conditions, no options may be available with a given strike price and premium combination that permit wheat producers or other market participants to lock in a desired minimum or maximum price.

Trade options are over-the-counter ("OTC") options not transacted on a regulated futures exchange and are offered by a person who reasonably believes that

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27. See *CFTC v. U.S. Metals Depository Corp.*, 468 F. Supp. 1149, 1155 (S.D.N.Y. 1979).

28. See *id.*

29. See *id.*

30. See *id.*

31. See Ed Jones & John F. Cook II, *The Commodity Futures Trading Commission Act of 1974*, 5 MEM. ST. U.L. REV. 457, 463-64 (1975).

32. See *U.S. Metals Depository Corp.*, 468 F. Supp. at 1155.

33. See *id.*

34. See *id.*

35. See *id.*

36. See *id.*

37. See Jones & Cook II, *supra* note 31, at 462.

38. See *id.* at 462-63.

the option is being purchased by a commercial entity for purposes related to its business.<sup>39</sup> Until the Commission's interim final rule establishing a pilot program became effective June 16, 1998, trade options were prohibited on any agricultural commodities enumerated in the CEA.<sup>40</sup> Trade options on other unlisted agricultural commodities and all nonagricultural commodities have been permitted under Commission Rule 32.4(a), subject only to antifraud and investor protection requirements.<sup>41</sup>

#### IV. REGULATION OF COMMODITY OPTIONS

Commodity futures and options contracts have been traded throughout the world for centuries.<sup>42</sup> In 1936, responding to a history of disruptions in the commodities markets attributed to speculative trading in options,<sup>43</sup> Congress prohibited the offer or sale of both exchange-traded and OTC option contracts in all commodities then under regulation.<sup>44</sup> This prohibition continued to apply only to the "enumerated" agricultural commodities regulated under the Commodity Exchange Act of 1936.<sup>45</sup> Any commodity not so enumerated, whether agricultural or not, was not subject to prohibition.<sup>46</sup>

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39. See CFTC Trade Options on the Enumerated Agricultural Commodities, 63 Fed. Reg. 18,821, 18,821 (1998) (to be codified at C.F.R. pts. 3, 32, 33) (interim final rules Apr. 16, 1998).

40. See *id.*

41. See 17 C.F.R. § 32.4(a) (1999).

42. See Jones & Cook II, *supra* note 31, at 458. "Regulated commodity markets existed in China, Egypt, Arabia and India as early as 1200 B.C. However, modern day exchanges dealing in commodity futures can more readily be traced to the medieval trade fairs of Twelfth Century Europe." *Id.*

43. See H.R. REP. NO. 74-421, at 1 (1935).

44. See Commodity Exchange Act, Pub. L. No. 74-675, 49 Stat. 1491, 1493 (1936) (codified as amended in scattered sections of 7 U.S.C. §§ 1-26 (1994)).

45. See H.R. REP. NO. 72-1555, at 4 (1932); H.R. REP. NO. 74-421, at 4 (1935).

46. See Jones & Cook II, *supra* note 31, at 467. Examples of non-enumerated commodities include coffee, sugar, gold, and foreign currencies. See *id.* at 466. Before 1974, the CEA covered only those commodities enumerated by name. The 1936 Act regulated transactions in "wheat, cotton, rice, corn, oats, barley, rye, flaxseed, grain sorghum, mill feeds, butter, eggs and solanum tuberosum (Irish potatoes)." Commodity Exchange Act, 49 Stat. at 1491. Subsequent amendments to the Act added additional agricultural commodities to the list of enumerated commodities. Wool tops were added in 1938. See Commodity Exchange Act, ch. 108, 52 Stat. 205, 205 (1938) (current version at 7 U.S.C. § 2 (1994)). "Fats and oils, (including lard, tallow, cottonseed oil, peanut oil, soybean oil and all other fats and oils), cottonseed meal, cottonseed, peanuts, soybeans and soybean meal" were added in 1940. Commodity Exchange Act, ch. 786, § 1, 54 Stat. 1059, 1059 (1940) (current version at 7 U.S.C. § 2 (1994)). Livestock, livestock products and frozen concentrated orange juice were added in 1968. See Commodity Exchange Act, Pub. L. No. 90-258, § 1(a), 82 Stat. 26, 26 (1968) (current version at 7 U.S.C. § 2 (1994)) (livestock and livestock products); Commodity Exchange Act, Pub. L. No. 90-418, 82 Stat. 413, 413 (1968) (current version at 7 U.S.C. § 2 (1994)) (frozen concentrated orange juice). Conversely, trading in onion futures on United States exchanges was prohibited in 1958. See Commodity Exchange Act, Pub. L. No. 85-839, § 1(a), 72 Stat. 1013, 1013 (1958) (current version at 7 U.S.C. § 2 (1994)).

The Commodity Futures Trading Commission Act of 1974<sup>47</sup> substantially strengthened the Commodity Exchange Act of 1936,<sup>48</sup> leading to the CEA as currently in effect.<sup>49</sup> The statute's scope was broadened by defining the term "commodity" to include "all services, rights and interests in which contracts for future delivery are presently or in the future dealt in."<sup>50</sup>

The Commodity Futures Trading Commission Act of 1974 created the Commission and vested the new independent federal agency with exclusive authority to regulate the offer and sale of commodity options on the previously unregulated, non-enumerated commodities.<sup>51</sup> The CEA's statutory prohibition on the offer and sale of options on the enumerated agricultural commodities was retained.<sup>52</sup>

Shortly after its creation, the Commission promulgated a comprehensive regulatory framework applicable to OTC commodity option transactions in the non-enumerated commodities,<sup>53</sup> including exempting "trade options" from most of the CEA's provisions.<sup>54</sup> Trade options on non-enumerated commodities are exempt from all of the requirements applicable to commodity options except under Commission Rule 32.8, which prohibits certain representations and requires prompt executions, and Commission Rule 32.9, which prohibits fraud.<sup>55</sup>

In contrast to the regulatory framework for commodity options on the non-enumerated commodities, as a consequence of both the continuing statutory bar and

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47. See Commodity Futures Trading Commission Act of 1974, Pub. L. No. 93-463, 88 Stat. 1389, 1389 (current version at 7 U.S.C. § 4(a) (1994)).

48. See Commodity Exchange Act, Pub. L. No. 74-675, 49 Stat. 1491, 1491 (1936) (codified as amended in scattered sections of 7 U.S.C. §§ 1-26 (1994)).

49. See 7 U.S.C. §§ 1-26 (1994).

50. *Id.* § 1a(3).

51. See *id.* § 6c. Section 6c(a) provides that no person shall offer "to enter into, or confirm the execution of, any transaction involving any commodity" regulated under this Act. *Id.* § 6c(a). The prohibition applies to commodities in the nature of an option "contrary to any rule, regulation, or order of the Commission prohibiting any such transaction or allowing any such transaction under such terms and conditions as the Commission shall prescribe . . ." *Id.* § 6c(b).

52. See *id.* § 6c(b).

53. See 17 C.F.R. pt. 32 (1999). See also CFTC Regulation and Fraud in Connection with Commodity and Commodity Option Transactions, 41 Fed. Reg. 51,808 (1976) (to be codified at 17 C.F.R. pt. 32) (adoption of rules Nov. 24, 1976); CFTC Commodity Options, 41 Fed. Reg. 44,560 (1976) (to be codified at 17 C.F.R. pt. 32) (interim rules Oct. 8, 1976); CFTC Regulation of Commodity Option Transactions Registration; Fraud, 41 Fed. Reg. 7,774 (1976) (to be codified at 17 C.F.R. pt. 32) (proposed Feb. 20, 1976).

54. See 17 C.F.R. § 32.4(a) (1999). Trade options are defined as OTC options offered by a person having a reasonable basis to believe that the option is offered to the categories of commercial users specified in the rule, where such commercial user is offered or enters into the transaction solely for purposes related to its business as such. See *id.* This exemption presumes that commercials had sufficient information concerning commodity markets as to transactions related to their business as such, so that application of the full range of regulatory requirements was unnecessary for business-related transactions in options on commodities. See CFTC Commodity Options, 41 Fed. Reg. at 44,563.

55. See 17 C.F.R. §§ 32.8-9 (1999).



Commission Rule 32.2, commodity options, including trade options, on the enumerated domestic agricultural commodities, were prohibited.<sup>56</sup>

Because of widespread abuse and fraud in non-enumerated commodities offers and sales, the Commission suspended all trading in commodity options except for trade options in 1978.<sup>57</sup> Congress later codified the Commission's options ban, establishing a general prohibition against commodity option transactions other than trade and dealer options.<sup>58</sup>

The Commission subsequently approved a three-year pilot program for the introduction of exchange-traded options on futures contracts on the non-enumerated commodities.<sup>59</sup> In the Futures Trading Act of 1982, Congress eliminated the statutory prohibition against options on enumerated commodities, permitting the Commission to establish a similar pilot program to introduce exchange-traded options on those agricultural commodities.<sup>60</sup> The Commission did so in 1984 under essentially the same rules previously applicable to options on all other commodities.<sup>61</sup> In proposing to permit exchange-traded options on the enumerated agricultural commodities, the Commission noted that section 4c(c) of the CEA and Commission Rule 32.4 permitted trade options on non-enumerated commodities and that "these may be possible benefits to commercials and to producers from the trading of these options in domestic agricultural commodities."<sup>62</sup> However, with its experience with agricultural options and the fact that the trading of exchange-traded options is subject to more comprehensive oversight, the Commission concluded that "proceeding in a gradual fashion by initially permitting only exchange-traded agricultural options" was the prudent course.<sup>63</sup> Nevertheless, the Commission requested comment from the public concerning the advisability of permitting trade options between commercials on domestic agricultural commodities.<sup>64</sup> Citing past

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56. See *id.* § 32.2.

57. See CFTC Suspension of the Offer and Sale of Commodity Options, 43 Fed. Reg. 16,153, 16,153 (1978) (to be codified at 17 C.F.R. § 32.11). Trading in options directly on securities or based on the value of securities is excluded from the jurisdiction of the Commission pursuant to Section 2a(i) of the CEA. See 7 U.S.C. § 2a(i) (1994).

58. See 17 C.F.R. § 32.2 (1999).

59. See CFTC Regulation of Domestic Exchange-Traded Commodity Options, 46 Fed. Reg. 54,500, 54,500 (1981) (to be codified at 17 C.F.R. pts. 1, 8, 9, 15, 16, 17, 18, 21, 33, 145, 147, 155, 166, 180).

60. See Futures Trading Act of 1982, Pub. L. No. 97-444, § 206, 96 Stat. 2294, 2301 (current version at 7 U.S.C. § 6c (1994)).

61. See CFTC Domestic Exchange-Traded Commodity Options; Expansion of Pilot Program to Include Options on Domestic Agricultural Commodities, 49 Fed. Reg. 2,752, 2,752 (1984) (to be codified at 17 C.F.R. pt. 33).

62. CFTC Domestic Exchange-Traded Commodity Options; Expansion of Pilot Program to Include Options on Domestic Agricultural Commodities, 48 Fed. Reg. 46,797, 46,800 (1983) (to be codified at 17 C.F.R. pt. 33) (proposed Oct. 14, 1983).

63. *Id.*

64. See *id.* at 46,798.

abuses associated with OTC options, the Commission retained the prohibition on OTC option transactions.<sup>65</sup>

#### V. PILOT PROGRAM FOR AGRICULTURAL TRADE OPTIONS

In 1997, the Commission's Division of Trading and Markets prepared a study entitled: "Policy Alternatives Relating to Agricultural Trade Options and Other Agricultural Risk-Shifting Contracts" ("Staff Report").<sup>66</sup> The Staff Report concluded, among other things, that trade options "bring the potential for a higher incidence of fraud. Th[e] potential arises mainly from the current unregulated nature of the option vendors . . . from the lack of a developed regulatory framework . . . and from a potential lack of transparency of their pricing."<sup>67</sup> The Commission requested comments on the proposed rules to lift the prohibition on agricultural trade options on the enumerated agricultural commodities and to permit offer and sale under regulated conditions.<sup>68</sup>

In 1997, the Commission published proposed rules to establish a three-year pilot program permitting the offer or sale of enumerated agricultural commodities trade options.<sup>69</sup> On June 15, 1998, the Commission's interim final rules, which established the pilot program, became effective.<sup>70</sup>

The pilot program rules were designed to provide numerous customer protections, including requirements that option vendors be registered and adhere to minimum customer disclosure, financial, and recordkeeping safeguards.<sup>71</sup> In addition, option vendors are required to have a system of internal controls and to report to the Commission on their option activity.<sup>72</sup> The rules also included a number of provisions to discourage the use of trade options for speculative purposes.<sup>73</sup> These requirements included agricultural trade options, if exercised, to be physically

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65. See CFTC Trade Options on the Enumerated Agricultural Commodities, 63 Fed. Reg. 18,821, 18,822 (1998) (to be codified at 17 C.F.R. pts. 3, 32, 33) (interim final rules Apr. 16, 1998).

66. See DIVISION OF ECONOMIC ANALYSIS, *supra* note 1, at 1.

67. *Id.* at 39.

68. See CFTC Trade Options on the Enumerated Agricultural Commodities, 62 Fed. Reg. 31,375, 31,382 (1997) (to be codified at 17 C.F.R. pt. 32) (proposed June 9, 1997).

69. See CFTC Trade Options on the Enumerated Agricultural Commodities, 62 Fed. Reg. 59,624, 59,624 (1997) (to be codified at 17 C.F.R. pts. 3, 32, 33) (proposed Nov. 4, 1997).

70. See CFTC Trade Options on the Enumerated Agricultural Commodities, 63 Fed. Reg. at 18,821. Commission Rule 32.13, entitled "Exemption from Prohibition of Commodity Option Transactions for Trade Options on Certain Agricultural Commodities," contains the regulatory requirements adopted by the Commission. 17 C.F.R. § 32.13 (1999). Commission Rules 3.13 and 3.14 set forth the registration requirements for agricultural trade option vendors. See *id.* §§ 3.13-14.

71. See CFTC Trade Options on the Enumerated Agricultural Commodities, 63 Fed. Reg. at 18,825-29.

72. See 17 C.F.R. § 32.13(d), (f) (1999).

73. See *id.* § 32.13(a), (d), (f).

delivered, and limitations on producers being the option grantor (including a prohibition on producers writing covered call options).<sup>74</sup>

#### A. *Registration of Agricultural Trade Option Merchants*

As noted in the interim final rules, "registration of commodity professionals is an important means by which the Commission polices the futures and option industry and is the primary mechanism for reassuring the public of the honesty and proficiency of futures professionals."<sup>75</sup> Commission Rules 32.13(a)(1) and 3.13(d)(2) currently require: (1) any person offering or selling an agricultural trade option to be registered as an Agricultural Trade Option Merchant ("ATOM") and (2) any ATOM sales agents to be registered with the Commission as "associated persons" of an ATOM, as well as to complete instructions covering the economic functioning and the legal requirements for the sale of agricultural trade options.<sup>76</sup> The responsibility for processing and ruling on the registration applications has been delegated by the Commission to the National Futures Association ("NFA"), the self-regulatory organization which performs similar functions for all the Commission registrants.<sup>77</sup>

#### B. *Disclosure*

Commission Rule 32.13(a)(7) currently requires that the agricultural trade option customer be provided two forms of risk disclosure: (1) a statement of the general risks of agricultural trade options provided prior to the customer's first transaction, and (2) specific disclosure giving information about the particular option contract being entered into.<sup>78</sup> In addition to providing customers with risk disclosures, the rules also require the option contract to be in writing and to contain a

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74. *See id.* § 32.13(a)(3), (5)(i), (5)(ii).

75. CFTC Trade Options on the Enumerated Agricultural Commodities, 63 Fed. Reg. at 18,825.

76. *See* 17 C.F.R. §§ 32.13(a)(i), 3.13(d)(2) (1999).

77. *See id.* § 32.13. *See also* CFTC Adverse Registration Actions by the National Futures Association with Respect to Agricultural Trade Option Merchants and Their Associated Persons and Applicants for Registration in Either Category, 63 Fed. Reg. 63,913, 63,913 (1998) (summary). One can verify the registration status of an ATOM or its associated persons by contacting the NFA (toll free (800) 621-3570, or if within Illinois (800) 572-9400 or consulting the NFA's website at <<http://www.nfa.futures.org>> (last visited Nov. 1, 1999)).

78. *See* 17 C.F.R. § 32.13(a)(7) (1999). "Where the full premium or purchase price of the option is not collected up front, or where through amendments to the option contract it is possible to lose more than the amount of the initial . . ." premium, the provisions of the transaction must reveal the worst possible financial outcome that could be suffered by the customer in a specific disclosure statement. *Id.* § 32.13(a)(8)(iv). The Commission has recently proposed the elimination of the transaction-specific disclosure requirement and to instead include some of the deleted material in the general risk disclosure statement to advise customers in fully understanding the particular option's procedure and fees. *See* CFTC Trade Options on the Enumerated Agricultural Commodities, 64 Fed. Reg. 47,452, 47,455 (1999) (to be codified at 17 C.F.R. pts. 3, 32) (proposed Aug. 31, 1999).

number of specified terms.<sup>79</sup> The contract must include terms denominating the procedure for exercise of the option contract, including: (1) the expiration date and latest time on that date for exercise; (2) the total quantity of the commodity underlying the contract; (3) the quality or grade of the commodity to be delivered if the contract is exercised and any adjustments to price for deviations from stated quality or grade, or the range thereof, plus a statement of the method for calculating such adjustments; (4) a list of elements comprising the purchase price to be charged, including the premium, mark-ups on the premium, costs, fees and other charges; (5) the strike price(s) of the option contract and additional costs, if any, which may be incurred if the commodity option is exercised; and (6) delivery location, if the contract is exercised.<sup>80</sup> ATOMs, or their designated agents, must also provide customers with information regarding their positions and accounts in a timely fashion and notify these customers of the expiration date of each option which is due to expire within the next month.<sup>81</sup>

### C. Financial Safeguards

Commission Rule 3.13(d)(1)(i) requires that an ATOM must maintain a minimum net worth of \$50,000.<sup>82</sup> In addition, ATOMs must safeguard customer funds which have been paid up-front by holding them in a segregated account.<sup>83</sup> ATOMs, however, may use up-front customer payments to purchase exchange-traded instruments as cover for the trade option transaction.<sup>84</sup>

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79. See *id.* § 32.13(a)(7).

80. See *id.* § 32.13(a)(7)(i).

81. See *id.* § 32.13(b). These requirements are in lieu of a monthly account statement. Many commentators took the view that requiring ATOMs to provide a monthly account statement would impose "a costly informational burden for a questionable benefit." CFTC Trade Options on the Enumerated Agricultural Commodities, 63 Fed. Reg. 18,821, 18,828 (1998) (to be codified at 17 C.F.R. pts. 3, 32, 33) (interim final rules Apr. 16, 1998). The Commission has recently proposed a rule to effectively permit ATOMs to satisfy these requirements through oral communications and notices to customers. See CFTC Trade Options on the Enumerated Agricultural Commodities, 64 Fed. Reg. 47,452, 47,455 (1999) (to be codified at 17 C.F.R. pts. 3, 32) (proposed Aug. 31, 1999).

82. See 17 C.F.R. § 3.13(d)(1)(i) (1999).

83. See *id.* § 32.6(a). The segregation requirement is a traditional means of better safeguarding customer funds. See CFTC Trade Options on the Enumerated Agricultural Commodities, 63 Fed. Reg. at 18,827.

84. See CFTC Trade Options on the Enumerated Agricultural Commodities, 63 Fed. Reg. at 18,827. An ATOM is also required to be audited on a yearly basis in accordance with generally accepted accounting principles and to file a copy of its certified financial statements with the Commission within 90 days after the close of its fiscal year. See 17 C.F.R. § 32.13(f) (1999). An ATOM must report immediately to the Commission if its net worth falls below the \$50,000 minimum net worth threshold and must notify the Commission of any material inadequacies discovered by a certified public accountant in its internal controls. See *id.* § 32.13(f)(5)(i).

#### D. *Recordkeeping and Reporting*

Commission Rule 32.13(c) currently requires ATOMs to maintain “full, complete, and systematic books and records.”<sup>85</sup> The maintenance of books and records is crucial to resolving customer complaints and ensuring the Commission’s ability to respond to complaints of customer abuse.<sup>86</sup> In addition to the keeping of books and records, the final rules impose routine and “special call” regulatory reporting requirements.<sup>87</sup>

#### E. *Physical Delivery Requirement*

Commission Rule 32.13(a)(3) requires OTC agricultural trade options to be exercised only by physical delivery of the commodity.<sup>88</sup> Rule 32.13(a)(3) allows for the delivery date to be amended or for a forward contract to be subsequently substituted “for the option contract prior to the option’s expiration or exercise.”<sup>89</sup> The rules also prohibit producers from writing or granting trade options, except when a call option is coupled with the purchase of a put option.<sup>90</sup>

As discussed earlier, forward contracts for the future delivery of Commodities are excluded from the Commission’s jurisdiction pursuant to Section 1a(11) of the CEA.<sup>91</sup> In 1985, the Commission’s Office of the General Counsel issued an interpretation identifying three crucial elements of a forward contract: (1) there must be a binding agreement on both parties to make and take delivery; (2) the parties must have the capacity to make or take delivery, and delivery, in fact, must routinely occur; and (3) the forward contract must be a commercial or merchandising transaction used in commerce.<sup>92</sup> The staff concluded that agricultural forward contracts encompassed transactions in which farmers pay premiums in return for “minimum price guarantees,” and that the transactions could even be subject to a pricing formula to be applied at a later date.<sup>93</sup> Notwithstanding the fact that these transactions possess characteristics of cash-settled put options, the minimum price guarantee placed floors on the farmers’ losses; the transactions were characterized as

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85. 17 C.F.R. § 32.13(c) (1999).

86. See CFTC Trade Options on the Enumerated Agricultural Commodities, 63 Fed. Reg. at 18,827.

87. See 17 C.F.R. § 32.13(e) (1999). “Routine reports are required for general market surveillance purposes, to permit the Commission to construct a picture of the market and to evaluate the impact of activity in the trade option market on the cash and exchange-traded markets.” CFTC Trade Options on the Enumerated Agricultural Commodities, 63 Fed. Reg. at 18,827. A special call is a reporting device used by the Commission for obtaining information as needed. See *id.*

88. See 17 C.F.R. § 32.13(a)(3) (1999).

89. *Id.*

90. See *id.* § 32.13(5)(ii).

91. See 7 U.S.C. § 1a(11) (1994).

92. See CFTC Characteristics Distinguishing Cash and Forward Contracts and “Trade” Options, 50 Fed. Reg. 39,656, 39,657-58 (1985) (to be codified at 17 C.F.R. ch. 1).

93. See *id.* at 39,660.

forward contracts under the CEA.<sup>94</sup> For similar reasons, an agricultural trade option, which is entered into for purposes of physical delivery, should also be characterized as a commercial forward contract, despite its ability to possess certain non-severable option characteristics.<sup>95</sup>

The current option may only be exercised by physical delivery which effectively limits the size of the trade option position to the size of the crop grown by producers and the volume of trade carried by elevators and dealers.<sup>96</sup> This requirement discourages excessive leverage in trade option positions, ensures that the trade option transactions are between commercials in normal marketing channels and reduces the likelihood that the trade option transactions will be used for speculation.<sup>97</sup>

Subsequent to the adoption of the interim pilot program, the Commission found that there was widespread support in the agricultural community for some permitted types of cash settlement, offset or cancellation of agricultural trade options<sup>98</sup> Numerous agricultural trade associations have advised the Commission that

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94. See CFTC Interpretative Letter No. 98-13, [1996-1998 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 27,264, at 46,151 (Dec. 3, 1997). In 1998, the Commission's staff found that transactions that establish both minimum and maximum price guarantees for agricultural commodities as to which the parties are contractually bound to make and take delivery are transactions used as marketing vehicles within the normal merchandising chain. See *id.* at 46,152. The staff concluded that even though these contracts include characteristics of options, if the option terms cannot be severed or marketed separately, such transactions are forward contracts not subject to regulation under the CEA. See *id.*

95. See CFTC Characteristics Distinguishing Cash and Forward Contracts and "Trade" Options, 50 Fed. Reg. at 39,660; CFTC Interpretative Letter No. 98-13, [1996-1998 Transfer Binder] Comm. Fut. L. Rep. (CCH) at 46,151.

96. See CFTC Characteristics Distinguishing Cash and Forward Contracts and "Trade" Options, 50 Fed. Reg. at 39,659.

97. See CFTC Trade Options on the Enumerated Agricultural Commodities, 63 Fed. Reg. 18,821, 18,823 (1998) (to be codified at 17 C.F.R. pts. 3, 32, 33) (interim final rules Apr. 16, 1998). As the Commission noted in adopting this provision, the physical delivery requirement does not preclude development of many types of innovative options contracts. See *id.* For example, consistent with the rule's requirement, revenue-type options contracts could be offered by referencing the yield on a designated number of acres, based either on the producer's actual yield for a reported average yield, thereby providing a minimum return to a producer per acre. See *id.* Congress has repeatedly over the years sought to limit specialization in agricultural commodities. See United States Cotton Futures Act of 1916, Pub. L. No. 64-190, 39 Stat. 476, 476-77 (1916) (current version at 7 U.S.C. § 15b (1994)); Future Trading Act, Pub. L. No. 61-66, 42 Stat. 187, 187 (1921) (superseded by Commodity Exchange Act, 7 U.S.C. §§ 1-26 (1994)); and Grain Futures Act, Pub. L. No. 67-331, 42 Stat. 998, 999 (1922) (codified as amended in scattered sections of 7 U.S.C. §§ 1-26 (1994)).

98. See CFTC Trade Options on the Enumerated Agricultural Commodities, 63 Fed. Reg. at 18,823. The Commission has previously issued an order permitting commercial participants in the crude oil and energy markets to avoid their standardized binding physical delivery obligations by entering into bilateral cash settlements, netting or offset arrangements, without being in jeopardy of violating the CEA. See CFTC Exemption for Certain Contracts Involving Energy Products, 58 Fed. Reg. 21,286, 21,293-94 (1993) (final order Apr. 20, 1993). The Commission did not categorize these alternatives to physical delivery as commodity options requiring registration by any persons. *Id.*

cash settlement and offset is consistent with sound business practices, and that highly engineered option products can be offered only if cash settlement is permitted.<sup>99</sup> As a result, in August 1999, the Commission proposed the removal of the Rule 32.13(a)(3) requirement that an agricultural trade option, if exercised, must result in physical delivery.<sup>100</sup> If the Commission ultimately adopts this rule change, Commission Rule 32.13(a)(7) will require that the summary disclosure statement provided by an ATOM advise potential purchasers that:

[Y]ou must be buying this option for business-related purposes. The terms and structure of the contracts must therefore relate to your activity or commitments in the underlying cash market. Any amendment allowed to the option contract or its cancellation or offset prior to its expiration date must reflect changes in your activity, in your commitments in the underlying cash market or in the carrying of the inventory.<sup>101</sup>

This furthers the goal of discouraging the speculative use of agricultural trade options.<sup>102</sup> The Commission has also clarified that eligible commercial entities include those selling inputs used in the production of the agricultural commodity as well as banks that routinely finance businesses involved in the production, processing or handling of the commodity.<sup>103</sup>

A related issue concerns prohibition of producers from writing call options. The purchaser of an option assumes limited risk.<sup>104</sup> The most that he or she can lose is the amount of the option premium.<sup>105</sup> The writer of an option, however, assumes unlimited risk in return for receiving that option premium.<sup>106</sup> Presumably, agricultural producers could write "covered calls," meaning the price risk created by the option is hedged or covered by the farmer's crop or livestock, which would similarly rise in price.<sup>107</sup> Some have suggested that permitting producers to write covered calls allows them to enhance their revenues by generating premium income.<sup>108</sup> However, this strategy creates the risk that the cover might be inadequate due to overwriting or crop failure. In such a case, the producer could face potentially

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99. See CFTC Trade Options on the Enumerated Agricultural Commodities, 64 Fed. Reg. 47,452, 47,454-55 (1999) (to be codified at 17 C.F.R. pts. 3, 32) (proposed Aug. 31, 1999).

100. See *id.* at 47,454-55.

101. *Id.* at 47,459.

102. See *id.* at 47,455.

103. See CFTC Trade Options on the Enumerated Agricultural Commodities, 64 Fed. Reg. 47,452, 47,454-55 (1999) (to be codified at 17 C.F.R. pts. 3, 32) (proposed Aug. 31, 1999).

104. See CFTC Characteristics Distinguishing Cash and Forward Contracts and "Trade" Options, 50 Fed. Reg. at 39,658-59.

105. See *id.* at 39,659.

106. *Cf. id.* (inferring that if the purchaser of an option assumes a limited risk, the writer of an option assumes an unlimited risk).

107. See CFTC, GLOSSARY 11 (1997). See also CFTC Characteristics Distinguishing Cash and Forward Contracts and "Trade" Options, 50 Fed. Reg. at 39,658.

108. See CFTC Characteristics Distinguishing Cash and Forward Contracts and "Trade" Options, 50 Fed. Reg. at 39,658-59.

unlimited price risk from the option.<sup>109</sup> This may also leave the ATOM vulnerable to substantial credit risk due to customer defaults.

One means of covered call writing is permitted under the pilot program rules.<sup>110</sup> This is the use of a “mini-max option spread” (also known as a “fence” or “window”).<sup>111</sup> In this contract, a producer exchanges the upside gain of a price increase by selling a call in return for insuring against a price decline by using the revenue from the sold call to buy a put.<sup>112</sup> If the strike price on the call is above that on the put, then there is a price range within which the producer bears the price risk.<sup>113</sup> In this context, allowing producers to write call options enables them to reduce the cost of buying a put to insure against a price decline.

#### F. *Persons Exempt from ATOM Registration*

Commission Rule 32.13(g) includes an exemption for high net-worth individuals or entities transacting agricultural trade options among themselves, as well as relief of similar option instruments traded on regulated futures exchanges.<sup>114</sup> Individuals or entities that are producers, processors, commercial users of, or merchants handling the commodity which is the subject of the option, or the byproducts of the commodity, and have a net worth of at least \$10 million, or are covered by a guarantee by an affiliate that satisfies this net worth requirement, are exempt from compliance with the ATOM registration requirements and the general agricultural commodity option prohibition.<sup>115</sup>

### VI. CONCLUSION

The so-called agricultural trade option that is entered into for legitimate commercial purposes can be a useful risk-management and hedging tool. To the extent that an agreement is entered into between commercial users who intend and have the ability to make and take delivery of the underlying commodity in the future, even if the Commission revises the interim rules to permit cash settlement, the transaction should be considered a forward contract excluded from the Commission’s jurisdiction under Section 1a(11) of the CEA.<sup>116</sup> Such a transaction should not be required to be marketed by registered ATOMs. An option is not solely

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109. *See id.* at 39,659.

110. *See* CFTC Trade Options on the Enumerated Agricultural Commodities, 63 Fed. Reg. 18,821, 18,823-24 (1998) (to be codified at 17 C.F.R. pts. 3, 32, 33) (interim final rules Apr. 16, 1998).

111. *See id.*

112. *See id.*

113. *See id.*

114. *See* 17 C.F.R. § 32.13(g) (1999).

115. *See id.*

116. *See* 7 U.S.C. § 1a(11) (1994).



a risk-shifting investment traded by speculators—it is an integral component of a transaction in the actual cash commodity.

Therefore, this author recommends that when the Commission revisits its pilot program in 2001, it consider distinguishing a transaction between commercial persons entered into for commercial or merchandising purposes from a speculative option based on the value of the commodity. The Commission should issue an interpretation that recharacterizes an agricultural trade option as an agricultural forward contract, apply appropriate reporting standards, clarify that the transaction is excluded from the CEA's general ban on options, and not impose an unduly burdensome registration requirement upon members of the agricultural community.<sup>117</sup> An interpretation characterizing deferred delivery agricultural transactions as forward contracts would preserve the ban on purely speculative agricultural options and encourage innovation in the development and use of agricultural hedging transactions.

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117. The Commission has in the past re-characterized certain commodity-based transactions as not being futures or commodity options subject to regulation under the CEA. *See, e.g.*, CFTC Statutory Interpretation Concerning Certain Hybrid Instruments, 55 Fed. Reg. 13,582, 13,582-83 (1990) (securities and debt instruments indexed to commodity prices); CFTC Policy Statement Concerning Swap Transactions, 54 Fed. Reg. 30,694, 30,694 (1989) (swap agreements indexed to commodity prices); Statutory Interpretation Concerning Forward Transactions, 55 Fed. Reg. 39,188, 39,189 (1990) (Brent oil market transactions). A Commission enforcement proceeding is currently pending, alleging that a respondent grain company marketed 2,670 illegal agricultural trade option contracts in ten states, including Iowa. *In re Cargill, Inc.*, CFTC Docket No. 99-16 (Aug. 26, 1999) (currently pending). In each transaction, the respondent paid a non-refundable premium to the producer, which was added to the nearby grain delivery price, in exchange for the producer's "firm offer" to sell corn, soybeans or wheat to the respondent for deferred delivery if, at a specified date, the futures price reached a specified strike price. *Id.* Because delivery was subject to the strike price condition, the Commission charged that the product was a prohibited agricultural commodity call option in violation of section 4c(b) of the CEA and Commission Rule 32.2. *Id.* Allegedly, no physical delivery of the grain was ever made. *Id.* Potential sanctions are cease and desist orders, futures trading bar, restitution, and monetary penalties of not more than \$100,000 or triple the monetary gain for each violation. *Id.*