UNITED STATES OF AMERICA
Before the
COMMODITY FUTURES TRADING COMMISSION

In the Matter of COMPETITIVE STRATEGIES FOR AGRICULTURE, LTD.; LEE DONALD AMUNDSON; TERRY ALLEN DIRKSEN; JEFFREY JAMES WICHMAN; WILLIAM EUGENE ARNOLD; GREAT PLAINS CO-OP; and HERMAN GERDES	CFTC Docket No. 98-4 OPINION AND ORDER

In September 1999, an Administrative Law Judge ("ALJ") issued a decision finding respondents Great Plains Co-op ("Great Plains") and Herman Gerdes ("Gerdes") liable for violating Section 4(a) of the Commodity Exchange Act ("Act") by engaging in off-exchange futures transactions. The ALJ imposed a cease and desist order on Great Plains, and both a cease and desist order and a ten-year trading prohibition on respondent Gerdes. *In re Competitive Strategies for Agriculture, Inc.*, [1998-1999 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 27,771 (Initial Decision Sept. 17, 1999) ("I.D.").[1] Both sides filed timely appeals from the ALJ's decision.

Respondents challenge several of the ALJ's procedural rulings and argue that his liability analysis is flawed due to both factual and legal errors. The Division defends both the ALJ's procedural rulings and liability analysis but challenges his choice of sanctions. In particular, the Division argues that the ALJ should have imposed civil money penalties on both Great Plains and Gerdes.

[1] By the time of this decision, all other respondents had resolved their disputes with the Commission by entering into settlement agreements. Consequently, only Great Plains, Gerdes, and the Division of Enforcement ("Division") are participants in this appeal. In this context, references to "respondents" include only Great Plains and Gerdes.

In light of our *de novo* review of the record, we conclude that respondents violated Section 4(a) of the Act by engaging in off-exchange futures transactions with grain producers. In order to expedite the final resolution of this matter, we decline to impose the money sanctions requested by the Division.

BACKGROUND

I.

Many facts material to the issues raised on appeal are undisputed. The allegations underlying this proceeding focused primarily on the conduct of respondents who settled with the Commission. These included two firms -- Competitive Strategies for Agriculture, Inc. ("CSA Inc.") and CSA Investor Services, Inc. ("CSA Investor") – as well as individuals who owned or worked for these firms.[2] Both firms were located in Iowa. CSA Inc. provided grain marketing consulting services to producers. CSA Investor provided brokerage services and was registered with the Commission as an introducing broker.

Respondents Jeffrey James Wichmann ("Wichmann") and William Eugene Arnold ("Arnold") offered grain marketing consulting services and brokerage services in Nebraska under the name CSA of Nebraska ("CSA"). Wichmann and Arnold operated as a partnership from 1993 to 1996. During this period, both were registered as associated persons sponsored by CSA Investor.

Respondent Great Plains was a grain coop with between 1,000 to 1,200 members. It operated two Nebraska elevators.[3] Respondent Gerdes managed Great Plains's grain

[2] For example, respondents Lee Donald Amundson ("Amundson") and Terry Allen Dirksen ("Dirksen") were the owners and principals of both CSA Inc. and CSA Investors.

[3] One was located in Stromsburg, and the other was located in Benedict.

department from September 1992 to April 1995. Great Plains had financial difficulties during 1995, and sold most of its assets to United Co-op of Hampton in February 1996.

During 1993, Gerdes, acting on behalf of Great Plains, entered into an informal arrangement with CSA to market hedge-to-arrive contracts ("HTA") to CSA producer-clients. From 1993 to 1995, Great Plains entered into over fifty such contracts with CSA clients.[4] Most of these CSA producer-clients failed to deliver grain to a Great Plains elevator. Instead, they delivered their grain to independent local elevators.[5]

Under the delivery procedure initially contemplated by Great Plains and CSA, CSA producer-clients located outside Great Plains's geographic area could fulfill delivery obligations imposed in Great Plains's HTA contracts by delivering grain to independent local elevators. Because these deliveries were treated as if they were made by Great Plains, the local elevator paid Great Plains rather than the CSA producer-client who actually delivered the grain. Eventually, Great Plains would pay the producer who delivered the grain under the terms of the HTA contract. The initial delivery procedure was used in a small number of instances and then abandoned because it resulted in delays in payment to producers.[6] While the parties agree that the initial procedure was abandoned, they disagree about the nature of the delivery procedure that was subsequently employed.

[4] Some producers entered into more than one contract.

[5] A few parties to the HTA contracts delivered no grain to anyone. For example, as described below, two business entities that only purported to be farms entered into HTA contracts with Great Plains.

[6] The record includes written documentation of two deliveries in which the initial procedure was employed, in February and April of 1994. DX-2098, 2099.

II.

The Commission issued its Complaint in this proceeding in December 1997. A portion of the Complaint alleged that the HTA transactions that Great Plains entered into with CSA producer-clients between 1993 and 1995 involved off-exchange futures contracts. It claimed that both Great Plains and Gerdes violated Section 4(a) of the Act in the context of these transactions.[7]

The Complaint generally described HTA contracts as "non-exchange traded agricultural contracts," and drew a distinction between general HTAs and what it termed a "new type" of HTA called the "Cross Country HTA." Complaint at 2, 8. The Complaint indicated that the challenged transactions involved Cross Country HTAs, but did not specifically describe the difference between a general HTA and a Cross Country HTA.

Great Plains and Gerdes filed separate Answers in January 1998. They denied any wrongdoing and insisted that the transactions at issue involved forward contracts excluded from the Commission's jurisdiction. In this regard, they denied that Great Plains operated a Cross Country HTA program and claimed that the HTAs it offered did not differ from those offered by other elevators.[8] In addition, they claimed that two courts had conclusively determined that HTAs are forward contracts excluded from the Commission's jurisdiction.

During the pre-hearing period, a factual dispute developed over the nature of the delivery process Great Plains used for CSA producer-clients following its abandonment of the initial process. The Division acknowledged that after the initial process was abandoned, CSA producer-clients continued to make grain deliveries to independent local elevators. It insisted,

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[7] The Complaint alleged that Gerdes was responsible both for direct violations of Section 4(a) and for aiding and abetting Great Plains's violations of Section 4(a).

[8] They did acknowledge that contracts were "occasionally labeled" Cross Country. Great Plain's Answer at 3.

however, that these deliveries had no meaningful connection to the producer's obligation to deliver grain to Great Plains under their HTA contract. In this regard, the Division emphasized that producers received payment for their grain directly from the local elevators. Then, after CSA contacted Great Plains on behalf of the producer, the HTA contract was independently cash-settled based on the difference between the futures price specified in the contract and the prevailing futures contract price at the time of settlement, with an adjustment for fees charged by Great Plains. In effect, the Division claimed that coincidental timing was the only connection between the two separate transactions.

Respondents, to the contrary, contended that the producers' deliveries to local elevators were integral to the settlement of their obligations under their HTA contracts with Great Plains. In support, they asserted that Great Plains commonly sold grain to elevators throughout Nebraska. Rather than fulfill its delivery obligations to these elevators directly, Great Plains permitted CSA producer-clients with HTA contracts to deliver their grain to the local elevators. Respondents claimed that this type of indirect delivery could be arranged over the telephone and be used to settle Great Plains's own contractual delivery obligations to the elevators in question. At trial, Gerdes referred to this process as "delivery through Great Plains." Another witness associated with Great Plains referred to the process as "direct ship" (*i.e.*, a seller to Great Plains would ship grain directly to a buyer from Great Plains without the grain passing through Great Plains's own facilities).

III.

The ALJ conducted a hearing in January and March 1999. The Division presented the testimony of: (1) five customers who participated in some of the challenged transactions;[9] (2)

[9] Thomas Bandur ("Bandur"), Thomas Bumgarner ("Bumgarner"), Kenyon Seim ("Seim"), Randy Solomon ("Solomon"), and Thomas Wagner ("Wagner").

three former Great Plains employees;[10] (3) three settling respondents (Wichmann, Arnold, and Amundson[11]); (4) a grain accountant at a firm that the Division had subpoenaed to produce records relating to grain transactions with CSA customers who entered into HTA transactions with Great Plains;[12] and (5) its expert, Peter Locke ("Locke"). Respondents presented the testimony of: (1) Clyde Haskins ("Haskins") a banker who dealt with one of the customers who testified for the Division; (2) Richard Gruber ("Gruber"), a CSA customer who owned a firm that entered HTA transactions with Great Plains and delivered grain to settle its delivery obligation; (3) former Great Plains employees Topil and Vanicek; (4) Kent Allen ("Allen"), president of Great Plains's board of directors; (5) respondent Gerdes; and (6) two expert witnesses.[13]

The Division's customer witnesses generally testified that they entered HTA transactions with Great Plains, did not deliver grain to a Great Plains elevator, and settled their obligations under their HTA contracts by receiving a cash payment from Great Plains or making a cash payment to Great Plains. Some noted that at the time they entered into an HTA transaction with Great Plains, at least a portion of their crop was already committed to another purpose, such as cattle feed. Transcript I at 69 (Bumgarner); 82 (Seim). The customers also noted that there were delays in receiving contracts from Great Plains. Sometimes transactions were resolved through a cash payment before the customer received the underlying written contract. Transcript I at 40

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[10] Joyce Brazda ("Brazda") worked in the grain department and assisted respondent Gerdes with various record keeping chores, including recording information on form contracts used for HTA transactions. Margaret Topil ("Topil") worked as Great Plains's grain accountant for about a one-month period. Leroy Vanicek ("Vanicek") worked for Great Plains after respondent Gerdes left the firm. His role was to try to resolve outstanding HTA transactions between Great Plains and CSA customers.

[11] Amundson used two firms he controlled to enter into HTA transactions with Great Plains. Neither firm produced the commodities underlying the HTA transactions.

[12] Janelle Martin ("Martin") worked for Pioneer Hybrid International ("Pioneer"), the firm that the Division subpoenaed. She testified that a search discovered no documents relating to a list of 79 specified producers that involved delivery of grain based on a contract between the producer and Great Plains.

[13] Richard Nathan ("Nathan") essentially offered a legal opinion about the proper interpretation of Section 4(a) of the Act. Timothy Lyons ("Lyons") was a consultant and member of the Chicago Board of Trade.

(Solomon); 96 (Seim); Transcript IV at 57 (Bandur). Customers said that they never intended to deliver grain to Great Plains, did not always notify CSA when they delivered their grain to an independent local elevator, and did not inform the local elevator that the delivery was related to an HTA transaction with Great Plains. Transcript I at 50-52 (Solomon); 69 (Bumgarner); 100-02 (Seim); Transcript II at 18-19, 20, 25 (Wagner); Transcript IV at 53, 57-58 (Bandur).

During his cross-examination of the Division's customer witnesses, counsel for respondents frequently noted that there was no express reference to a "cross country" HTA in documents that the customer witnesses identified as pertinent to transactions challenged in the Complaint. Transcript I at 25, 41 (Solomon); 65 (Bumgarner); Transcript II at 20 (Wagner). The Division's customer witnesses insisted that the transactions did involve Cross Country HTAs, but did not specifically address how they knew this. Transcript I at 41, 46, 48 (Solomon); Transcript II at 21 (Wagner); Transcript IV at 51 (Bandur). Some customers indicated that CSA personnel referred to the contracts as Cross Country HTAs. Transcript I at 48 (Solomon); 86 (Bumgarner); Transcript IV at 53 (Bandur). Bumgarner also noted that he received a 1996 letter from Great Plains referring to Cross Country HTAs. Transcript I at 68.

Respondents Arnold and Wichmann testified about their understanding of Great Plains's Cross Country HTA program. Most of their testimony was based on alleged conversations with respondent Gerdes. They also relied on their experience as intermediaries between producers and Great Plains in the transactions at issue, as well as communications with other Great Plains employees.

Arnold testified that, around the time CSA commenced business, he and Wichmann met with representatives of Great Plains, including Herman Gerdes, and discussed the possibility of arranging for CSA producer-clients to enter into HTA transactions with Great Plains. Tr. III at

11-12. In these discussions, the participants referred to a category of HTAs as Cross Country HTAs. *Id.* at 12. According to Arnold, the concept for Cross Country HTAs was that a producer-client of CSA would contract to sell grain to Great Plains and either deliver to Great Plains or, if the producer-client were outside Great Plains's geographic area, into the local cash market. *Id.* at 12. The local feedlot or receiving elevator would send payment to Great Plains. Great Plains would make adjustments, such as deducting Great Plains's fees, and forward the adjusted payment to the producer-client. *Id.* at 13.

Arnold claimed that "pretty much all" of CSA producer-clients delivered their grain to independent local elevators rather than to Great Plains. *Id.* at 47. He explained that during the early stages of CSA's relationship with Great Plains, none of CSA's producer-clients were located near Great Plains's two elevators. *Id.* Eventually, however, CSA represented a number of producer-clients located close to a Great Plains elevator. *Id* at 52. Rather than dealing with Great Plains through CSA like most of CSA's producer-clients, most of these local producer-clients dealt directly with Great Plains. They also resolved their HTA obligations by delivering grain to a Great Plains elevator. In Arnold's view, these distinctions showed that these local producer-clients had entered into "standard" HTAs with Great Plains rather than Cross Country HTAs.

According to Arnold, the reference price for the grain covered by Cross Country HTAs was based on the price of a designated Chicago Board of Trade ("CBOT") or MidAmerica Exchange ("MidAm") futures contract. When Great Plains entered into a Cross Country HTA transaction, it would establish a corresponding futures hedge position by selling futures contracts on the CBOT or MidAm. The basis component of the sales price would be established later, at a time chosen by the producer. *Id.* at 15.

According to Arnold, Gerdes did not indicate that Great Plains would negotiate with local elevators for the producer-clients who chose not to deliver to Great Plains's two elevators. *Id.* Great Plains's basis did not influence the cash price that producer-clients received when they chose not to deliver to Great Plains's two elevators. *Id.* at 16. According to Arnold, Great Plains charged a two-cents per bushel fee on Cross Country HTAs in 5,000-bushel increments and a higher fee on transactions involving 1,000-bushel increments. *Id.* at 17. Arnold said that Gerdes told him that the fees would be waived for grain delivered to Great Plains.[14] *Id.*

Arnold testified that CSA producer-clients entered into "dozens and dozens, if not more" Cross Country HTA transactions with Great Plains. *Id.* at 26-27. In some instances, the written contracts underlying Cross Country HTA transactions included language referring to Cross Country HTAs, but in others, the written contract documents only referred to HTAs. According to Arnold, it made no difference whether an offer specifically included the words "cross country." *Id.* at 39.

Arnold was questioned about producer-clients who delivered the commodity covered by a Cross Country HTA to an independent local elevator "in Great Plains's name." *Id.* at 43. He testified that one producer-client used this approach, but complained about delays in receiving payment from Great Plains. *Id.* at 43-47. As a result, the parties changed to what Arnold described as an "evolved type of process." According to Arnold, it later became a normal practice for producer-clients who delivered the commodity covered by a Cross Country HTA to an independent local elevator to deliver in their own name and obtain direct payment from the local elevator. At that point, CSA would contact Great Plains and direct it to "lift the position [it

[14] Arnold testified that he and Gerdes discussed rolling delivery obligations in exchange for a service fee. *Id.* at 22-25. Under this practice, a client-producer was allowed, at some time after the contract was entered into and before delivery, to change the delivery date along with the designated futures contract used as the reference for pricing the contract. *Id.* at 22. According to Arnold, one function of rolls was to allow producers to take advantage of expected favorable movements in price spreads between futures contracts with earlier and later delivery dates. *Id.* at 23.

was] maintaining in [its] hedge account." *Id.* at 47. Great Plains did not require documents or verification of delivery. *Id.* at 48. There would then be a financial adjustment between Great Plains and the producer based on the difference between the current futures price and the reference price in the Cross-Country HTA, with an adjustment for Great Plains's service fee. Sometimes Great Plains provided a check to the producer-client, and sometimes the producer-client provided a check to Great Plains. *Id.* at 50.

Arnold was asked about Great Plains's record keeping. He testified that when CSA attempted to reconcile its records with Great Plains's records, it often found that documents were unavailable. *Id.* at 45. He also said that CSA updated Great Plains's database to match its records. *Id.* at 46. He testified that until Great Plains hired Topil, contracts were provided to producer-clients only sporadically. *Id.* at 52.

On cross-examination, Arnold testified that CSA was in the business of representing grain producers, not speculators. *Id.* at 80. He further testified that he believed that he had made representations to Great Plains to the effect that the parties to the Cross Country HTAs were grain producers and that the contracts had grain behind them. *Id.* at 80-83. Arnold admitted that he subsequently learned that Wichmann had established an entity called C & J Farms that was not, in fact, a grain producer, and that C & J had entered into Cross Country HTAs with Great Plains. *Id.* at 83. According to Arnold, this was inconsistent with what Arnold "believed CSA stood for" and with what CSA had represented to Great Plains. *Id.* at 83-84. Arnold testified that, when the information came out in the spring of 1996, Wichmann was fired. *Id.*[15]

According to Wichmann, Great Plains, in practice, had two types of HTAs. Under one type, delivery of grain to Great Plains was expected. Under the second type, which was

[15] Arnold also testified that he learned that Wichmann had sold "300 and 400 and 500 percent of his clients' crop" and that this was contrary to what CSA stood for and had represented to Great Plains. *Id.* at 84.

sometimes, but not always, identified as a Cross Country HTA, delivery was not required and obligations could be cash settled. Transcript V at 13, 19, 44. According to Wichmann, Great Plains's HTA transactions with CSA producer-clients generally involved the second type of contract, except for one producer-client located near Great Plains's facilities who had a prior relationship with Great Plains. *Id.* at 15, 44-45. Wichmann stated that, in many instances, Great Plains entered into HTAs with CSA clients, and subsequently settled them, without the use of a written contract.[16] *Id.* at 35.

Amundsen testified about what Wichmann told him about Great Plains's Cross Country HTAs and about Cross Country HTA transactions he entered into for two entities that he controlled.[17]

Brazda was a Great Plains employee from 1982 until 1996. Transcript IV at 7. She was responsible, among other things, for handling paperwork associated with grain contracts and purchases, often based on information supplied by other employees such as Gerdes. *Id.* at 18. Brazda testified that Great Plains made only limited use of HTAs before it became involved with CSA. *Id.* at 12. She agreed that she associated the words "Cross Country" HTAs with Great Plains's CSA business. *Id.* at 33-34. She acknowledged that she was unaware of any CSA clients who settled HTA transactions with Great Plains by delivering grain to Great Plains's

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[16] Wichmann also offered testimony about Cross Country HTA transactions he handled for his father and for an entity called C & J Farms. The latter was a shell corporation owned by Wichmann's wife. *Id.* at 28. C & J Farms did not produce grain. Nevertheless, Wichmann used it to enter several Cross Country HTAs with Great Plains.

[17] Amundsen testified that he set up two unincorporated business entities, L & D Farms and Five-A Enterprises for the purpose of doing Cross Country HTA transactions with Great Plains. Neither entity had any agricultural production capability. *Id.* at 106-07. Amundsen had Wichmann arrange these entities' transactions with Great Plains. *Id.* at 107.

On cross-examination, Amundsen acknowledged that parties to Great Plains's contracts were supposed to have grain available. *Id.* at 115. He further acknowledged that his personal transactions through L & D Farms and Five-A Enterprises were inconsistent with CSA's business of representing producers and not speculators. *Id.* at 115-16.

elevators. She also testified that that she never talked to any non-Great Plains facility, including elevators or feed lots, regarding deliveries of grain by CSA clients. *Id.* at 32-33.

On cross-examination, Brazda agreed that, prior to Topil's arrival, Great Plains's record keeping was a "mess" and that it was "possible" that hundreds of documents "didn't find their way into the right file." *Id.* at 44. She acknowledged, however, that the normal practice was to try to put documents relating to each producer into a separate file. *Id.* at 47.[18]

Gerdes first made use of HTA contracts in 1982 while working for an elevator other than Great Plains.[19] Transcript VIII at 177. He believed that the contracts benefited producers by allowing them to capture a better basis. *Id.* at 179. Gerdes emphasized that trust played an important roll in the grain business. *Id.* at 186. In this regard, he noted that 90 percent of his cash transactions did not involve a written contract.[20] *Id.* He said that it was not Great Plains's practice to verify a producer's claims about their capacity to grow and deliver grain and that Great Plains did not have any formal mechanism to detect efforts to deceive or cheat the firm. *Id.* at 185-86.

Gerdes "guessed" that he was first contacted by Arnold and Wichmann in the early summer of 1993. *Id.* at 196. They inquired about the possibility of Great Plains providing HTAs to CSA clients. *Id.* at 197. Gerdes agreed, but only if the clients were actual grain producers and the grain under contract would either "be delivered to Great Plains or marketed through Great Plains." *Id.* at 197-98. According to Gerdes, Arnold and Wichmann did not object to these

[18] Topil also testified about Great Plain's record keeping. She acknowledged that when she arrived paperwork had built up because contracts were not sent out. Transcript VI at 27-29. She testified that during her efforts to get the paperwork "up to speed," she discovered some errors. Transcript IX at 296.

[19] Gerdes testified that he came to work for Great Plains in September of 1992. *Id.* at 180. He left Great Plains in the Spring of 1995, partly as a result of medical problems and partly as a result of major losses suffered by Great Plains. The losses originated in business not involving HTAs but extended into HTA business as well. *Id.* at 181.

[20] He did acknowledge that written confirmations were used. *Id.*

conditions and indicated that their clients were all grain producers and not speculators. *Id.* at 198-99. Gerdes testified that he never told CSA or anyone else that delivery was not required under Great Plains's HTAs. *Id.* at 200.

Gerdes testified that he never used the term "cross country" to describe an HTA, although there was "a term like that in the grain trade." *Id.* at 210-11. He stated that he did not treat contract offers from CSA labeled as "cross country" differently than other HTA offers. *Id.* at 211.

Gerdes testified that he anticipated delivery under all of the Great Plains HTAs. He specifically denied telling Solomon that delivery was not required. *Id.* at 224-26. He noted, however, that any grain contract could be amended if there was a "legitimate" reason. *Id.* at 226. He also indicated that the deliveries he anticipated included both deliveries directly to Great Plains and sales "through Great Plains Co-op on a cash contract that was already in place." *Id.*

On cross-examination, Gerdes was asked about the difference between his experience with CSA clients and non-CSA clients. He estimated that 80 percent of non-CSA clients settled their HTA transactions by delivering to one of Great Plains's elevators. *Id.* at 259. He agreed that not a single CSA client settled an HTA transaction by delivering to one of Great Plains's elevators. He claimed, however, that CSA clients delivered "through Great Plains." *Id.* According to Gerdes, a delivery "through" transaction arose in the context of Great Plains's sale of grain to other grain dealers such as Peavey. *Id.* at 206. He explained that a CSA client who entered into an HTA transaction with Great Plains might wish to deliver to a local Peavey facility. If Great Plains had a contract to sell to Peavey, it could fulfill it by permitting the CSA client to deliver to Peavey. *Id.* Gerdes claimed that he could make arrangements over the telephone in such a way that Great Plains got credit for the delivery.[21] *Id.* at 208.

At one point, the ALJ asked respondents' counsel for a specific example where a CSA client settled an HTA transaction with Great Plains by delivering through Great Plains. *Id.* at 208. Counsel did not offer a direct response. Instead, he elicited testimony from Gerdes indicating that 90 percent of Great Plains's purchases and sales of grain were oral, and agreeing that by their very nature, an oral transaction meant there was "nothing in writing." *Id.* at 208-09. At another point, however, Gerdes acknowledged that calculating payments to CSA clients in the context of delivery through transactions would normally require documentation.

Allen testified that Great Plains had equity ownership in other entities that used grain, including other grain elevators and an ethanol plant. Tr. VIII 319-20. He testified that "to the best of [his] knowledge" grain covered by HTA transactions with Great Plains was directed to such entities. *Id.* at 320. Allen also testified that Great Plains's 1996 annual report included figures on average prices of grain sold by Great Plains in 1995 and 1996, and separate average prices for "direct ship" grain. *Id.* at 340. The average prices for "direct ship" grain were higher. *Id.* at 340-42.

The parties' experts submitted written testimony and were then subjected to cross-examination and limited redirect.[22] Locke testified that Great Plains's Cross Country HTAs were

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[21] Gerdes testified that having a producer deliver grain directly to an independent local elevator, for credit against a sale of grain by Great Plains to that local elevator, could have benefits to the producer in terms of cost and convenience. Id. at 213. It also could save Great Plains substantial amounts of money, for example by reducing transportation costs and costs associated with moving grain into and out of Great Plains's own storage elevators. Id. at 213-15.

[22] As noted above, Nathan's testimony essentially involved legal opinions. To the degree these views are material, we note them in the context of our discussion of legal issues.

futures contracts, not forward contracts.[23] In his view, the record showed that producers who entered into Cross Country HTAs with Great Plains did not intend to deliver to Great Plains. In this regard, he noted that these producers rolled their delivery obligations to dates later than those specified in their contracts, did not actually deliver to Great Plains, and settled their contracts with cash payments based on losses or gains on corresponding exchange-traded futures positions.

Locke acknowledged that, "[a]t or near the time that a Great Plains cross country hedge-to-arrive contract was offset, a producer may have been delivering some commodity to another producer." This delivery did not alter his conclusion that parties to the HTA transaction did not intend delivery because, according to Locke, in most instances Great Plains was: (1) not aware of the delivery location; (2) not aware of the price paid by the receiving elevator; (3) not in contact with the receiving elevator; and (4) did not receive a payment from the receiving elevator. Locke Declaration at 11.[24]

On cross-examination, Locke acknowledged that in determining the parties' agreements, he did not limit himself to the language of their written contracts. For example, he said that despite the absence of express written language, he believed the parties anticipated that there would be a right to "offset" their obligations. Transcript VII at 17-18. He acknowledged that the intent of both parties to the transaction was material to his analysis. *Id.* at 38-39, 47.

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[23] Locke limited his opinion to CSA clients who were not "local producers" in relation to Great Plains, but did not define this group in terms of a specific distance. Locke Declaration at 9.

[24] Locke noted that, in a few instances there was evidence that the third party recipient of grain had sent a check to Great Plains and that Great Plains had made payment to the producer. Locke's understanding was that the payment in these cases reflected "the cash price negotiated by the producer with the purchaser (the check received by Great Plains), plus the value (positive or negative) of the Great Plains cross country hedge-to-arrive contract, less accumulated Great Plains' service fees." Locke Declaration at 11. According to Locke, these transactions were also futures contracts because (1) Great Plains never had possession or control of, or title to, the commodity; (2) the producer was responsible for marketing the grain; and (3) Great Plains had no financial interest in the price received from the third party recipient of the grain.

Lyon's testimony largely dealt with HTAs in general. For example, he explained that in most cash grain trading in the United States, the price paid for the grain has two components: the futures price (determined by the price of the relevant exchange-traded futures contract) and the local basis for the time and place of delivery. In this context, a reference to a futures price in a grain contract does not imply that the contract is a futures transaction.

According to Lyons, an HTA transaction is not primarily speculative, rather it is designed to allow the parties to lock in some elements of the sales transaction in advance while retaining flexibility to establish other elements later. Lyons further testified that, under all types of grain marketing contracts, "it is not unusual to have an elevator allow a producer to deliver to an open destination, which may be a destination apart from that elevator's physical location." Lyons Declaration at 4.

In addition to testimony, the Division relied on documentary evidence that it claimed evidenced Cross Country HTAs with Great Plains that were settled through cash payments. It introduced documents associated with forty-three payments from Great Plains to CSA clients and seven payments from CSA clients to Great Plains. In each of these fifty transactions, the amount of the payment in question was calculated based on the difference between the original reference futures contract price in the contract and the price of the relevant futures contract at the time of settlement, with an adjustment for Great Plains's fees.

The Division insisted that there was no meaningful connection between these payments and grain deliveries by CSA producer-clients to independent local elevators. In support, it noted that after the initial delivery process was abandoned, independent local elevators made payments directly to CSA producer-clients rather than to Great Plains. It also emphasized that, despite a reasonable search, it had been unable to obtain any contemporaneous records documenting the relationship between the grain CSA producer-clients delivered to independent local elevators and the payments that CSA producer-clients made to or received from Great Plains to settle their HTA transactions.[25]

The record also included numerous examples of Great Plains's HTA contract form. The forms included a space in which to designate a reference futures contract and the price of the reference contract as of the date of execution of the HTA. The forms further provided that the seller would "set the 'cash basis' to determine the cash value of the grain in this contract on or before" a specified date to be inserted in the contract. (Ordinarily the specified date was the end of the month before the delivery month of the reference futures contract.) The form defined the "cash basis" as "the difference between the price of the futures contract and the cash bid posted, for the delivery period of this contract, by the BUYER at the time the SELLER elects to set the 'cash basis.'" The contract also included a blank space in which to insert a service fee charged to the seller. The fee was typically two cents per bushel.

The form also included spaces in which to insert a description of the grain, a delivery period, a quantity, a destination, the cash basis, and the cash price. (The latter two spaces were evidently to be used if and when the seller set the basis.) On almost all of the completed contracts on the record involving CSA clients, the destination was specified as "open," or "seller's call," or some similar expression.

The contract forms said nothing about rolling the delivery dates of the contracts or about cash settlement between the parties without the setting of the basis. Some versions of the form

[25] In this regard, the Division noted that documentation for HTA transactions with CSA clients subpoenaed from Great Plains made no reference to local grain deliveries except in two early transactions in which Great Plains concededly was involved in the delivery. *See* DX-2098, 2099. The Division also issued subpoenas for documents to two large companies, Peavey and Pioneer Seed, that purchased grain from CSA clients with outstanding Great Plains HTA contracts. These firms' responses to the subpoenas indicated that they located no documents referring to transactions in which Great Plains was involved with deliveries by listed CSA customers. DX –585, 585A; Exhibits A and B to Joint Stipulations (Record Vol. 8).

included a sentence in which the seller stated that the seller had or would have grain available that could be delivered under the contract.

IV.

The ALJ did not make any express credibility determinations in his September 1999 I.D. He based his findings on portions of the testimony offered by almost every witness who testified at the hearing.

The ALJ found that there was a "very clear distinction" between Great Plains's Cross Country HTA transactions and its "general" HTA transactions. I.D. at 48,679 n.8. In this regard, he noted that Cross Country HTA transactions had several common characteristics: (1) CSA faxed orders for such transactions to Great Plains's Stromsburg office; (2) almost all the faxed orders included a designation indicating that the order involved a Cross Country HTA transaction; (3) Great Plains maintained a separate account at its futures commission merchant for futures positions hedging Cross Country HTA transactions; and (4) form contracts for Cross Country HTA transactions indicated that the delivery destination was "seller's call," "seller's option," "open," or did not include any information about the delivery destination. I.D. at 48,680-81. The ALJ noted that not all the documents evidencing a Cross Country HTA transaction used the words "cross country," but found this was unimportant in view of testimony indicating that contracts lacking this language could "function as" Cross Country HTAs. *Id.* at 48,680.

Having determined that his analysis should be limited to the group of transactions that he identified as Cross Country HTA transactions, the ALJ made findings about the circumstances material to characterizing the nature of the transactions under the Act. He noted that Great Plains entered into Cross Country HTA transactions with CSA customers "located outside its traditional territory." *Id.* at 48,681.[26] He also found it significant that Great Plains did Cross Country HTA business not only with producers who operated seed corn businesses or feedlot businesses, but also with non-producers. *Id.* He pointed out that the cash payments Great Plains made to participants in Cross County HTA transactions were for "futures profits minus Great Plains service fees," and did not include a deduction for moisture content or taxes. *Id.* The ALJ also emphasized that Great Plains permitted routine rolling, prepared a promotional brochure indicating that contracts could be "offset" if participants would rather not make delivery of grain; and did not fill in many of the blanks in the form contracts for Cross Country HTA transactions, including those for "Cash Basis" and "Cash Pricing." *Id.* Finally, he found that none of the producers who undertook Cross Country HTA transactions delivered grain to Great Plains. *Id.*

In the analysis portion of his decision, the ALJ explained that he gave little weight to what he described as "self-serving" contract provisions. *Id.* at 48,684. Instead, he focused on the parties' conduct, noting that CSA producer-clients were located outside Great Plains's traditional territory, but respondents never asserted that they intended to offer a grain price that was high enough to entice participants to deliver grain from a distant location. *Id.* at 48,685. According to the ALJ, the "bottom line" was that "Great Plains entered into a contract with any producer that CSA sent to it regardless of the impracticality or sheer burden of delivery." *Id.* Similarly, the ALJ found it significant that Great Plains entered into contracts with participants who had no grain to deliver, such as non-producers, seed corn producers, and feedlot operators; and that Great Plains did not investigate whether CSA customers had the capacity to deliver. *Id.* at 48,686-87.

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[26] In this regard, he cited to Gerdes's testimony that half a dozen CSA customers were within Great Plains's traditional territory and the remainder were outside the traditional territory. *Id.* at 48,681 n.48.

The ALJ rejected Great Plains's theory that deliveries by CSA producer-clients to independent local elevators should be considered a form of delivery to Great Plains because the deliveries were made to fulfill obligations of Great Plains to the elevators in question. *Id.* at 48,681 n. 52. He characterized this theory as a "defense" to the case made by the Division. *Id.* He noted that this defense did not apply to some participants in Cross Country HTA transactions such as non-producers, or those who operated seed corn or feedlot businesses; and that, even under Great Plains's version of the facts, Great Plains never received possession and control of the underlying commodity. *Id.* He also found that delivery "through" Great Plains occurred only in a few early transactions; and that, subsequently, delivery was made to local elevators with no mention of Great Plains. *Id.*

In view of this analysis, the ALJ ruled that Great Plains's Cross Country HTA transactions did not fall within the Act's "narrow cash forward exclusion." The ALJ concluded that the "probative evidence of record" proved that:

> [T]he Great Plains-CSA enterprise was a bucket shop operation masquerading as a "cash forward hedge-to-arrive" business. Great Plains took not one bushel from a CSA customer. The Great-Plains CSA operation could have been housed in the backroom of a tavern or pawnshop. There was certainly no need for a grain elevator.

Id. at 48,690.

In conclusion, the ALJ held that Great Plains and Gerdes violated Section 4(a) of the Act, and entered a cease and desist order against both respondents and a 10-year trading prohibition on Gerdes. The ALJ did not explain why a civil money penalty was not an appropriate sanction. *Id.* at 48,691.

V.

Respondents' appeal challenges the ALJ's decision on a number of grounds. They argue that errors in a variety of the ALJ's procedural rulings resulted in a denial of a fair hearing on the Complaint's allegations. They also contend that the ALJ gave undue weight to respondent Wichman's incredible testimony, ignored the Division's admission that respondents did not tell customers that delivery was not required; and failed to give proper weight to the language of the contract underlying the transactions at issue. In this regard, they emphasize that in a recent opinion discussing the characterization of HTA transactions under the Act, the United States Court of Appeals for the Seventh Circuit specifically held that the "starting point" of the analysis "must always be the words of the contract itself." *Lachmund v. ADM Investor Services, Inc.*, 191 F.3d 777, 786 (7^{th} Cir. 1999).

Finally they emphasize that the ALJ failed to properly weigh factors indicating that the transactions at issue were forward contracts. These include: (1) that the transactions were based on grain merchandising contracts not offered to the general public; (2) that key contract terms were not standardized; (3) that apart from those who breached their contracts or defrauded Great Plains, all participants had the ability to make or take delivery of the underlying grain and the underlying grain had inherent value to them; (4) that the transactions were not merely for speculative purposes; (5) that delivery could not be avoided through "exchange style" offset; and (6) that the participants intended delivery. In regard to the final factor, respondents emphasize that the record shows its customers delivered grain in connection with their HTA transactions and insist that the Division's emphasis on the parties' failure to limit delivery to one of Great Plains's elevators is misplaced.

The Division argues that respondents' procedural challenges are without merit. In particular, it contends that the ALJ properly ruled that he was not bound by court decisions resolving independent parties' disputes about the application of the Act to HTA transactions. In addition, it defends the ALJ's discovery rulings and limits on examination during the hearing as consistent with both Commission rules and due process.

The Division defends the ALJ's reliance on Wichman's testimony as well as his focus on the challenged transactions' substance rather than the language of the underlying contracts. In this regard, it notes that the *Lachmund* court acknowledged that it was "often necessary to look beyond the written contract" in characterizing a transaction under the Act. Division's Answering Brief at 21. In addition, the Division emphasizes that the record showed that 80 percent of the time, no written contract was in place when a CSA customer cash settled a Cross Country HTA transaction. *Id.* at 22. It also notes that some of the written contracts lacked language specifically warranting that the contracting party had the ability to deliver the underlying grain.

According to the Division, many of the factors that respondents rely on to characterize the transactions are merely elements that "facilitate" exchange trading rather than "essential" elements of a futures contract.[27] *Id.* at 28. Indeed, the Division claims that two circumstances were sufficient to support the ALJ's analysis – Great Plains's documented practice of "routinely cash liquidating . . . [Cross Country HTAs]" and "routinely permitting rolling upon request." *Id.* at 24. In discussing intent to deliver, the Division emphasizes that "there can be no cash forward

[27] In the Division's view, these include: (1) availability to the general public; (2) settlement through exchange-style offset; and (3) standardized contract terms.

contract where there is never any delivery." In this regard, it argues that only delivery to or through Great Plains merited weight in the analysis. *Id.* at 31.[28]

DISCUSSION

I.

We turn initially to respondents' procedural challenges. While respondents raise a variety of complaints about the ALJ's procedural rulings, their essential claim is that the ALJ denied them a fair opportunity to develop the record on facts material to their liability. For example, they claim that the ALJ should have: (1) compelled the Division to respond to requests for admission and produce exculpatory documentation; (2) refused to quash subpoenas directed at attorneys who represented some of the Division's customer witnesses; (3) granted their objections to the Division's request for modifications to the transcript prepared by the reporter; (4) granted counsel broader leeway in examining witnesses; and (5) refrained from interrupting counsel with comments and interjections during his examination of witnesses.

Our review of the record relating to the noted rulings does not establish a basis for inferring that the ALJ abused his discretion. Moreover, respondents have not shown that the ALJ's ruling prejudiced their opportunity for a fair hearing.[29] Accordingly, we reject their procedural challenges as unsupported by the record.

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[28] In essence, the Division argues that delivery "through" Great Plains should be treated as equivalent to delivery in the name of Great Plains. In this context, it claims that the record shows that, with the exception of two instances, delivery through Great Plains "never happened." *Id.* at 35.

[29] For example, respondents claim that the ALJ cut off Allen's testimony concerning Great Plains's expansion of its feed business. *Id.* Allen, however, only referred to the feed business for purposes of analogy to Great Plains's grain business, and only the latter business is material to this case. *See* Tr. VIII at 315-17. In these circumstances, the ALJ's limitation of testimony concerning the feed business cannot be viewed as prejudicing respondents' ability to develop the record on issues material to their defense.

Respondents also note that when Great Plains employee Topil glanced at respondents' counsel table during her testimony, "she was admonished not to look at her attorneys and [to] tell the truth." Br. at 23. Even if we assume the instruction was unnecessary, respondents do not explain how Topil's compliance with the instruction can be viewed as prejudicing their interests.

II.

Respondents challenge the ALJ's implicit credibility determinations as contrary to the record. In particular, they challenge what they term the ALJ's "blind[] accept[ance]"of Wichman's testimony. Respondents' Appeal Brief at 7.

As a general rule, we defer to a presiding officer's credibility determinations in the absence of clear error. *In re Piasio*, [1999-2000 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 28,276 at 50,685 (CFTC Sept. 29, 2000) ("*Piasio I*"), *aff'd*, *Piasio v. CFTC*, No. 02-4032 (2d Cir. December 31, 2002). We have found that a presiding officer commits clear error when he limits himself to general and conclusory factfinding and fails to address material conflicts between witness testimony and reliable documentary evidence. *Piasio I*, ¶ 28,276 at 50,686. Here, we find that the ALJ committed clear error by failing to resolve material credibility disputes arising out of conflicts between the testimony offered by Arnold, Wichman, and Gerdes.

There were significant conflicts in the testimony offered by Arnold and Wichman. For example, Arnold acknowledged that he had assured Great Plains that the clients CSA represented were grain producers and that their HTA contracts had grain behind them. Tr. III at 80-83. He then admitted that Wichman acted contrary to this assurance when he entered into HTA contracts with Great Plains on behalf of an entity that was not a grain producer. Arnold said that when he discovered this fact, Wichman was fired. *Id.* at 83-84. Wichman, however, denied both making a misrepresentation to Great Plains and being fired. Tr. V at 107, 108.

As settling respondents, both Arnold and Wichman had some incentive to be cooperative with the Division. On the whole, however, Arnold's testimony was balanced, internally logical, reasonably specific, and consistent with available documents. Wichman's testimony was broad, conclusory, and frequently evasive. To the degree Wichman's testimony conflicts with Arnold, we give it no weight.

There is also a significant conflict in the testimony offered by Arnold and Gerdes. Arnold testified that his conversations with Gerdes included a discussion of a Cross Country HTA program where CSA producer-clients outside Great Plains's geographic area could deliver into the local cash market. Tr. III at 12. He candidly acknowledged that although Cross Country HTAs were understood to be a special class of HTA transaction, the label was not used in a consistent, disciplined fashion. Tr. III at 39, 52-53. Gerdes, in contrast, insisted that he never used the term "cross country" to describe an HTA and did not treat contract offers labeled "cross country" differently than other HTA offers. Tr. VIII at 21-211. His claim that the term essentially had no significance flies in the face both of Arnold's testimony and the term's frequent appearance in Great Plains's own documents. We decline to credit this aspect of Gerdes's testimony.

We also decline to credit Gerdes's testimony about the delivery process that Great Plains used after the initial process was abandoned. While Gerdes insisted that there was a meaningful connection between CSA producer-clients' grain deliveries to independent local elevators and the cash payments used to settle their delivery obligations under HTA contracts with Great Plains, his testimony on this issue was notably vague. Tr. VIII at 206-08. In effect, he claimed that there were interconnecting transactions between Great Plains and the independent local elevators, but that the interconnecting transactions were always informally arranged by telephone and never subsequently documented. Such claims fly in the face of evidence that Great Plains created and maintained a system to document its HTA transactions with CSA clients.[30]

[30] In his deposition testimony, Gerdes himself acknowledged that a customer's delivery of grain on Great Plains's behalf would be documented in certain ways. The record also includes more general information about Great

III.

Our decision today in *In re Grain Land*, CFTC Docket No. 97-01 (CFTC Nov. 25, 2003) provides a useful template for approaching the liability issues raised by the parties. There, we began by reiterating a principle that we initially articulated in *In re Stovall*, [1977-1980 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,941 at 23,788 (CFTC Dec. 6, 1979):

> [A] major difference between an excluded cash commodity-deferred delivery contract and contracts of sale of a commodity for future delivery is that the former entails not only the legal obligation to perform, but also the generally fulfilled expectation that the contract will lead to the exchange of commodities for money. In contrast, parties to a futures contract do not usually expect delivery and it rarely occurs.

We then indicated that in assessing parties' expectations or intent regarding delivery, we would apply a "facts and circumstances" approach rather than any bright line test. *Grain Land, slip op.* at 27. We acknowledged that the language of any written agreement underlying the challenged transactions was a relevant factor, but declined to give such language controlling weight in all circumstances. Indeed, we indicated that in assessing intent, evidence of the parties' conduct would generally be given at least as much weight as evidence of the words they used to characterize their transaction. *Id.*[31]

Plains's recordkeeping process. For example, there was testimony indicating that Great Plains initially struggled to maintain the quality of its recordkeeping process, but took steps to correct the problem. For example, Arnold testified that until Great Plains hired Topil, Great Plains provided written HTA contracts to CSA producer-clients only sporadically. Tr. III at 52. Topil testified that during her effort to get the paperwork up to speed, she discovered some errors. Tr. IX at 296. Such errors, however, would not explain the lack of any documentation for an entire class of interrelated delivery transactions. Moreover, apart from Gerdes, no witness claimed that Great Plains regularly undertook transactions that were never documented.

Allen's general testimony about "direct ship" deliveries does not substantially corroborate Gerdes's claims because the testimony was not directly linked to the transactions at issue in this case. Tr. VIII at 320. As a Great Plains board member, it seems unlikely that Allen was sufficiently involved in the day-to-day operations of the coop to have specific knowledge of such a link. *Id.* at 312-13.

[31] Respondents' claim that we must limit our analysis by applying the parole evidence rule is contrary to controlling court precedent. For example, in *CFTC v. Co Petro Marketing Group, Inc.*, 680 F.2d 573, 581 (9th Cir. 1982), the court explained that:

Our facts and circumstances analysis in *Grain Land* focused on several factors pertinent to the parties' intent at the time they entered into their HTA transactions: (1) the participants in the transactions possessed characteristics consistent with an intent to deliver – they were in the grain business, had made or taken delivery in the past, and used contracts that were individualized with respect to terms such as quantity, grade, and type of grain; (2) in many instances, the language of the written contracts underlying the challenged transactions imposed an obligation to deliver or accept delivery of grain, but permitted the producer to roll the deadline for delivery or cancel the delivery obligation and substitute a cash settlement based on futures price differences; (3) the parties' conduct regarding delivery was widely varied rather than relatively uniform -- some producers cancelled their delivery obligations and settled their obligations through cash payments, but many producers resolved their obligations under their HTA contracts by delivering grain to Grain Land. *Id.* at 29-31.

In concluding that the Division had failed to establish that the challenged transactions fell within our regulatory jurisdiction, we noted that, for purposes of assessing the parties' intent regarding delivery, the significance of the broad cancellation right included in Grain Land's contracts depended largely on its "use." *Id.* at 30. Given the variation in the parties' conduct regarding delivery, and the Division's failure to develop the record on either the reasons parties

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> In determining whether a particular contract is a contract of sale of a commodity for future delivery over which the Commission has regulatory jurisdiction ..., no bright-line definition or list of characterizing elements is determinative. The transaction must be viewed as a whole with a critical eye toward its underlying purpose.

See also Lachmund v ADM Investor Services, Inc., 191 F.3d 777 (7th Cir. 1999) (applying a facts and circumstances approach that considered the language of the contract, the course of dealings between the parties, and the totality of the business relationship); *The Andersons, Inc. v. Horton Farms, Inc.*, 166 F.3d 308, 319-320 (6th Cir. 1998) (refusing to treat the terms of the written contract as dispositive and holding that the ultimate focus is on whether the contract in question contemplated actual, physical delivery of the commodity).

cancelled their delivery obligations or the circumstances affecting their decision, we were unable to identify the parties' "actual intent when they undertook their delivery obligation." *Id.* at 29.

The circumstances at issue here are both somewhat similar to and somewhat different from those we considered in *Grain Land*. With a few exceptions, the participants in the transactions challenged in both cases were quite similar -- they were in the grain business, had made or taken delivery in the past, and used contracts that were individualized with respect to terms such as quantity, grade, and type of grain.[32] On the other hand, the language of the written contracts in this case differs from that of the contracts at issue in *Grain Land*. Great Plains's HTA contract forms, unlike many of the HTA contract forms used by Grain Land, contained no written provisions conferring either a right to roll the deadline for delivery or a right to cancel the delivery obligation and substitute cash settlement based on futures price differences. Thus, Great Plains correctly observes that, in this case, both the nature of the parties to the transactions and the language of the underlying written agreements are consistent with an intent to deliver the grain specified in the parties' HTA contracts.

Given these circumstances, the Division's case rises or falls on evidence concerning the parties' conduct. Specifically, the Division must show that the parties' conduct in Cross Country HTA transactions supports an inference that they did not intend to make or receive deliveries of grain pursuant to their HTA contracts. In this regard, the Division emphasizes that Great Plains permitted cash settlement of delivery obligations and never took delivery of any grain under a Cross Country HTA contract. In support, they cite to Gerdes's and Brazda's testimony acknowledging "that no CSA client ever delivered grain to Great Plains pursuant to a Cross-Country HTA." Division Answering Brief at 7.

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[32] We find it unnecessary to reach the issue of whether Great Plains knew, or had a duty to know, the true nature of the pseudo-farm entities with which it entered into HTA contracts.

Respondents raise two fundamental challenges to this element of the Division's analysis. One amounts to a claim that the uniformity of the parties' conduct regarding delivery is more apparent than real. According to respondents, the Division manufactured the apparent uniformity by limiting its analysis to participants in Great Plains's so called "cross country" HTA program. As noted above, respondents claim that they never had such a program and suggest that the designation had no real significance. They note that if the scope of the conduct analysis is extended to include parties to Great Plains's standard HTA transactions, there is no reliable basis to support the Division's claim that Great Plains did not intend that its HTA transactions result in grain deliveries.

Contrary to respondents' argument, the record shows that the "cross country" designation had significance in the context of Great Plains's overall HTA business. As noted above, Gerdes's testimony to the contrary is incompatible with the term's frequent appearance in Great Plains's own documents. Moreover, Great Plains's employee Brazda testified that she associated the "cross country" designation with Great Plains's CSA-related business. Most importantly, Arnold credibly testified that the "cross country" designation was discussed at the initial meeting where the relationship between CSA and Great Plains was established. Clearly it had some significance to Gerdes and Great Plains.

Respondents' emphasis on evidence that the "cross country" designation was not used in a uniform or consistent manner in written documents is misplaced. The record shows that Great Plains's contracting practices were fairly informal. For example, sometimes customers did not receive the written agreement underlying a particular HTA transaction until after the outstanding obligations had been cash settled. It is reasonable to infer that the same type of informality affected the use of the "cross country" designation. Indeed, Arnold candidly acknowledged that it made "no difference" whether a producer-client's offer specifically included the "cross country" designation. He credibly explained, however, how he could distinguish between Great Plains's standard HTAs and its Cross Country HTAs in the absence of the label – participants in Cross Country HTAs were located outside Great Plains's geographic area.

As noted above, Arnold testified that "pretty much all" of CSA producer-clients delivered their grain to independent local elevators rather than to Great Plains. The relative uniformity of this conduct is striking in view of the underlying written contracts' lack of any cancellation provision. Because the written agreement in *Grain Land* included an express right to avoid delivery by invoking the cancellation option, it is not surprising that some producers decided that delivery avoidance was preferable while others chose to deliver. When, as here, the written agreement contemplates settlement of obligations only by delivery, it is clearly anomalous that almost every producer-client found delivery avoidance to be advantageous.[33]

The significance of this result in the context of an intent inquiry, however, depends largely on whether it could be anticipated at the time the parties entered into their HTA transactions.[34] In other words, is there a basis to infer that at the time Great Plains entered into

[33] As noted above, the Division argues that Gerdes's and Brazda's testimony supports a finding that Great Plains never took delivery of grain under a Cross Country HTA. In our view, while this testimony generally corroborates Arnold's more precise description of the parties' conduct, it is too ambiguous to merit significant weight. Gerdes's testimony that there were no deliveries to a Great Plains elevator was given in response to a question that referred to all CSA clients rather than only those who participated in Cross Country HTAs. While Gerdes's answer may have been intended to refer to the majority of CSA clients – who did participate in Cross Country transactions – the literal language of his testimony conflicts with Arnold's acknowledgment that a few local CSA producer-clients delivered to a Great Plains elevator. Given her limited role at Great Plains, Brazda's lack of knowledge of any deliveries by CSA clients to a Great Plains elevator is not persuasive evidence that none actually took place.

[34] For example, an unexpected change in circumstances can provide an innocent explanation for an apparent mismatch between the parties' intent at the time of the transaction and the ultimate result of the transaction. On the other hand, a fairly consistent mismatch without any material change in circumstances may suggest that the formal elements of the transaction have been manipulated to disguise the parties' true intent at the time a transaction was entered.

HTA transactions with CSA producer-clients outside its geographic area, its intent regarding delivery was substantially different from its intent when it entered into standard HTAs?[35]

The admitted purpose of Great Plains's arrangement with CSA was to extend Great Plains's business to a new customer base.[36] Arnold's testimony clearly establishes that Gerdes was aware that CSA's potential clientele included producer-clients outside Great Plains's geographic area. Given the profit margins typical for grain producers, Gerdes had no basis to infer that these producer-clients would be indifferent to the cost of transporting their grain to more distant elevators. Indeed, by discussing arrangements to permit these producer-clients to deliver into the local cash market, Gerdes demonstrated his recognition that this portion of CSA's potential clientele was likely to have expectations about delivery different from those of Great Plains's usual HTA clientele. This recognition led to the development, but subsequent quick abandonment, of the initial delivery process.

Which brings us to respondents' second fundamental objection to the Division's focus on the failure of CSA producer-clients, apart from old Great Plains members located near Great Plains facilities, to deliver grain to a Great Plains elevator. In essence, respondents claim that the Division has confused two independent inquires: (1) did the parties to the challenged transactions intend to make or take delivery of grain; and (2) if so, where did they intend to make or take delivery? Put simply, respondents claim that proof that a CSA producer-client lacked an intent to deliver grain to one of Great Plains's two elevators does not amount to proof that the client-producer lacked an intent to deliver grain for Great Plains's benefit.

[35] For these purposes, we assume that Great Plains's intent when entering into standard HTAs was to take delivery of grain from a producer.

[36] The record shows that Great Plains did not treat CSA-related business as part of its general HTA program. For example, it maintained a separate futures brokerage account for purposes of hedging its exposure on its CSA-related HTA transactions, and generally prepared monthly reports on its CSA-related HTA contracts separate from those on its other business. Tr. III at 62; Tr. IV at 34-35.

We agree that the mechanics of the delivery – particularly whether it is direct rather than circuitous – is not usually an important factor in assessing parties' intent to deliver. We have traditionally used the intent inquiry to help us distinguish transactions that are primarily concerned with merchandizing a commodity from those that are primarily concerned with futures speculation or hedging. Innovations in merchandizing transactions should not be discouraged simply because they may complicate our efforts to analyze the intent underlying particular transactions. Consequently, when a producer enters into a delivery contract with a grain dealer such as Great Plains, and the producer delivers grain to a third party in fulfillment of the dealer's independent delivery obligations, the producer will generally be deemed to intend delivery within the meaning of our precedent.

In assessing intent, however, our precedent has generally eschewed approaches that elevate a transaction's form over its substance. Arrangements for indirect delivery may provide tempting opportunities to blur the lines between merchandizing transactions and related transactions of a different character. Consequently, in order to prevent regulatory evasions, we must look beyond a challenged transaction's ostensible purpose and identify the parties' most likely intent.

Here, the record suggests that Great Plains's initial innovations regarding delivery were benign. As described by Arnold, Great Plains's initial process for indirect delivery was firmly rooted in the merchandizing context. CSA producer-clients entered into HTA transactions with Great Plains and then delivered grain to independent local elevators in Great Plains's name. The independent local elevator generated appropriate documents and provided them to Great Plains along with the negotiated payment for the grain. Great Plains then paid the CSA client-producer in accordance with the terms of their HTA agreement. These circumstances establish the existence of two independently negotiated but interrelated merchandizing transactions. There is no basis for deeming either transaction to be within our regulatory jurisdiction.

Respondents acknowledge, however, that the initial delivery process was abandoned due to complaints from CSA producer-clients. At this point, the record shows that Great Plains permitted CSA producer-clients to treat their merchandizing transactions with independent local elevators as completely separate from their HTA transactions with Great Plains.[37] For example, in his role as intermediary between CSA producer-clients and Great Plains, Arnold observed no indications that deliveries by CSA producer-clients were being applied to delivery obligations on the part of Great Plains. In many instances Arnold arranged cash settlements of HTA contracts with CSA producer-clients without informing Great Plains where and when the relevant grain was delivered, making it difficult, if not impossible, for Great Plains to match deliveries by these clients against any delivery obligations on the part of Great Plains.

The absence of any documentation for the alleged matching of merchandizing transactions between Great Plains and the independent local elevators reinforces our conclusion that there was no meaningful link between Great Plains's HTA transactions with CSA producer-clients and the deliveries made to local elevators by these producer-clients. As noted above, for the period after the initial delivery process was abandoned, there was no reference to independent delivery obligations fulfilled by CSA producer-client deliveries to local elevators in either documents that the Division obtained from Great Plains or documents Great Plains chose to submit to the hearing record. Concededly, there is evidence that Great Plains's record keeping

[37] The ALJ erroneously characterized Great Plains's "delivery through" theory as a "defense" to the Division's case. Generally speaking, a party raising a defense to an enforcement action has the burden of proving the facts that establish the defense. In this case, we hold that, once Great Plains raised the "delivery through" issue, the Division had the burden of proving that CSA producer-clients' intent to deliver grain to local elevators did not amount to an intent to deliver grain pursuant to their HTA contracts with Great Plains. As discussed in the text, the Division met this burden.

was sloppy. Nevertheless, considerable documentation of CSA-related HTA transactions was located and introduced in this proceeding. If "delivery through" Great Plains took place in a significant number of instances, it is implausible that no written records at all of such transactions would be locatable.

Finally, even if Great Plains's records were unreliable, it is significant that neither Peavey nor Pioneer Seed was able to locate documents referring to "delivery through" transactions involving Great Plains and CSA clients, even though a number of CSA producer-clients delivered grain to elevators operated by these companies shortly before cash-settling their obligations under HTA contracts with Great Plains.

Taken together, this evidence is sufficient to establish that, after the initial delivery procedure was abandoned, Great Plains was not involved, even indirectly, in deliveries of grain by CSA producer-clients. Certainly, most CSA producer-clients had an intent to deliver grain to their local elevator and many cash settled their outstanding obligations under their HTA contracts with Great Plains shortly after making delivery. We agree with the Division, however, that such coincidental timing does not transform what is essentially a futures hedging transaction into a merchandizing transaction. The record shows that Great Plains continued to enter into contracts with CSA clients over a period of two years, and cash settled something over fifty contracts, without either direct or indirect deliveries occurring. This continued course of dealing provides strong evidence that Great Plains intended that its contracts be used in the manner they were in fact used – as devices that provided an opportunity for hedging or speculating on futures prices with no genuine expectation of delivery. Based on these facts, we find that the contracts at issue in this case were off-exchange futures contracts, not cash forward contracts.

IV.

Finally, throughout this proceeding, respondents have challenged our authority to independently assess the issues before us. According to respondents, either federal or state courts have resolved all the issues pertinent to the proper characterization of the challenged transactions in their favor. Respondents contend that our failure to dismiss the Complaint in accordance with these decisions would "stand[] the doctrine of separation of powers on its head," and put the Commission on "constitutionally infirm ground, by purporting [to] act as a final reviewer of judicial decisions." Respondents' Appeal Brief at 19.

We have great respect for the many court decisions addressing issues raised by HTA contracts. The courts, however, generally agree that distinguishing forward contracts from futures contracts involves a facts and circumstances analysis focused on intent in which "no bright-line definition or list of characterizing elements is determinative." *See, e.g.*, *Co Petro*, 680 F.2d at 581. Moreover, while both the courts and the Commission sometimes broadly refer to "standard" HTA contracts, our experience indicates that standardization in this area is often more apparent than real. For example, the record in this case shows that, over the years, Great Plains continuously used a type of HTA form contract, but made a variety of changes in the form. The changes might be immaterial for many producers, but highly material to others. Moreover, Great Plains was not always consistent in its use of written contracts. For example, there was evidence presented that Great Plains's HTA transactions were sometimes resolved prior to a producer-client's actual receipt of a written contract.

Given these circumstances, claims that an "HTA" described and analyzed in one case is the same as an "HTA" at issue in another case cannot be accepted at face value. Indeed, if a generalized analysis were sufficient to resolve HTA-related issues, there would be no need for the multiplicity of cases addressing the topic. In any case, having reviewed the pertinent caselaw, we are satisfied that the approach underlying our analysis in this proceeding is fully consistent with that favored by most courts seeking to distinguish forward contracts from futures contracts.[38]

In this regard, we note that our analysis here differs from the streamlined approach that the Ninth Circuit endorsed in *Bybee v. A-Mark Precious Metals, Inc.*, 945 F.2d 309, 313-14 (9th Cir. 1991). In that case, the court found that A-Mark entered into transactions with Bybee that had characteristics of an off-exchange futures contract. Nevertheless, the court held that the transactions involved forward contracts excluded from the Commission's jurisdiction. The court recognized that this outcome was contrary to *Co-Petro*, where its analysis focused on both evidence of the parties' "subjective intent [regarding delivery] as well as an objective showing of the delivery obligation." 945 F.2d at 313. Nevertheless, it held that it was appropriate to defer to the views the Commission expressed in its Statutory Interpretation Concerning Forward Transactions, 55 Fed. Reg. 39188 (September 25, 1990) ("Brent Interpretation"). Because the court interpreted the Commission as enunciating a special rule for commercial parties -- that the

[38] Great Plains's argument that the Commission is bound by the results of litigation between Great Plains and various private parties under principles of issue preclusion is plainly wrong. There is no identity of interest between the parties in question and the Commission. The private parties' interest was in avoiding unprofitable contract obligations while the Commission's interest is in enforcing Congressional mandates with respect to the ordering of futures trading. *See U.S. v. Mendoza*, 464 U.S. 154, 159 (1984) (U.S. government has different interests from private litigant even when litigation involves interpretation of same statute); *Moldovan v. Great Atlantic & Pacific Tea Co., Inc.*, 790 F.2d 894, 899 (3d Cir. 1986) (as a matter of due process, identity of issues cannot justify issue preclusion without identity of interests); *cf. Grain Land Coop v. Kar Kim Farms, Inc.*, 199 F.3d 983, 993 (8th Cir. 1999) (distinguishing private HTA case from CFTC enforcement case).

NLRB v. Donna-Lee Sportswear Co., 836 F.2d 31 (1st Cir. 1987), on which Great Plains relies, is distinguishable. In that case the NLRB had adjudicated the contractual rights of private parties – an employer and a union – and ruled in favor of the union. Having done so, the NLRB's interests with respect to the contract were essentially aligned with those of the union. By contrast, in this proceeding the Commission is not directly addressing any party's private rights. Any potential effect on private rights would be incidental to the Commission's interest in vindicating statutory requirements focus of the analysis should be solely on the existence of a "legal obligation to make or take delivery upon the demand of the other" – and the contracts at issue created such an obligation, the court held that they must be viewed as "forward contracts outside the Commission's jurisdiction.." *Id.* at 314.

The Brent Interpretation specifically addressed transactions in oil from the so-called Brent System of oil fields,[39] but also stated that it was intended to address commercial contracts with similar characteristics. The Interpretation did not specifically address the nature of the contracts it deemed similar, but it did emphasize how much commercial practice had changed since Congress amended the Act in 1974 "to encompass a broad spectrum of items which may be the subject of futures contracts in addition to the enumerated agricultural commodities." *Brent Interpretation* at 39,191. The Commission also noted that in these evolved commercial segments, transactions:

> [S]erve the same commercial functions as did those forward contracts which were the subject of the section 2(a)(1) exclusion notwithstanding the fact that, in specific cases and as separately agreed to between the parties, the transactions may ultimately result in performance through the payment of cash as an alternative to actual physical transfer or delivery of the commodity.

Id.

[39] Brent contracts were traded by a variety of businesses, all of which were commercial participants in the crude oil market or entities that bought and sold petroleum products in connection with a line of business. All participants had the capacity to make or take delivery of Brent oil. Contracts between participants in the Brent Market incorporated standard terms and conditions but were "individually negotiated" between counterparties. *Id.* The contracts did not confer a right to discharge delivery obligations by offset or cash settlement. Parties entered into the contracts "with the recognition that they may be required to make or take delivery." *Id.* Delivery of Brent contracts involved a chain of notices between purchasers and sellers. Each purchaser was obligated to pay the full negotiated purchase price, and each seller was responsible to its purchaser for delivery of oil.

The Interpretation indicated that many transactions were resolved by the cash "payment-of-differences" based on a "separate individually-negotiated cancellation agreement referred to as a 'book-out.'" *Id.* at 39,190. It indicated that these agreements were common when two counterparties had multiple offsetting positions with each other, when participants found themselves selling and purchasing oil more than once in a particular delivery chain, and when three or more participants identified a circle or loop transaction among themselves. *Id.*

In our view, both the sharp contrast the Brent Interpretation drew between the agricultural commodities that the Act addressed in 1936 and the other commodities addressed in and after 1974, and its emphasis on the need to address evolved practices in the latter markets, suggests that the Commission did not intend to include agricultural producers when it referred to "commercial counterparties." Consequently, even if we assume, for purposes of decision, that the *Bybee* court correctly ruled that the Brent Interpretation endorsed a streamlined approach to analyzing the forward exclusion in the context of transactions between commercial counterparties, there is no basis for applying that approach in the context of this case.[40]

V.

We agree with the Division that a civil money penalty would be appropriate to deter future violations by Great Plains and Gerdes. Prior to imposing a civil penalty, however, a remand would be necessary to permit the Division to develop the record on net worth and ability to remain in business. *See In re Nikkhah*, [2000-2002 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 28,275 (CFTC Sept. 26, 2000). In the circumstances of this case, we will forego the imposition of a civil money penalty in the interest of quicker implementation of the other

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[40] In regulating futures and option transactions, Congress has consistently drawn distinctions based on differences between the agricultural sector and other commodity sectors regulated by the Commission. For example, at the time the Commission issued the Brent Interpretation, such distinctions were evident in such sections of the Act as Section 4c(d) (authorizing trading in dealer options on physical commodities other than the agricultural commodities listed in the pre-1974 version of Section 2(a) of Act); Section 4m(1) (providing a registration exclusion for commodity trading advisors who are cash-market dealers, brokers or processors in agriculture commodities and provide advice solely incidental to that business); and Section 6a (requiring boards of trade to accept cooperative associations as members).

Congress recognized the continuing importance of such distinctions in the Commodity Futures Modernization Act of 2000. *See, e.g.*, Sections 1a(13) and (14) (dividing commodities into three classes – "excluded," "exempt," and "agricultural"); and Sections 2(d), 2(f), 2(g) and 2(h) (providing various exclusions or exemptions from the Act for certain transactions in excluded or exempt commodities, but not for transactions in agricultural commodities).

In this regard, we note that our decision not to apply the Brent Interpretation to the facts of this case does not represent a reluctance to extend regulatory relief to the agricultural sector where appropriate, but rather a determination to proceed with due deliberation based on legislative intent and current Commission policy.

sanctions we impose. *In re Volume Investors Corp., Inc.*, [1990-1992 Transfer Binder] (CCH) ¶ 25,234 at 38,679 (CFTC Feb. 10, 1992).

CONCLUSION

Based on our independent review of the record, we conclude that Great Plains and Gerdes violated Sections 4(a) of the Act by engaging in off-exchange futures transactions with grain producers. As sanctions, we impose a cease and desist order on Great Plains, and both a cease and desist order and a ten-year trading prohibition on respondent Gerdes. These sanctions shall become effective on the thirtieth day following the date that this order is served.[41]

IT IS SO ORDERED.

By the Commission (Chairman NEWSOME and Commissioners HOLUM, and LUKKEN)
(Commissioner BROWN-HRUSKA, dissenting).

Jean A Webb

Jean A. Webb
Secretary to the Commission
Commodity Futures Trading Commission

Dated: November 25, 2003

[41] A motion to stay the effect of this decision pending reconsideration by the Commission or a notice of appeal seeking review by the relevant United States Court of Appeals must be filed within 15 days of the date this order is served.

Dissenting Opinion of Commissioner Sharon Brown-Hruska

Under either the Brent Interpretation or the standard enunciated by the Seventh Circuit in the *Nagel* decision, the Cross Country Hedge-to-Arrive contracts marketed by Great Plains clearly would have passed muster as valid cash forwards exempt from our jurisdiction. Yet under the facts and circumstances approach adhered to by the Commission, those very same contracts are deemed to be illegal off-exchange futures transactions subject to our jurisdiction. Apart from the incongruity of results arising from application of this standard, continued adherence to this approach discourages those contemplating innovation in the agricultural markets from doing so, and is contrary to our efforts to provide clarity and legal certainty in both our statute and in our regulation.

The adverse decision in this case is ultimately determined by a standard that fails to give controlling significance to contract terms and relies upon *ex post* observation to deduce what the parties intended. In holding that the challenged transactions constitute illegal futures contracts, the analysis seeks to surmise whether the parties contemplated delivery by relying on whether they delivered to one of the Great Plains' elevators. Even though a key innovation of the contracts offered by Great Plains enabled delivery to a third party elevator at the option of the farmer, the *ex post* analysis employed in the decision insists that there must be documentation to prove the connection of third party deliveries to the Great Plains' contracts. This narrow interpretation of what constitutes delivery, combined with the respondents' failure to maintain adequate documentation, leads the majority to dismiss the deliveries as merely coincidental, and to declare the contracts illegal off-exchange futures contracts.

The problem with an approach that relies upon an inflexible interpretation of whether the parties contemplated delivery, as I explained in my concurring opinion in the *Grain Land* matter, is two-fold. First, it views as the defining characteristic a feature that is common to both forwards and futures.[1] More specifically, this approach ignores the

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[1] *See Nagel v. ADM Investor Services, Inc.*, 65 F. Supp. 2d 740, 751 (N.D. Ill. 1999) where Judge Easterbrook critiqued basing the outcome upon delivery:

> Treating "delivery" (actual or intended) as the defining characteristic of a forward contract under § 1a(11) is implausible. Recall the definition of a futures contract: a "contract for future *delivery*." Every commodity futures contract traded on the Chicago Board of Trade calls for delivery of the commodity. Every trader has the right to hold the contract through expiration and to deliver or receive the cash commodity. Using "delivery" to differentiate between forward and futures contracts yields indeterminacy, because it treats as the dividing line something the two forms of contract have in common--not only in the statutory text but also in the commercial world. According to the Chicago Board of Trade, during 1998 some 131.1 million bushels of corn were delivered under corn futures contracts. That is about 1.6% of the total U.S. corn crop for the year, quite a respectable figure, which puts the lie to the commonly expressed belief that futures contracts rarely lead to delivery.

overriding logic of both *Brent* and *Nagel* that it is "the contract's economic function in the delivery process, not the regularity of actual delivery itself," that is the key to determining the contract's nature.[2] Second, it attempts to assess by *ex post* means something that should be determined *ex ante*--whether the parties anticipated delivery at the time they entered into their HTA transactions.

Anticipated Delivery

In analyzing the HTA contracts here, the majority uses evidence of anticipated delivery as a proxy for whether the parties entered into forward transactions. In my view, this approach is unsuited for determining the objective nature of the contracts in the first place. To determine what the counterparties *contemplated* at the inception of the contract, the majority relies exclusively on evidence of what the parties did after they entered into their agreement—holding that that the "Division's case rises or falls on evidence concerning the parties' conduct."

Looking at what the parties *did ex post* does not necessarily reveal what they *intended to do ex ante*. Moreover, in practice the analysis amounts to little more than counting the number of actual deliveries that took place. If certain deliveries can be eliminated from consideration, as in the present case, where deliveries were made to third party elevator in fulfillment of the delivery obligation of the Great Plains HTA, then the exercise in gleaning intent becomes even more superficial.

While such an *ex post* perspective may be appropriate for determining whether one or more of the parties failed to live up to their agreement, it is not well suited for determining what they agreed to in the first place. To do that one must look at the parties' "*objective* intent, as revealed by what they wrote."[3] An *ex post* perspective is equally unsuitable for determining the original legal *nature* of their contractual relationship, for as Judge Easterbrook explains: "Nothing is worse than an approach that asks what the parties [subjectively] 'intended' or that scrutinizes the percentage of contracts that led to delivery *ex post*."[4] It also undermines the very premise behind a rational enforcement policy, as Judge Richard Posner explains, since "if the legality of a contract cannot easily be

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[2] *In re Cargill,* [2000-2002 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 28,425 at 51,229 (ALJ Nov. 22, 2000).

[3] *Ocean Atlantic Development Corp. v. Aurora Christian Schools, Inc.*, 332 F.3d 983, 996 (7th Cir. 2003) (emphasis added) (whether there is a binding contract "turns not on what the parties subjectively believed, but on what they expressly manifested in their writing."). *Accord, Johnson v. Land O'Lakes, Inc.,* 18 F. Supp.2d 985, 999 (N.D. Iowa 1998) ("Whether the [HTA] *agreements* anticipate actual delivery is a question of an objective delivery obligation").

[4] *Nagel*, 65 F. Supp. 2d at 752. *See also, Haren v. Conrad Coop.,* 198 F.3d 683, 684 (8th Cir. 1999) (farmer's subjective intent alone does not transform HTA contracts into illegal futures contracts).

determined in advance, that might be a factor rebutting the presumption . . . that illegal contracts are unenforceable."[5]

Conflict With *Brent* And *Nagel*

Of more fundamental significance is the fact that our approach threatens the commercial viability of "modern, more sophisticated forward contracts"[6] that may be settled by cash payment in addition to delivery.[7] Indeed, it was concerns that such privately negotiated commercial transactions—including swaps, hybrids, and Brent North Sea crude oil contracts—would be viewed by the Commission as subject to the CEA's exchange-trading requirement that drove us to issue a number of statutory interpretations and policy statements during the 1980s and 1990s to clarify their legal status, and that drove Congress three years ago to enact legislation to provide legal certainty for such transactions.[8]

In these interpretations, the Commission rejected the notion that delivery must be intended and occur most of the time with every forward contract. Instead, the Commission held that such transactions constitute forward contracts notwithstanding the fact they do not *contemplate* delivery "in all or most instances."[9] In backing away from its traditional emphasis on delivery, the Commission explained:

> While the infrequency of delivery of the commodity in such transactions would tend to preclude their characterization as forward contracts within the Act's jurisdictional exclusion, such transactions nonetheless appear to be

5 *Nagel v. ADM Investor Services, Inc.*, 217 F.3d 436, 441 (7th Cir. 2000) ("*Nagel II*").

6 *Bybee v. A-Mark PreciousMetals, Inc.*, 945 F.2d 309, 314 (9th Cir. 1991).

7 *See Regulation of Hybrid and Related Instruments,* [1987-1990 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶23,995 at 34,492 (CFTC Dec. 11, 1987) (refraining from exercising regulatory jurisdiction over swap transactions "which contemplate cash settlement rather than delivery of the physical commodity"). *See also,* Statutory Interpretation Concerning Forward Transactions ("Brent Interpretation"), [1990-1992 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶24,925 at 37,368 (CFTC Sept. 25, 1990) (holding that 15-day Brent oil contracts were forward contracts notwithstanding the fact that such transactions "may ultimately result in performance through the payment of cash as an alternative to actual physical transfer or delivery of the commodity").

8 *See Policy Statement Concerning Swap Transactions*, 54 Fed. Reg. 30,694 (1989) ("This statement reflects the Commission's view that at this time most swap transactions . . . are not appropriately regulated (as futures contracts) under the Act and regulations."); *Regulation of Hybrid and Related Instruments,* ¶23,995 at 34,492; *Brent Interpretation*, ¶24,925; Commodity Futures Modernization Act of 2000, Pub. L. No. 106-554, 114 Stat. 2763 (2000). *See also,* Louis Vitale, *Interest Rate Swaps Under the Commodity Exchange Act,* 51 Case W. Res. L. Rev. 539, 542 (2001) ("The Commission's sporadic, *ad hoc* interventions (proposed and actual) into OTC derivative markets drove the practical concerns that motivated the enactment of the Modernization Act.").

9 *Regulation of Hybrid and Related Instruments,* ¶23,995 at 34,491.

> essentially private, commercial transactions that generally involve the exchange of interests in an actual physical commodity. As such . . . such transactions may be suitable for a Commission no-action position to the extent that they occur other than on a designated contract market.[10]

Had the Commission adhered to its traditional emphasis on delivery in these matters, it would have placed in jeopardy the use of many innovative risk-management tools that have become commonplace in today's modern financial marketplace, and it would have killed the Brent market for good measure. Indeed, as one commentator noted, had we applied our traditional model to these transactions, "the Act's jurisdictional fog, like an angel of death, would have enveloped the OTC derivative markets, suffocating all who would make use of them."[11]

But while the Commission relaxed its stance with respect to delivery in those instances, it steadfastly refuses to do so when the principals include farmers. Rejecting the overriding logic of the *Brent,* hybrids, and swaps interpretations, the majority insists that it cannot apply a *Brent*-like objective approach here *because* the counterparties to the Great Plains contracts include agricultural producers. Although such a paternalistic concern for the welfare of individual farmers has a long tradition in our body of law, and while agricultural producers may require a fuller panoply of regulatory protections than do other commercial users,[12] neither consideration, in my view, alters the essence of these contracts.[13] For the same contract that constitutes a forward when utilized by a commercial party does not magically transform into a futures contract when the counter party is a farmer.[14]

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[10] *Id.* at 34,492.

[11] Vitale, 51 Case W. Res. L. Rev. at 590. *See also,* Section 408 of the CFMA (declaring that no hybrid instrument or covered swap agreement "shall be void, voidable, or unenforceable . . . based solely on the failure of the [swap or hybrid] to comply with the terms or conditions of an exemption or exclusion from any provision of the" CEA or CFTC regulation).

[12] *See Regulation of Hybrid and Related Instruments,* ¶23,995 at 34,494 (observing that commercial users "may not always require the full panoply of regulatory protections that apply to futures contracts and many warrant prospective no-action treatment").

[13] *See* Declaration of Richard E. Nathan, *In re Competitive Strategies, Ltd.,* CFTC Docket No. 98-4, (Aug. 4, 1998) at 17 ("But the Commodity Exchange Act reflects a single, consistent notion of a 'future.' Accordingly, only contracts that meet the economic-purpose test and are otherwise capable of contract-market designation are subject to the off-exchange prohibition contained in Section 4(a).").

[14] Moreover, the commercial arrangement involved in Brent was neither unique to that market nor inconsistent with the contractual arrangement found here. Both *Brent* and the Cross Country HTA contracts involve "transactions entered into for commercial purposes related to the business of a producer, processor, fabricator, refiner or merchandiser, who may wish to purchase or sell a commodity for deferred shipment or delivery in connection with the conduct of its business." *Brent Interpretation,* ¶ 24,925 at 37,368. Both share the commercial objective of acquiring a raw material by means of a merchandising transaction--in the case of Brent, crude oil, and in the case of

Aside from this conceptual problem, the majority's emphasis on anticipated delivery for HTA transactions does not square with the position of the Seventh Circuit in the *Nagel* HTA case, which instead stressed the importance of a contract's fungibility—or lack thereof—and relegated consideration of delivery to whether or not it would eventually occur.[15] Specifically, if this standard were applied in this matter, I would suggest that a different outcome is likely, since the transactions at issue here called for delivery of a fixed quantity of grain based upon terms that were individually negotiated between Great Plains and CSA's producer-clients; the contracts were not fungible and could not be settled by exchange-style offset; the parties were members of the grain industry, who had made or taken delivery in the past; and nothing in those contracts suggested that delivery could be deferred forever.[16]

Although the majority's approach is consistent with the general approach used by most other courts (with the exception of the Seventh Circuit, and the Ninth Circuit in *Bybee*), it nevertheless cannot provide a plausible explanation for why courts have consistently found HTA contracts to be valid cash forward contracts.[17] Or why proceedings in the courts and in this agency have reached precisely opposite conclusions even when they involve the same parties and the same type of contracts.[18] As a result, it

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Competitive Strategies, grain. *Id.* Finally, both involve contracts wherein the commodity in question has an "inherent value" to the transacting parties. *See Oeltjenbrun v. CSA Investors, Inc.,* 3 F. Supp.2d 1024, 1036 (N.D. Iowa 1998) ("the grain has an 'inherent value' to the farmer who produced it as the source of his income and to the buyer, such as an elevator, because the elevator is in contact with potential buyers, such as the flour miller, and the elevator has the facilities to store, condition, and load out the grain and earn additional income from these services.").

[15] *Nagel II*, 217 F.3d at 441 ("[d]elivery cannot be deferred forever"). *See also, Haren.,* 198 F.3d at 684 ("while an obligation to delivery is not necessary to place a contracts within the cash-forward exception, it is sufficient."); *Farmers Cooperative Co., v. Lambert,* 2000 WL 1421364 (Ct. App. Iowa, 2000) (unpublished opinion) (holding that lack of subjective intent to deliver does not transform HTA contracts into illegal futures contracts).

[16] *See, e.g.,* Hearing Transcript VIII ("Tr.") at 197-98, 292 (Mar. 29-31, 1999); Respondents' Prehearing Memorandum at 8.

[17] *Nagel*, 65 F. Supp. 2d at 744 (noting that farmers' arguments that HTA contracts are illegal futures have been "uniformly unsuccessful in court" and that as of 1999 "[n]o federal court has decided any of these suits [alleging that HTA's are illegal futures] in favor of any farmer."). *See* Christina A. Barone, *The Hedge-To-Arrive Controversy: Conflicting Outcomes in Administrative and Judicial Proceedings,* 52 Admin. L. Rev. 1423, 1426 (2000) (noting that CFTC and federal courts analyzing HTA contracts according to traditional case law multi-factor approach reach "opposing outcomes"); Vitale, 51 Case W. Res. L. Rev. at 562 (noting that federal courts have "uniformly rejected" illegality argument regarding HTAs). Although the interests of the parties in these private lawsuits is not identical to that of the Commission in enforcing our Act, as the majority notes, the ultimate legal issue in both type of proceedings is the same--whether the challenged HTA contracts are enforceable cash forward contracts under the CEA.

[18] *Compare In re Grain Land Coop.,* [1998-1999 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 27,459 (ALJ Nov. 6, 1998) (holding that Grain Land sold illegal off-exchange futures contracts)

appears that "two distinct bodies of case law [have] emerged"--one for the courts and one for the CFTC--creating legal uncertainty for the agricultural industry as to whose logic will prevail.[19] And with the outcome set forth here, we again find ourselves in the position of being at direct odds with that of the judiciary on this important issue.[20]

The Cross Country HTA Contracts

Even if I were inclined to agree with the traditional approach employed by the Commission, I would not endorse the conclusion that the counterparties did not anticipate delivery in this case. Although delivery to either Great Plains or a local elevator was clearly a feature of the contract between the parties--whether written or orally agreed to--the majority maintains that delivery was illusory because there was "no meaningful connection" between delivery to a local elevator and Great Plains. The absence of

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with In re Grain Land Coop., 978 F. Supp. 1267, 1277 (D. Minn. 1997), *aff'd Grain Land Coop v. Kar Kim Farms, Inc.*, 199 F.3d 983 (8th Cir. 1999) (granting summary judgment in favor of Grain Land on ground that HTA contracts it sold were forward contracts); *In re The Andersons, Inc.*, [1998-1999 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 27,526 (CFTC Jan. 12, 1999) (Order accepting settlement offer imposing $200,000 civil money penalty against Andersons for marketing Convertible HTA contracts that CFTC deemed illegal futures) *with Andersons,* 166 F.3d 308 (concluding that Flex/Convertible HTA contracts marketed by Andersons were forward contracts, excluded from CEA coverage); *In re Farmers Cooperative Co.*, CFTC Docket No. 99-6 (Mar. 9, 2000) (settlement order imposing $100,000 penalty against Farmers Cooperative for marketing HTAs between 1993 to 1996 that CFTC deemed to be illegal futures contracts) *with Farmers Cooperative Co., v. Lambert,* 2000 WL 1421364 (Ct. App. Iowa, 2000) (holding that HTAs marketed by Farmers Cooperative from 1994 to 1996 to be legal cash forward contracts). Although the majority dismisses such inconsistent outcomes as a consequence of unspecified differences in the form contracts at issue, such differences are "more apparent than real." For example, in *Haren*, the Eighth Circuit found the HTA contracts marketed by Conrad Cooperative to be substantively identical to those marketed by Grain Land Cooperative even though the Conrad ones did not contain a rolling provision:

> The contracts signed by the farmers *differed slightly* from those signed by Obermeyer [the complainant farmer in *Grain Land Coop v. Obermeyer*], in that the HTA documents themselves did not explicitly contemplate a right to roll the delivery obligation . . . [but] there was nothing about the contracts entered into by [the farmers in *Haren*] that compelled a different conclusion.

Haren, 198 F.3d at 683-84 (emphasis added).

[19] Barone, 52 Admin. L. Rev. at 1436 n.69. Elsewhere Barone observes that federal courts have consistently found HTAs to be cash forward contracts because, unlike the Commission, they give "significant weight to the contract terms." *Id.* at 1427 n.16.

[20] *Compare* our action today *with Sack Bros. v. Great Plains Coop., Inc.*, 616 N.W.2d 796, 808 (Neb. 2000), where the Supreme Court of Nebraska, relying on *Nagel*, concluded that "as a matter of law," Great Plains' HTA contracts, with Competitive Strategies acting as the marketing agent, were cash forward contracts exempt from the CEA.

documentation at the local elevators and the lack of any contractual relationship between the local elevators and Great Plains are relied upon to nullify the relationship of delivery of grain to a local elevator and the HTA contract calling for delivery. On this score, the majority discredits the testimony of Great Plain's manager Herman Gerdes that he did not distinguish between the cross country HTAs and the standard HTAs. Decoupling the deliveries to local elevators from the HTAs enables the conclusion that contracts were cash settled without physical deliveries occurring.

The fact that local elevators had little if any documentation of a relationship with Great Plains specific to these deliveries does not void the connection between the deliveries and performance on the HTA contract. CSA's lack of documentation and poor record keeping in this and other instances shows inadequate business practices that created serious problems for the respondents as they sought to corroborate their understanding of the obligations created by the contracts and the performance expected thereof. While this failure is a concern and would be important if the contracts were breached and parties sought legal recourse, in my view, it does not controvert the obligation nor does it provide a basis for concluding that delivery to third party elevators was inconsequential to these contracts and somehow merely coincidental.

As for the testimony of Gerdes, his view that there was little distinction between the two types of HTAs marketed by Great Plains is bolstered by the fact that, in its basic economic character, there is no difference between the cross country HTAs and the standard HTAs. In fact, Gerdes and Great Plains used the "same contract" for "all accounts" and "all clients" whether or not they specified delivery to Great Plains.[21] From Great Plains' perspective, the cross country HTA with delivery to a local elevator looked just like a standard HTA with delivery to Great Plains. In both cases, farmers entered into the HTA at the current futures price, agreed to deliver (to some elevator), and cash settled on the date that delivery was confirmed at the price prevailing in the futures market. Fees varied according to the services provided by Great Plains, such as whether the grain was scaled, weighed, sampled, graded, transported, stored, etc, (and the implicit profit margin over cost also varied).[22] The contract basis was derived from the difference between the futures price and the cash price quoted at the Great Plains elevator.[23]

As noted by the Division's expert Peter Locke, if delivery was made to a third party elevator, this did not require Great Plains to know anything about delivery--neither the place, price, or even verification that delivery occurred at all.[24] However, the farmers did need to supply the information as to when delivery took place in order to fix the price for settlement and give Great Plains the opportunity to unwind the companion hedge they had

[21] Tr. at 231-33.

[22] *Id.* at 213-215.

[23] *Id.* at 271.

[24] Locke Declaration at 11.

put on in the futures market. By leaving the third party local basis (that would input the third party elevator's cash price) out of the HTA settlement while also allowing for local delivery, the settlement price did not contain a specific component (which would be purely financial) that would account for delivery to a third party elevator. By not building in the local basis, neither CSA nor Great Plains assumed the risk, leaving the farmers to retain the basis risk associated with their choice of local delivery options.[25]

The observation that the CSA HTAs and the standard HTAs were economically the same supports the view of Gerdes that there was no material difference between the two and that delivery was expected in all these contracts *ex ante*.[26] The fact that there was not a contractual provision for rolling, or more importantly, for cancellation and cash settlement, is immaterial since the farmer was expected to deliver to an elevator of his choice and payment was made based on the date confirmed to Great Plains (via CSA) that delivery had in fact taken place.[27] Moreover, these transactions were frequently confirmed orally and relied upon a relationship of trust between the farmers and CSA.[28]

The fact that a number of these transactions were cash settled is also immaterial given our prior assent in the *Brent Interpretation* to settlement in analogous circumstance "through the payment of cash as an alternative to actual physical transfer or delivery of the

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[25] Tr. at 192-93. As a result, the implicit basis that the producer realized reflected his choice regarding delivery. Tr. at 264.

[26] The Great Plains' HTA contracts warranted that producers possessed and would deliver the grain they had committed. Resp. Prehearing Mem. at 8.

[27] Although the contracts contained no provision for rolling delivery, Tr. at 292, rolling, cancellation and cash settlement, or amendment of terms were possible if both parties were in agreement, or if crop or production failure or other instances of "commercial impracticality" intervened. Resp. Prehearing Mem. at 5-7. But neither the absence of an explicit contractual provision for rolling nor the possibility that such contracts could ultimately be satisfied by cash payment have the legal significance that the majority ascribe to them. *See Haren,* 198 F.3d at 683-84 (holding that HTA contracts that did not explicitly contemplate a right to roll delivery obligation did not compel a different result from that reached in *Grain Land* cases where such a right was included); *Nagel,* 65 F. Supp2d. at 748 ("Every contract . . . can be canceled by agreement, which may be contingent on a side payment"); *Land O'Lakes,* 18 F. Supp.2d at 995-96 (opportunity to roll or buy out HTA contracts "fails to generate a genuine issue of material fact as to intent to deliver"). As Judge Easterbrook points out,

> [A]ll a contract does is oblige the parties to perform or pay. The point here is that the HTA contract specifies delivery and cannot be unwound, as a standard futures position may be unwound, by buying an identical and offsetting contract in the market.

Nagel, 65 F. Supp.2d at 748.

[28] Gerdes estimated that 90 percent of the grain that Great Plains procured was purchased by oral contract. Tr. at 186. *See Nagel II,* 217 F.3d at 441-42 (recognizing that oral terms may govern HTA contract).

commodity."[29] As we observed in our hybrids notice release, commodity transactions between commercial counterparties in today's markets "are frequently satisfied by the cancellation of contractual obligations based upon the payment of intervening market price changes."[30] As long as the parties entering into these contracts have the capacity to bear the economic risks associated with owning the commodity, how they discharge their obligations is immaterial as long as they do not do it "through exchange-style offset."[31]

Conclusion

In my view, the cross country HTAs developed by Great Plains were innovative in their terms that allowed farmers to lock in a forward price while also enabling delivery by a farmer to a third party elevator at his option. Given the majority decision, however, if an elevator contemplated such a contract in the future, it is likely that it would have to contract with any and all third party elevators that a farmer may select to ensure the connection was deemed "meaningful" under the Commission's standard. In addition to creating burdens and imposing costs on those who might contemplate such an innovation, the legal uncertainty created by the approach used in this case is more likely to discourage these innovations from ever being attempted again.

In our *Brent,* swaps, and hybrids interpretations, we recognized that the "changing face of forward contract transactions" called for a more objective approach in analyzing these transactions based upon the written terms of such contracts.[33] Moreover, in those interpretations, we came to the realization that our statutory exclusion for forward contracts was not reserved for "only the simplest forms of merchandising arrangements."[34] We should also never lose sight of the fact that "the development of inventive ways to meet customer needs is a hallmark of successful merchandising activities, with which the

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[29] *Brent Interpretation*, ¶24,925 at 37,368.

[30] *Regulation of Hybrid and Related Instruments*, ¶23,995 at 34,492 (CFTC Dec. 11, 1987). Indeed, the hybrids' release grants no-action relief for transactions for deferred delivery "which contemplate cash settlement rather than delivery of a physical commodity." *Id.* at 34,494.

[31] *Brent Interpretation*, ¶24,925 at 37,368.

[32] *Nagel*, 65 F. Supp. 2d at 750 (referring in particular to the CFTC's administrative case against Competitive Strategies).

[33] *Bybee,* 945 F.2d at 314 (noting that in *Brent*, the CFTC "recognized that the commercial landscape had changed, and that modern, more sophisticated forward contracts" had entered into commerce).

[34] Nathan Declaration, at 20-21 ("while all merchandising transactions are excluded from the Act under the forward-contract exclusion, it does not follow that only the simplest forms of merchandising arrangements are excluded from regulations under its terms.").

Commission should never have occasion to interfere."[35] Unfortunately, by our ruling today, we needlessly interfere with and prohibit an innovative financial tool, in part because it was used by the farming community. Therefore, I respectfully dissent from the majority's opinion.

[signature] 11/19/03

Commissioner Sharon Brown-Hruska   Date

[35] Nathan Declaration, at 25. *See also* Tr. at 383 (intent of Grain Futures Act was to ensure that regulatory agency did not intrude into the commercial merchandising activities of producers or cooperatives).