UNITED STATES OF AMERICA
Before the
COMMODITY FUTURES TRADING COMMISSION

In the Matter of	CFTC Docket No. 97-01
GRAIN LAND COOPERATIVE	OPINION AND ORDER

Respondent Grain Land Cooperative ("Grain Land") appeals from an Administrative Law Judge's ("ALJ") decision ordering it to cease and desist from violating Section 4(a) of the Commodity Exchange Act ("Act") by engaging in off-exchange futures transactions.[1] It principally argues that the ALJ's conclusion that the transactions at issue involved futures contracts is flawed due to both factual and legal errors. The Division of Enforcement ("Division") defends the result of the ALJ's liability analysis and emphasizes that the record shows that the parties to the challenged transactions intended to speculate on future price changes and retained the right to avoid delivery of the underlying commodity.[2]

As explained more fully below, we conclude that the record does not reliably establish that the transactions at issue involved futures contracts rather than forward contracts excluded from our jurisdiction. Accordingly, we vacate the ALJ's decision and dismiss the Complaint.

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[1] During the period at issue, Section 4(a) prohibited transactions in or in connection with "a contract for the sale of a commodity for future delivery" unless the transactions were conducted on, or subject to the rules of, a designated contract market. The Commodity Futures Modernization Act of 2000 amended Section 4(a) in certain respects, but the changes do not materially affect the analysis of the issues raised in this case.

[2] The Division has also appealed, but, in the circumstances presented, we need not consider the issues it raises.

BACKGROUND

I.

The Commission commenced this proceeding by issuing a Complaint on November 13, 1996. The Complaint alleged that, between 1993 and 1996, Grain Land entered into transactions involving what were commonly referred to as "flex hedge-to-arrive contracts" ("FHTAs"). The Complaint alleged that these FHTA transactions involved futures contracts that could be offered legally only through a registered board of trade.

In January 1997, Grain Land filed an answer denying the material allegations of the Complaint. In essence, Grain Land claimed that the transactions involved sales of a cash commodity for deferred shipment or delivery, commonly referred to as forward contracts, which are excluded from the Commission's jurisdiction.

II.

Many of the facts material to characterizing the challenged transactions are undisputed. Grain Land was a cooperative whose members were local producers. It was formed in April 1993 and ceased doing active business in September 1996. Grain Land's core business was purchasing grain from its members for resale to members and non-members. It also sold agricultural inputs, such as feed, to its members.

The producers who contracted with Grain Land were members of the coop. All of the contracting producers had the capacity to deliver the commodity underlying the FHTAs they entered into with Grain Land. Many producers did fulfill the legal obligations arising out of their FHTA transactions by delivering commodities to Grain Land. Some of the producers who entered FHTA transactions with Grain Land, however, had alternative plans for their crops at the time they contracted with the coop. For example, some producers normally used the crops they grew to feed their livestock. Others generally sold the crops they grew to other elevators that were closer or offered better terms. Still others contracted to deliver an amount of grain that exceeded their expected production in the period between the formation of the contract and the specified delivery month.

The transactions challenged in the Complaint involved either corn or soybeans. All the challenged transactions were documented in written contracts of some sort. In general, the contracts were prepared in advance and included preprinted material along with blank spaces that could be filled in as needed in actual transactions. Some of the contracts were designated "Flex Hedge-to-Arrive Contract" at the top, while others were designated "Hedge-to-Arrive Contract."

All of the contract forms included blanks where an amount of grain to be delivered and the delivery month and price of a futures contract could be specified. These terms were generally specified by the producer in an offer to enter into the contract and were inserted in blanks in the contract forms. The amount of grain had to be a multiple of the size of a corresponding futures contract offered on the Chicago Board of Trade ("CBOT"), which Grain Land entered into to hedge the risk it incurred by entering into the FHTA.[3] The price in the contract was the price of the CBOT futures position and

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[3] Some of the contracts included language suggesting that the parallel futures hedge transaction was undertaken for the producer. For example, some contracts stated that the "BUYER [*i.e.*, Grain Land] confirms the following futures transaction was made for seller today on the Chicago Board of Trade:" followed by contract terms specifying, among other things, quantity, price, and futures contract month. Other contracts included language indicating that "[t]he following futures pricing on the Chicago Board of Trade is being made at the Seller's request as of the date shown above," followed by a listing of a futures contract month, price, and quantity.

the delivery month of the futures position matched the delivery month that the producer specified for the FHTA transaction.

Some of the contract forms included express language imposing a delivery obligation on the producer. For example, one form stated that "[t]he producer agrees to sell and deliver the above grain . . . to the Grain Land Coop, not later than __." Other forms lacked this clear language, but included blank spaces for the "arrival period" and "destination" of the grain subject to the contract.[4] All of the forms included blank spaces for the "cash price" and "cash basis" of the grain covered by the contracts. Under the terms of the contracts, these spaces were left blank until the producer "set the basis," as described below.

As noted earlier, the cash price Grain Land paid at the time of delivery was based on the reference futures contract price specified in the FHTA contract. The formula used to calculate the payment due to the producer involved the subtraction of Grain Land's posted basis for the time and place of delivery from the designated futures price. The parties to the transaction chose the relevant futures contract at the time the FHTA contract was entered, but the basis was left open at this point. All of the contracts gave the producer some leeway in setting the basis. This gave the producer an opportunity to increase the final cash price by setting the basis at a time when the posted basis for the delivery period appeared to be favorable.

In general, the contracts permitted the producer to set the basis (and thus determine both the delivery date and final cash price) at any time before the futures delivery month specified in the contract. The producer set the basis by giving notice to

[4] Many of the completed forms in the record include the word "open" in the blank space for arrival period. The blank space for destination sometimes reflects the word "open" and other times reflects a specific location for one of Grain Land's nine elevators.

Grain Land. Some contracts shifted the right to set the basis to Grain Land if the producer failed to set the basis by the 25th day preceding the delivery month of the reference futures contract specified in the FHTA.[5] Other contracts shifted the right to set basis if the producer failed to set the basis "prior to delivery or before __." Still a third group of contracts provided that the deadline for making delivery would be automatically adjusted if the producer failed to set the basis in a timely manner.[6]

Two "flex" features distinguished Grain Land's FHTA contracts from generic HTA contracts. The "rolling" option involved a mechanism to delay delivery and adjust the formula for determining the cash price payable at delivery. The "cancellation" option involved a mechanism for substituting a cash payment for the producer's obligation to deliver the underlying commodity.

The rolling mechanism is not comprehensively addressed in any of the contracts. There is general agreement between the parties, however, about how the mechanism worked.[7] For example, it is undisputed that producers were charged a fee of two cents per bushel if they elected to roll their delivery obligation. It is also undisputed that, absent an invocation of the cancellation option, the producer did not exchange payments with Grain Land until delivery of the underlying commodity was actually made.[8]

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[5] These contracts provided that the shift in the right to set basis could be averted by an agreement to other terms by the parties to the transaction.

[6] This involved a "rolling" of the delivery date. This "flex" feature of the FHTA transactions is discussed below.

[7] The parties dispute whether Grain Land's FHTA contracts gave producers an unfettered right to invoke the rolling option. Some of the contracts did not include a rolling provision, but in these cases, the Division claims, Grain Land had a policy of permitting rolling.

[8] According to testimony by Grain Land's expert and other witnesses, rolling involved a switch to a new reference price based on a CBOT futures contract with a new delivery month. When a producer elected to roll, Grain Land would reposition its hedge by liquidating the initial futures position and establishing a new futures position with a delivery month corresponding to the new delivery month for the FHTA transaction. Under the revised price formula for the FHTA transaction, the spread (as of the time of the roll) between

Two groups of contracts expressly granted the producer a right to substitute a cash payment for the commodity delivery promised at the time the FHTA contract was entered.[9] Another group of contracts, however, did not have any language addressing cancellation.[10] It is undisputed that Grain Land paid profits to a few canceling producers by check. One group of contracts, however, included language specifying that delivery of grain was a condition for the producer's "right to collect any . . . gains [from cancellation]."[11] Another group of contracts provided that any payment due a producer as a result of cancellation would be "divided by the number of bushels cancelled and added to the cash price of a like number of bushels physically delivered at a future date."

Grain Land employees created documents relating to their solicitation of producers to enter into FHTA transactions. Some of these documents cited the ability to

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the reference price initially specified and the price Grain Land paid for its new futures position would be added to (or subtracted from) the original reference price. If and when the producer set the basis and delivered the grain, the producer would receive a cash price equal to the adjusted reference price, minus the appropriate basis, and minus a two-cent per bushel rolling fee. Klemme Supplemental Expert Declaration at 15-16. Under this formula, any gain or loss resulting from a difference between the price of the existing CBOT position closed by Grain Land in connection with the roll and the price of the new CBOT position established by Grain Land would implicitly be passed through to the producer. Money did not change hands at the time of the roll; realization of any gain or loss associated with the change of futures reference month was delayed until the time of delivery or cancellation.

[9] One group of contracts provided that the producer had "the right to cancel contract at a cost of 5 cents per bushel, plus or minus cancelled price of the futures and the contract price." Another group stated that the producer had "the right to cancel this contract at a cost of 10 cents per bushel plus or minus the difference between the CBOT intrasession price of the selected futures and the Futures Contract Price [specified in the FHTA]."

The payment exchanged when these provisions were invoked was based on the amount of the cancellation fee plus or minus the difference between the FHTA's original reference price (as adjusted for the effect of any rolls) and the price of Grain Land's corresponding hedge position at the time of cancellation. If the FHTA price exceeded the sum of the CBOT price and the cancellation fee, Grain Land would owe a balance to the producer. If the FHTA price were less than the sum of the CBOT price and the cancellation fee, the producer would owe a balance to Grain Land.

[10] Once again, the Division claims that the record shows that Grain Land had a policy of permitting producers who signed these contracts to substitute a cash payment for the delivery promised at the time the FHTA was executed.

[11] Testimony suggests that gains from cancellation would be added to the price paid to the producer for grain delivered in a later transaction, such as a spot sale or a delivery pursuant to another contract.

defer delivery, lock in a price for multiple crop years, and take advantage of changes in futures prices and basis as potential benefits of FHTA transactions.

Grain Land maintained written records relating to the number of bushels of grain covered by outstanding FHTA contracts. These records indicate that, as of December 31, 1993, Grain Land had contracted for 1,952,000 bushels of corn and soybeans under FHTAs. The number of bushels under FHTAs rose to over 4,000,000 in mid-1994, but fell to 2,998,000 by December 31, 1994. Beginning in the spring of 1995, the number of bushels under FHTAs rose sharply, reaching a peak of 21,746,000 as of January 31, 1996. As of April 30, 1996, the last date covered by the Grain Land data, the number of bushels under contract had declined to 19,759,000. Generally speaking, ninety percent or more of the crop under FHTAs was corn.

The record also includes correspondence between producers and Grain Land relating to certain producer cancellations of delivery obligations created at the time FHTA contracts were entered. These letters address the period March through May 1996 and suggest that, during this three-month period, about 50 producers cancelled FHTA contracts covering approximately 850,000 bushels of grain.[12]

III.

At the hearing conducted by the ALJ, the Division presented three types of witnesses in support of the Complaint's allegations. It offered the testimony of two former Grain Land employees, Joseph Burke ("Burke") and Joseph Daly ("Daly"), to establish facts relating to Grain Land and its FHTA program. It offered the testimony of seven producers who participated in FHTA transactions to establish facts about their

[12] As discussed below, these cancellations took place during a period of market inversion when the cash value of grain generally exceeded the price payable on an FHTA contract.

solicitations, their understanding of Grain Land's FHTA program, and their intent to deliver the commodity underlying the FHTA transactions they entered. Finally, the Division offered the testimony of an economist-expert who evaluated the significance of some of the characteristics of Grain Land's FHTA transactions.

Joseph Daly served as corn merchandiser for Grain Land from 1993 until May of 1995. Tr. I at 135. He testified that Grain Land established its hedge-to-arrive program as a competitive response to another grain dealer and at the request of several producers. Tr. I at 137. The Grain Land FHTA contract was developed by taking an "ordinary" hedge-to-arrive contract and adding certain flexible privileges based roughly on those offered by the competing grain dealer. *Id.* According to Daly, the primary advantages of FHTA contracts to producers were:

> one, they had the right to establish a basis at a later date, which was an advantage to the producer if he didn't like the basis, but he liked the futures price. Two, if the market had gone from a higher value than he had established his hedge-to-arrive value he had the right to lift that futures position and be able to open in the market for his delivery of that grain. Three, if the value had gone higher and he elected to take and deliver it for cash on the higher value and roll that particular contract forward he could.

Tr. I at 141-42.

Daly testified that Grain Land permitted producers to roll their FHTAs from one crop year to another. Tr. I at 146. He also testified that Grain Land gave each producer a "right to cancel his futures portion of the contract" for a five-cent fee. Tr. I at 147.

> Lets say . . . that he [the producer] got into a short futures position started at $3 and it dropped back down to $2.50, and he recognized there was a 50 cent gain in that futures position. At that point in time he had the right to lift that futures position for a nickel which meant there was 45 cents remaining that was credited to his account upon delivery of that grain.

Id.

According to Daly, producers who invoked the cancellation option remained under an obligation to deliver grain, but could do so at their convenience.[13] Consequently, delivery could involve crops produced in a crop year different than the crop year of the FHTA transaction at issue. Tr. I at 148-49.

Daly was questioned about producers who entered FHTA contracts with Grain Land even though they normally used the grain they grew to feed their own livestock. According to Daly, Grain Land expected delivery under these FHTAs through the use of a mechanism that Daly referred to as "redelivery." Tr. I at 150. Under this mechanism, the producer sold the amount of grain designated in the FHTA contract to Grain Land and, in turn, Grain Land sold a comparable amount of grain to the producer for use as feed for livestock. Tr. I at 151. Due to the circular nature of the transaction, the grain underlying this type of transaction remained with the producer and was never physically moved to Grain Land's elevators. Tr. I at 151-52.

Richard Ernest ("Ernest"), a producer, testified that Grain Land employees explained that, under the FHTA program, a producer who wished to deliver when the specified month arrived could set the basis and proceed with delivery. Tr. I at 25. Otherwise, the producer could elect either to roll to an earlier or later reference month or cancel his delivery obligation for a five-cent fee. *Id.* According to Ernest, he was told that he had the "unfettered ability" to roll the contract.

Ernest testified that he was particularly attracted by the flexibility of the FHTA. Tr. I at 27. "We could change our crop mix. If I didn't want to grow any corn that year, I

[13] He acknowledged, however, that there were two instances in which Grain Land paid cash to producers who cancelled their FHTA contracts. Tr. I at 148-49.

don't have to grow corn. If I wanted to participate in a federal government reserve storage program we could do that and not deliver corn. We could just do a whole number of things." *Id.* Ernest acknowledged that he delivered grain to Grain Land after entering into FHTAs with the coop, but claimed that these deliveries were not pursuant to his FHTAs. Tr. I at 35. Ernest testified that, in March of 1996, a Grain Land representative advised him that Grain Land was going to impose marketing policy changes on its members due to the increased cost of hedges covering outstanding FHTA contracts. Tr. I at 37-38. The representative told Ernest "something to the effect like just because you guys aren't paying the margin calls doesn't mean you're not short futures." Tr. I at 38.

Mark Sahr ("Sahr"), another producer, testified that during 1995 and 1996 he expected to use all the corn he grew to feed livestock. Tr. I at 72. According to Sahr, a Grain Land representative nevertheless told him that an FHTA transaction would give him an opportunity to roll his delivery obligation and then cash it out for a five-cent fee. *Id.* On cross-examination, Sahr acknowledged that, in the event of a decline in the price of corn, it was possible to deliver corn to Grain Land under his FHTA contract and then buy feed grain back at the lower market price. Tr. I at 89. He insisted, however, that this was not his intent when he entered into his FHTA transaction. Tr. I at 89-91.

Dean Caldwell ("Caldwell"), another producer, testified that, as a matter of business practice, he preferred to deliver to a certain grain terminal where he could obtain higher prices than those paid by Grain Land. Tr. I at 94. He claimed that Grain Land encouraged him to enter into an FHTA transaction even after it learned of his preference. Tr. I at 99, 102. Caldwell acknowledged that he delivered about a third of the grain covered by his FHTA contract during a period when Grain Land's price on delivery was unusually high relative to the grain terminal price. Tr. I at 104-05. He noted, however, that he suffered a loss when he used the cancellation option for about a quarter of grain covered by his FHTA contract.[14] According to Caldwell, one of the benefits of FHTA contracts for producers was the opportunity to avoid the interest cost of borrowing money to meet margin calls. Tr. I at 125. He explained that Grain Land was "putting on [futures] positions instead of me having to do it myself and having to worry about margins calls." *Id.*

Bruce Anderson ("Anderson") was another producer who sold grain to Grain Land. Tr. II at 3. Anderson testified that Daly touted Grain Land's FHTAs as giving producers an opportunity to market their entire expected crop without having to worry about weather. If bad weather resulted in a small crop, the producer could either roll the delivery obligation to a later time or cancel part of the contract. Tr. II at 5-6. Anderson also claimed that Daly told him that FHTAs allowed producers to contract for multiple years of sales, and that there was no financial risk to the producer because Grain Land took care of margin requirements and commissions.[15] Tr. II a 6.

Anderson testified that he entered into corn FHTAs with Grain Land in July of 1993 and January of 1994. Tr. II at 8. During this period, Daly advised Anderson that, if the futures reference price in the contract was higher than the equivalent current CBOT futures price, Anderson could obtain a profit by canceling some of his contracts and getting paid the difference in futures prices (minus the five-cent cancellation fee) by Grain Land. *Id.* According to Anderson, he sold his entire 1993 crop on the spot market

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[14] At the time of the hearing, Caldwell apparently had an outstanding delivery obligation for the remainder the grain covered by his FHTA contract.

[15] According to Anderson, Daly told him that producers could place multiple years of crops under FHTAs and cancel if they did not have enough grain to deliver. Tr. II at 7.

with the expectation that he would roll or cancel his FHTAs rather than deliver during those time periods. Tr. II at 9. Later, in 1994, market prices fell and Anderson asked Daly if he could cancel some of his contracts and take the profit resulting from his advantageous short position. Tr. II at 13. Daly, however, "was really dragging his feet on letting us cancel out of any [contracts] at that time." Tr. II at 14. Daly continued to discourage Anderson from canceling and Anderson ultimately set basis and delivered some grain under his FHTAs during 1994 and 1995. Tr. II at 15, 42. In early 1995, Anderson arranged to cancel a limited number of his FHTA contracts at a profit. Tr. II at 16-17. He rolled the delivery date of the remainder of his contracts to later years. Tr. II at 42.

Jason Mortvedt ("Mortvedt") was another producer who entered into FHTAs with Grain Land. Tr. II at 44. Mortvedt testified that he delivered some grain to Grain Land under his FHTAs. Tr. II at 56-57. He cancelled at least one contract at a gain, which Grain Land paid him by check. Tr. II at 50-51. During the period he had FHTAs outstanding, Mortvedt also sold some grain to Grain Land for cash. When he did this, he rolled his FHTAs to a later delivery date. Tr. at 53.

David Rennpferd ("Rennpferd"), another producer, testified that a Grain Land soybean merchandiser described FHTAs as a way to lock in a good price for multiple years; described FHTAs as a "win, win" situation because of the ability to roll; and advised that "if [an FHTA contract] didn't work to [the producer's] advantage – or if it worked to [the producer's] advantage we could cash out of it with a nickel or we could stay in it and roll it ahead or just sell for cash." *Id.* According to Rennpferd, the merchandiser also told the producers that, if they wanted to "buy back" the contract (*i.e.*, exercise the cancellation option), Grain Land would write them a check for any gain on the transaction. Tr. II at 65-66. Rennpferd acknowledged that he set basis and delivered grain on some of his FHTAs with Grain Land. When he cancelled others for a profit, Grain Land advised that it could not pay him by check because it was not a legal broker. Tr. II at 68-69. Consequently, Grain Land paid some of the profit to Rennpferd when he delivered grain to Grain Land. Tr. II at 69-71. Grain Land also used part of Rennpferd's profit to offset a debt he owed the coop for certain services. Tr. II at 71.[16]

Sean Olson ("Olson"), another producer, testified that he asked a Grain Land representative how FHTAs would be relevant to his business since he needed all of his corn production for his own hogs. The representative advised Olson that he could take advantage of FHTAs by using the cancellation option and that if prices moved in an unfavorable direction, he could roll the contract unlimited times until prices were more favorable. Tr. III at 7.

Gregory Kuserk ("Kuserk"), an economist with the Commission's Division of Economic Analysis, appeared as an expert witness for the Division. Kuserk Declaration at 1. Kuserk testified that the key characteristics distinguishing futures and forwards relate to delivery and the purpose of the contract. *Id.* at 4-6.

Kuserk stated that the primary purpose of futures contracts is to shift price risk. In this regard, he emphasized that the opportunity for cash settlement or offset of futures contracts permits the holder of a futures contract to realize the value of the contract without delivery of a physical commodity. *Id.* Kuserk opined that the primary purpose

[16] Rennpferd subsequently entered into additional FHTAs with Grain Land, but sold the covered grain to a local elevator for cash. Tr. II at 73. He testified that he did this because there were "rumors floating around" about Grain Land's ability to pay. *Id.*

of forward contracts is to transfer ownership of a commodity from one party to another. *Id.* at 5. He thus characterized them as "mandatory delivery contracts."[17] *Id.* at 6.

Kuserk testified that there were three methods of avoiding delivery included in Grain Land's FHTA contracts – rolling, cancellation, and redelivery. *Id.* at 6-7. He asserted that these alternatives showed that FHTA transactions involved futures contracts rather than forward contracts. *Id.* at 6-8. As to the rolling option, Kuserk noted that it created an opportunity to speculate on price fluctuations that was typically absent in the context of cash forward contracts, because a "speculative component not related to the production or storage of that grain" was incorporated in the price of grain when producers committed several year's production under an FHTA and therefore had to roll contracts from one crop year to another. *Id.* at 9-10.

Grain Land presented the testimony of seven witnesses in its defense. It offered the testimony of its chief financial officer and its most recent grain merchandiser to establish facts relating to general business practices and its operation of the FHTA program. It offered the testimony of three producers who participated in FHTA transactions to establish facts about their solicitations, their understanding of Grain Land's FHTA program, and their intent to deliver the commodity underlying the FHTA transactions they entered. Finally, it offered the testimony of an expert on practices in the grain industry and a legal expert who addressed interpretive issues under the Act.

William Erickson ("Erickson"), Grain Land's controller and chief financial officer during the period at issue, testified that Grain Land entered into a total of over 2,000 HTA contracts with producers. Tr. IV at 58. Erickson testified that, whenever Grain

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[17] Kuserk acknowledged that not all forward contracts result in delivery, but he emphasized that "[w]hen delivery on a forward contract does not occur, it is due to unusual circumstances and only on rare occasions. Delivery is not avoided as a way to capture changes in the value of the contract." *Id.* at 8.

Land contracted for grain, it hedged its exposure by purchasing futures contracts; FHTAs were treated no differently than other contracts in this regard. Tr. IV at 28, 30. Erickson further testified that, in all cases, the hedge position was established in Grain Land's name and the coop was responsible for meeting any margin requirements. Tr. IV at 37. The ALJ asked Erickson about language in some versions of Grain Land's written contracts stating, "Buyer confirms the following futures contract was made for the seller." Tr. IV at 62-63. Erickson responded, "But in fact the rest of the document clearly makes statements it's a reference price in effect, and it was – basically Grain Land would not have entered into this contract with the producer had we not been able to market that grain at the same price level." *Id.*

Erickson testified that rolls of FHTAs had to be "mutually agreeable," but that generally Grain Land "did not have a practice of limiting the number of rolls" before 1996. Tr. IV at 41. Erickson acknowledged that there was a cancellation provision in some of Grain Land's FHTA contracts. Tr. IV at 56. Upon cancellation, a comparison was made between the current futures market price and the futures reference price in the contract, as adjusted for any rolls. The producer was also charged a cancellation fee of five cents per bushel. Tr. IV at 56-57. According to Erickson, Grain Land charged this fee to discourage cancellations because it wanted delivery of the grain. *Id.* He claimed that the five-cent cancellation fee had only minimal impact on the profitability of Grain Land's FHTA program and noted that his review of Grain Land's accounting records identified only between six and twelve disbursements to producers in the context of FHTA cancellations.[18] Tr. IV at 58.

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[18] Erickson was not asked about cancellations that did not result in disbursements to producers.

Erickson testified that Grain Land's policy was to take delivery of all the grain it contracted for. He acknowledged, however, that due to transportation difficulties, there probably were occasions when Grain Land temporarily was unable to accept grain deliveries. Tr. IV at 59. Erickson also testified about the number of bushels delivered under Grain Land's FHTA program. Tr. IV at 43. According to Erickson, to the extent that he could remember, 30,000 bushels were delivered in 1993; 1.7 million bushels were delivered in 1994; approximately 1.5 million bushels were delivered in 1995; and about 2.5 million bushels were delivered in 1996. Tr. IV at 43. When asked about 1997, Erickson testified that he thought that another company had accepted delivery of about 1 million bushels on behalf of Grain Land. Tr. IV at 43-44.[19]

Finally, Erickson testified about Grain Land's disputes in the fall of 1995 through the spring of 1996 with producers who had entered into FHTA contracts. As a result of price rises in the cash market for grain, producers who had rolled their delivery obligations under FHTA contracts could obtain more by selling their grain in the cash market than by fulfilling their delivery obligation to Grain Land. Tr. IV at 53. Consequently, about 15 million bushels of grain were not delivered pending resolution of disputes with about 150 or 160 producers.[20] Tr. IV at 54.

Curt Miller ("Miller") was employed as Grain Land's grain merchandiser from April of 1995 until the end of 1996. Tr. IV at 85-86. Miller testified that it was his expectation that grain subject to FHTAs would be delivered and that he had to make accommodations to store and ship out the grain in question. Tr. IV at 89. In doing this,

[19] Some producers who entered into FHTA transactions with Grain Land were apparently still delivering grain as of the time of the hearing. *Id.*

[20] These disputes resulted in private litigation between Grain Land and the producers in question.

Miller took into account the possibility that delivery dates for grain subject to FHTAs might be rolled. Tr. IV at 91-92. Miller acknowledged that, at one point, as much as 20 million bushels of grain were deliverable to Grain Land under FHTA contracts and that Grain Land could not have accepted delivery on that amount of grain had all the producers decided to deliver at the same time. Tr. IV at 101-02. He also acknowledged that, during the winter of 1995-96, a limited supply of rail cars made it difficult for Grain Land to ship out grain to purchasers. Tr. IV at 97.

Steve Schultz was a producer and director of Grain Land. Tr. IV at 8-9. He testified that, based on what he learned at marketing seminars put on by Grain Land employees, the purpose of hedge-to-arrive contracts was to lock in current prices when the producer believed that current prices were high and likely to go down. Tr. IV at 15. He testified that Grain Land's intent in entering into such contracts was to buy grain from producers. Tr. IV at 16.

Arnold Legred, another producer and director of Grain Land testified that his understanding was that Grain Land's FHTAs were tools for "marketing" grain, but only became contracts to "sell" grain when a producer under an FHTA chose to set the basis. Tr. IV at 118-19. He explained, however, that Grain Land expected that grain covered by FHTAs "would be delivered some time in the future." Tr. IV at 120-21.

Mark Nowak ("Nowak"), a producer and a vice-president of a bank, testified that he entered into numerous FHTAs with Grain Land. When he did so, he expected to produce grain and deliver it under the contracts. Tr. IV at 122-23, 125-28. In some instances, he rolled his delivery obligation, but he always resolved his obligations under FHTA contracts by delivering grain to Grain Land. Tr. IV at 127-30. According to

Nowak, presentations by Grain Land employees led him to believe that Grain Land expected that FHTA contracts would ultimately result in the delivery of grain to the coop. Tr. IV at 131-133. Nowak also noted that he had discussed Grain Land's FHTA contracts with many producers in the context of his banking business and did not recall anyone proposing to use the contracts as a vehicle for speculating on futures positions. Tr. IV at 134-35.

Grain Land's expert, Diana Klemme ("Klemme"), was in the business of advising grain elevators and other agribusinesses on marketing and related subjects.[21] Klemme testified that it was common in the grain industry to use a pricing formula that included both a futures reference price and a basis component and to determine the futures reference price and basis component at different times. Klemme Declaration at 20. Klemme also testified that it was not unusual for forward contracts to include flex elements such as rolling of the delivery date or using a money adjustment in the context of a cancellation of the delivery obligation. She acknowledged, however, that rolling and cancellation were typically based on separate agreements reached after the underlying forward contract had been entered. Klemme Declaration at 14; Klemme Supplemental Expert Declaration at 14-15

Klemme also testified as to the likely reasons for the expansion of the volume of Grain Land's FHTAs in 1995 and the collapse of Grain Land's business in 1996. According to Klemme, in the summer of 1995, corn prices were high, and there was an inverted market with futures prices for December 1996 deliveries lower than futures prices for earlier delivery months. Klemme Declaration at 22. Based on historical

[21] As noted above, Grain Land presented testimony by two expert witnesses. The testimony of its legal expert consisted largely of an analysis of the law relating to the definition of a futures contract.

experience, there was a widespread expectation that the inversion would shrink or change to a carry. *Id.* As a result, in late 1995 many producers entered into FHTAs, with Grain Land and other dealers, with delivery dates in 1995 or early 1996. The producers expected to profitably roll their contracts to a 1996 crop year delivery month when the market inversion abated. *Id.* Contrary to expectations, during 1996, the futures market inversion increased to unprecedented levels. As a result many producers were faced with the necessity of rolling their FHTAs under market conditions that resulted in a reduction of their contract price to very low levels. Klemme Declaration at 22-23, 27-28. The result was to discourage farmers from delivering grain under their FHTAs while Grain Land had to continue to bear the cost of meeting margin calls on the associated positions on the CBOT. Klemme Declaration at 28. As a result, Grain Land was unable to close out its hedge positions or obtain adequate revenue from grain sales, and had to go out of business. *Id.*

VI.

The ALJ issued his decision sanctioning Grain Land in November 1998. *In re Grain Land Coop.*, [1998-1999 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 27,459 (Nov. 6, 1998) ("I.D."). He made 124 findings of fact, but did not expressly analyze the credibility of the witnesses who testified.[22] He did explain that he found the testimony of all expert witnesses unpersuasive. I.D. at 47,179.

The ALJ focused his analysis on whether the record showed that FHTA transactions required delivery of the underlying commodity. I.D. at 47,191. He emphasized that, "as

[22] He did note that "multiple livestock producers" provided "credible testimony" that they had "no intention to physically deliver any of the grain contracted." *Id.* At 47,196. In this regard, the ALJ remarked that "[t]he fact that these 'producers' may have been few in number does not diminish the significance of their existence." *Id.*

written," the contracts "permit[] the producer to unilaterally and unequivocally avoid delivery for any reason" by exercising the cancellation option. *Id.* According to the judge, the existence of this unilateral option "precludes Grain Land from successfully arguing that it entered into [FHTA contracts] expecting delivery." *Id.* The ALJ concluded that the factors that Grain Land emphasized, such as the absence of any solicitations of the general public and limitation of parties to individuals who were in the grain trade, were immaterial in the context of a contractual provision allowing a party to "unilaterally and unequivocally avoid delivery for any reason." I.D. at 47,193.

The ALJ found that the "main purpose" of Grain Land's FHTA contracts was speculation and that, "[q]uite simply, the [FHTA] contract provided an opportunity for producers to obtain futures positions financed by Grain Land." *Id.*[23] He also noted that some of the terms of Grain Land's FHTA contracts were standardized. I.D. at 47,196.[24]

In view of his analysis, the ALJ found that Grain Land violated Section 4(a) of the Act and imposed a cease and desist order.

IV.

Grain Land raises a variety of challenges to the ALJ's decision. It raises both general and specifically targeted challenges to the accuracy and thoroughness of the

[23] In this regard, the ALJ noted that one version of Grain Land's written FHTA contract stated that the "BUYER [*i.e.*, Grain Land] confirms the following futures transaction was made for seller today on the Chicago Board of Trade:" followed by contract terms specifying, among other things, quantity, price, and futures contract month and that another version included language indicating that "[t]he following futures pricing on the Chicago Board of Trade is being made at the Seller's request as of the date shown above," followed by a listing of a futures contract month, price, and quantity. I.D. at 47,195. He also cited: (1) Grain Land's marketing of its FHTA contracts as representing the underlying short futures position with the coop covering all transaction costs; (2) Grain Land's payment by check of some gains accruing on cancellation; (3) the change in the FHTA's pricing mechanism when the producer's delivery obligation was rolled; and (4) the increased opportunity for speculation provided by the rolling option.

[24] The judge pointed to the bushel increments that matched the size of the corresponding futures contracts, the grade of corn specified in some contracts, the limitation of delivery months to those available under corresponding futures contracts, the rolling and cancellation fees, and the limitation of the delivery location to one of Grain Land's nine elevators. I.D. at 47,196.

ALJ's factual assessments.[25] It also challenges the ALJ's legal analysis for effectively treating a single factor – the availability of a mechanism to avoid the delivery obligation – as dispositive. In this regard, it emphasizes that the ALJ's narrow focus is contrary to the nuanced "facts and circumstances" approach followed by both the Commission and the courts.[26] It also argues that the judge erred by failing to require the Division to distinguish between what parties might have intended at the time they entered FHTA contracts and what reliable evidence shows they actually did intend.[27]

The Division defends the result of the ALJ's liability analysis. It acknowledges that characterizing a transaction as involving a futures contract involves more than determining that the underlying contract includes a broad cancellation option. It also agrees that such a determination requires consideration of factors such as other material terms in the contract, the intentions of the parties, and their course of dealing in the past. Division Answering Br. at 31. It emphasizes that the relevant factors are considered in order to identify the "underlying purpose" of the transaction.

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[25] Grain Land specifically challenges findings that: (1) Grain Land's FHTAs involved separate forward contracts that were entered when a producer chose to set the basis; (2) producers who entered into Grain Land FHTA contracts were free to roll their delivery obligations indefinitely; (3) that the "redelivery" mechanism did not involve a valid delivery of the commodity underlying an FHTA contract; and (4) producers entered into FHTAs without an intent to deliver the underlying commodity.

[26] Grain Land cites several characteristics traditionally found in forward contracts (transactions within the commercial merchandising chain; limitation of participants to commercial parties; limitation of participants to parties with capacity to make or take delivery; deferral of delivery for reasons of commercial convenience or necessity; transactions routinely result in delivery; and individualized negotiation of terms) as well as several characteristics traditionally found in futures contracts (offered to the general public; participation open to parties with no capacity to make or take delivery; offered merely for speculative purposes; principally entered into to assume or shift price risk without transferring the underlying commodity; participants do not normally intend to deliver the underlying commodity; most transactions settled by offset; the underlying commodity has no inherent value to the contracting parties; terms are standardized; and performance is generally secured by earnest money, or margin).

[27] Grain Land also challenges the ALJ's failure to analyze factors undermining the credibility of the Division's producer witnesses. It emphasizes that these witnesses were involved in private litigation with Grain Land at the time of the hearing and had a significant financial incentive to testify that they did not intend to deliver at the time they entered into FHTA transactions with Grain Land.

Within this analytical context, the Division relies primarily on the existence of the rolling and cancellation options as evidence that the parties to Grain Land's FHTAs did not intend to deliver the underlying commodity. According to the Division, the existence of these options shows that the contracts were designed to serve as a vehicle for hedging and speculating on CBOT futures price movements without the delivery of grain. *Id.* It also cites to: (1) the emphasis Grain Land's marketing efforts gave to the flexibility of FHTA contracts; (2) the broad latitude Grain Land permitted producers who chose to roll or cancel; (3) Grain Land's use of a "redelivery" mechanism that focused on the appearance of delivery rather than the actual transfer of the underlying commodity; and (4) Grain Land's entry into FHTAs with livestock-raising producers who planned to feed the crops that they produced to their own animals. Finally, the Division notes that, at one point, the total volume of grain subject to Grain Land FHTAs was considerably larger than Grain Land's capacity to accept grain for immediate delivery.

DISCUSSION

I.

As explained below, our review of the record indicates that the ALJ's primary error was in adopting an unduly narrow legal approach. We agree with Grain Land, however, that there also were flaws in his factfinding. As a matter of efficiency, we focus on two examples rather than undertake an exhaustive analysis.

As noted above, at the hearing, the Division offered the testimony of seven producers and Grain Land offered the testimony of three more. None of these witnesses were truly disinterested in the outcome of this proceeding. Moreover, they represent a small percentage of the producers who entered into FHTA transactions with Grain Land.

Nothing in the record indicates that either side selected its witnesses in a manner suggesting that they were representative of the larger group of producers.

Nevertheless, in his I.D., the ALJ made a number of broad findings about what producers as a class were told by Grain Land representatives and about how they viewed different aspects of Grain Land's FHTAs. For example, the ALJ found that producers "viewed the Flex HTA contracts as a superior method of funding a futures position" because Grain Land was responsible for margins and other costs associated with a conventional futures contract. I.D. at 47,182. At best, however, the testimony of only three producers supports this finding. Consequently, the ALJ did not have a proper basis for determining what all or even most producers believed.

The ALJ made a similar broad finding about Grain Land's marketing of its FHTAs, this time relying on documents. According to the judge, Grain Land marketed FHTAs "as a method of capturing futures trading gains and losses." I.D. at 47,182. The marketing literature on which the ALJ primarily relied, however, is ambiguous with respect to the purpose of Grain Land's FHTAs. It is often unclear whether particular passages refer to futures prices *per se* or to the futures component of the price paid for grain upon delivery. As Grain Land's expert Klemme reliably testified, the value of futures positions is widely used as an element in the pricing formulas for grain contracts. Within this context, Grain Land's marketing literature may reasonably be interpreted as touting FHTAs as a method of capturing gains and losses in the futures component of cash prices paid for grain delivered to Grain Land. *See, e.g.,* DX-414 at 2078-79. The ALJ erred by ignoring this plausible alternative to his own interpretation.

II.

As noted above, the ALJ found that the transactions at issue did not involve forward contracts because the parties' written agreements included a broad cancellation provision. According to the judge, the existence of such a unilateral option to avoid delivery fatally undermined Grain Land's claim that it entered into FHTA contracts "expecting delivery." The ALJ did not explain why the inferences arising from this aspect of the parties' written agreements outweighed evidence showing that many producers who signed such agreements settled their obligations by delivering the underlying commodity to Grain Land.

Given these circumstances, respondents are correct in claiming that the ALJ's legal analysis strayed from our traditional approach eschewing any bright-line definition or list of characterizing elements. The traditional approach to distinguishing forward contracts from futures contracts had its genesis in our decision in *In re Stovall*, [1977-1980 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,941 (CFTC Dec. 6, 1979). In that case, respondent bought and sold contracts for the delivery of various commodities. Stovall claimed that the transactions involved forward contracts, but in virtually all cases the transactions did not result in the delivery of the underlying commodity. Instead, customers offset their delivery obligation by entering into a matching transaction with Stovall. The matching transaction resulted in a cash payment reflecting the price difference between the two transactions. In determining that the transactions at issue involved futures contracts rather than forward contracts, the Commission articulated several general principles.

First, the Commission noted that, as a general rule, transactions that involve futures contracts have a different purpose than transactions that involve forward contracts. It explained that futures contracts "are entered into primarily for the purpose of assuming or shifting the risk of change in value of commodities, rather than for transferring ownership of the actual commodities." *Stovall* at 23,777. By contrast, "the desire to acquire or dispose of a physical commodity is the underlying motivation for entering into … a [forward] contract, [although] delivery may be deferred for purposes of convenience or necessity." *Stovall* at 23,778. The Commission particularly emphasized the parties' expectations regarding delivery:

> [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.

Id.

In analyzing the specific transactions at issue, the Commission had to address the significance of language in the written contracts executed by the parties to the transactions. For example, Stovall's written contracts included language stating that the parties contemplated actual "delivery and/or receipt" of the commodity underlying the transaction. *Stovall* at 23,782. The Commission concluded that it would not give such language controlling weight because doing so would make it impossible to properly distinguish transactions involving futures contracts from those involving forward contracts. *Stovall* at 23,782. This effectively established the second principle guiding the traditional approach -- that substance (or conduct) would be given at least the same weight as form (or words) in assessing the parties' intent.

Finally, in assessing the parties' intent, the Commission made it clear that it would apply a "facts and circumstances" approach rather than any bright line test.[28] For example, it noted that the record showed that: (1) Stovall solicited the general public; (2) the parties to Stovall's contracts generally lacked the capacity to take delivery; (3) Stovall touted the transactions as a vehicle for earning speculative profits; (4) Stovall's contracts were standardized in a manner calculated to facilitate offset; and (5) the result of most transactions was the payment of cash after offset rather than the delivery of the underlying commodity.[29]

Since *Stovall*, most courts distinguishing between transactions involving futures contracts and those involving forward contracts have considered both the form and the substance of the parties' relationship in applying a facts and circumstances approach to identifying the parties' intent regarding delivery. For example, in the widely cited *Co Petro* decision by the United States Court of Appeals for the Ninth Circuit, the court explained that:

> 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.

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[28] The Commission specifically stated that it was not articulating an "exhaustive catalogue of factors to which we will look in every case" and explained that it would "look at each operation in context and ... not hesitate to look behind whatever label the parties may give to the instrument." *Stovall* at 23,779 (citation omitted).

[29] Our 1990 Interpretation regarding forward contracts did emphasize that the parties' initial written agreement did not include a provision creating a right to resolve delivery obligations through offset. *Statutory Interpretation Concerning Forward Transactions*, 55 Fed. Reg. 39,188 (CFTC Sept. 25, 1990) (the "Brent Interpretation"). It did not, however, suggest that whenever the parties' initial agreement included such a provision, the transaction at issue involved a futures contract. Indeed, the Brent Interpretation specifically focused its analysis on the transaction's "underlying purpose" and reiterated that there was no "definitive list" of elements of either a futures contract or a forward contract.

680 F.2d at 581. In determining that the contracts at issue were not forward contracts, the court noted that: (1) most of Co Petro's customers were speculators from the general public; (2) the commodity underlying the transactions (petroleum) had no inherent value to most of Co Petro's customers; and (3) most of Co Petro's customers had neither the intention of taking delivery nor the capacity to do so. 680 F.2d at 578-79. The court held that the contracts at issue in the case were futures contracts because they "represent[ed] speculative ventures in commodity futures which were marketed to those for whom delivery was not an expectation." *Id.* Because physical delivery was not intended, the contracts were treated as futures even though the transactions were arranged so that title to goods was at least nominally transferred between various parties. *Id.* *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).

As noted above, the Division acknowledges that an analysis of the transactions at issue should consider factors such as the material terms of the contracts, the intentions of the parties, and their course of dealing in the past. While citing a range of factors, however, the Division relies primarily on the existence of the rolling and cancellation options as evidence that the parties to Grain Land's FHTAs did not intend to deliver the underlying commodity. According to the Division, the existence of these options shows that the contracts were designed to serve as a vehicle for hedging and speculating on CBOT futures price movements without the delivery of grain.

Grain Land emphasizes that 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 of grain, grade and type of grain, time of delivery, and place of delivery. It also claims that participants delivered a significant amount of grain either at the delivery date specified in their contracts, or at a later date determined under the contract's rolling provision.

In our view, the factors tending to indicate that the transactions at issue involved futures contracts, taken as a whole, do not outweigh those tending to indicate that they involved forward contracts.

Unlike the Division, we do not view either the existence or exercise of an option to roll delivery obligations as incompatible with intent to deliver the underlying commodity. It is undisputed that many FHTA participants delivered grain to Grain Land after rolling their delivery obligations. As the Seventh Circuit noted in *Nagel v. ADM Investor Services, Inc.*, 217 F.3d 436, 441 (7th Cir. 2000), the rolling fee that Grain Land charged tended to place "a practical limit on how long delivery [could] be deferred." The Division has not persuasively shown that, despite this practical limit, participants in the FHTAs at issue believed that indefinite rolling was a plausible tool for obtaining speculative profits.[30]

[30] The Division has not offered a persuasive explanation of why indefinite rolling would be an attractive business strategy for the parties, given that producers would become subject to high cumulative rolling fees while Grain Land would have to bear the cost of maintaining margins on CBOT hedge positions associated with the rolled FHTAs for indefinitely extended periods of time. Moreover, an indefinitely rolled FHTA

The analysis of the Division's expert does show that the rolling option created speculative opportunities different than those offered by more traditional forward contracts. The testimony of Grain Land's expert, however, establishes that forward contracts can take many forms and that variations are frequently developed because they permit producers to speculate on factors affecting the price they will receive on delivery. In any case, the touchstone of our analysis of the difference between futures contracts and forward contracts has been the parties' intent regarding delivery, *Stovall* at 23,778, and the record does not establish that, outside the context of cancellation, participants in Grain Land's FHTA transactions earned speculative profits without making or taking delivery.

In contrast to the rolling provision, the broad right to cancel included in many of Grain Land's contracts is clearly a circumstance supportive of the Division's theory of the case. The terms of the cancellation provisions employed by Grain Land meant that Grain Land's FHTAs potentially could have been used to speculate or hedge without delivery if the parties to the contracts had wished to do so. This possibility, however, is insufficient by itself to establish that Grain Land's FHTAs were futures contracts. Under the case law discussed above, contract language must be considered in the context of the transaction as a whole. Thus, the true significance of the cancellation provisions depends largely on how they were used. Grain Land plausibly argues that this option had little or no significance for those participants who resolved their FHTA transactions by delivering the underlying grain to Grain Land. At best, the record can be read as showing that perhaps 60 or 70 producers exercised some sort of cancellation option. Moreover, the

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would not appear to have the same economic effects as a futures contract because, without delivery or cancellation, the parties to the contract would realize no gain or loss.

significance of even these cancellations is largely equivocal. Grain Land's expert reliably testified that in transactions involving forward contracts, cancellations are not unusual in the context of crop failures or similar extraordinary circumstances. Consequently, to assess the significance of the cancellations established on the record, it is important to know whether the cancellations took place in the context of such extraordinary circumstances.

In most instances, the Division failed to develop the record on either the reasons for cancellation or the circumstances in which producers chose to exercise this option. Absent such evidence, we cannot determine whether the breadth of the cancellation option described in the contract had any significance in the context of the parties' actual conduct. In these circumstances, neither the cancellation option in the parties' agreements nor the actual cancellations merit significant weight in our analysis.

The other circumstantial evidence that the Division relies upon does little to buttress its showing. For example, it claims that most of the grain covered by Grain Land's FHTAs was not ultimately delivered. The record, however, does not reliably establish either the amount of grain actually covered by Grain Land FHTA contracts or the amount of covered grain actually delivered to Grain Land. The parties do not agree on how many producers actually exercised the cancellation option, but even the larger figure the Division offers would not explain the limited deliveries shown on the record. Absent information on what happened if producers neither cancelled nor delivered, it is impossible to reliably assess the significance of the apparently missing bushels to an analysis of the intent of the parties to Grain Land FHTAs.[31]

[31] Most of the volume of undelivered grain apparently developed during the spring of 1996, when economic conditions in the corn market were highly unusual and Grain Land's FHTA program was collapsing. As a

Similarly, we do not believe that the record supports an inference that Grain Land lacked the capacity to take delivery of the volume of grain it expected to be delivered under its FHTA contracts. The statistics in the record concerning the monthly volume of grain covered by outstanding contracts do not include information about the delivery dates specified in the contracts. Moreover, the availability of the rolling option created a level of uncertainty about when the grain covered by an FHTA contract would actually be delivered. As a result, evidence that there were periods when the total volume of grain under FHTAs exceeded Grain Land's *immediate* ability to accept delivery is inadequate to prove that Grain Land did not expect delivery at the time it entered into its contracts. Indeed, Grain Land witnesses testified that the coop's delivery planning took into account the likelihood that deliveries would be spread out over time due to the rolling option.

The Division cites to marketing statements by various Grain Land representatives indicating that producers had broad discretion with respect to how they used FHTAs and were free to cancel and take profits without delivery. At best, however, these representations are suggestive of how FHTA contracts could be used. Moreover, almost all of the marketing representations that the Division relies upon also mention delivery, perhaps after one or more rolls, as a purpose of the contracts. Thus, as with the evidence regarding cancellations, the implications of Grain Land's marketing materials are equivocal.

Finally, the Division emphasizes the testimony offered by its producer witnesses who did business in a way that implied that they were unlikely to deliver grain to Grain Land and testified that they did not intend to deliver grain pursuant to the FHTAs they

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result, we do not believe that reliable inferences about parties' intentions at the time they entered into contracts can be drawn from this information.

entered. As noted above, Grain Land insists that this testimony is incredible because the witnesses had an interest in the subject matter of the proceeding. Even if the testimony is credited, the record indicates that several of these witnesses ended up delivering some grain, and at least one was repeatedly discouraged from canceling contracts. More importantly, the testimony is insufficient to establish either Grain Land's intent or the intent of the hundreds of producers who participated in Grain Land's FHTA program but did not testify.[32]

CONCLUSION

The record does not establish that the transactions at issue involved futures contracts. Consequently, we vacate the ALJ's decision and dismiss the Complaint for a failure of proof.

IT IS SO ORDERED.

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

Jean A Webb

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

Dated: November 25, 2003

[32] As noted above, neither the Division nor respondents made any effort to show that the views offered by their witnesses were representative of other participants in the transactions at issue.

Concurring Opinion of Commissioner Sharon Brown-Hruska

The issue before us—whether the hedge to arrive contracts marketed by Grain Land Cooperative are subject to the Commodities Exchange Act--goes to the core of our mission. This decision requires us to decipher the scope of an exclusion, in this case the forward contract exclusion, and to navigate the reach of our jurisdictional authority. In light of the important role that forwards and futures play in underpinning other financial instruments, our decision here will have far-reaching implications beyond how it affects the immediate parties in this case.[1]

While the utility of innovative contracts, including hedge to arrive and agriculture trade options, for hedging and price certainty for farmers, elevator operators, and grain merchants is abundantly clear, the cloud of legal uncertainty that has hung over them for the last decade has given rise to post-contractual lawsuits and protracted Commission deliberation and review. In the end, this has had a chilling effect on the variety and availability of these contracts.

Given the seemingly limitless variation in contractual terms that are associated with today's financial tools, it is imperative that we interpret the parameters of our jurisdiction clearly. Commercial parties, including farmers, contemplating introducing or entering into novel transactions must be able to rely upon the guidance provided by both our statute and our interpretation thereof. Although we reach the right outcome in the case before us, we should not let pass an opportunity to articulate a standard that is clear and predictable. It is with this in mind that I write this concurrence.

The Commission's Approach

Although I agree that the approach employed by the Administrative Law Judge George Painter was "unduly narrow," the approach favored by the majority, in my view, is also flawed. That standard--which we describe as a "facts and circumstances" approach, and which the courts characterize as either a "totality of the circumstances," "multi-factor," or "holistic" approach--holds that whether a contract is a forward or a future "depends on the facts and circumstances of each case."[2]

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[1] Swaps, for example, are "nothing more complicated than a series of forward contracts strung together." *In re Cargill,* [2000-2002 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 28,425 at 51,232 n.127 (ALJ Nov. 22, 2000) (quoting John Hull, Options, Futures, and Other Derivative Securities 19 (2d ed. 1993)). *See also,* Charles W. Smithson & Clifford W. Smith, Jr., Managing Financial Risk: A Guide to Derivative Products, Financial Engineering and Value Maximization 36 (1995) ("a swap contract, like a futures contract, is like a portfolio of forward contracts"); Louis Vitale, *Interest Rate Swaps Under the Commodity Exchange Act,* 51 Case W. Res. L. Rev. 539, 543 (2001) ("The basic building block of a swap is the forward transaction.") (citing Robert M. McLaughlin, Over-the-Counter Derivative Products 70 (1999)).

[2] *Motzek v. Monex International Ltd.,* [1992-1994 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 26,095 at 41,626 (CFTC Jun. 1, 1994).

In practice, our approach--which has its origins in the Commission's 1979 *Stovall* matter and the Ninth Circuit's 1982 opinion in *CFTC v. Co-Petro*--constitutes a catalog of elements dressed as a standard. The opacity inherent in this approach is illustrated by the advice that the Commission has provided to the courts on how to distinguish between forwards and futures. In a set of *amicus* briefs submitted to the Sixth and Seventh Circuits in connection with the *Grain Land Coop* and *Lachmand* HTA cases, the Commission urged those courts to adopt an approach that "requires the examination of a variety of factors" [3] and that "takes into account all relevant circumstances."[4]

A year following the submission of this guidance, Seventh Circuit Judge Frank Easterbrook complained that our *amicus* brief in *Lachmund* "read more as an exegesis of *Co-Petro* than as an independent analysis of the statutory or economic issues."[5] That critique captures the essence of my concerns with our traditional approach, in that it studiously avoids giving controlling significance to specific, meaningful criteria. The inherent difficulty is evidenced in the manner that the majority opinion conveys the outcome in the present case:

> In our view, the factors tending to indicate that the transactions at issue involved futures contracts, taken as a whole, do not outweigh those tending to indicate that they involved forward contracts.

Admittedly, the dividing line between a contract for the purchase or sale of a commodity for *future* delivery and a contract for the sale of a cash commodity for *deferred* shipment or delivery poses both semantical as well as substantive challenges. Neither challenge, however, justifies adherence to a standard that, in the words of Judge Richard Posner, casts "a [legal] cloud over forward contracts by placing them at risk of being reclassified as futures contracts traded off-exchange and therefore illegal."[6] The absence of a clear line means that those who seek to offer innovative contracts are unable to know *in advance* whether a transaction is legal and enforceable, and therefore they must assume the additional risk that legitimate contracts could be invalidated years after the fact.

The fundamental problem with our approach is that it looks "back to the future." This is evidenced by the factors that the Commission focuses upon, virtually all of which

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[3] Brief of *Amicus Curiae,* Commodity Futures Trading Commission, at 5, *Grain Land Coop v. Obermeyer*, 199 F.3d 983 (8th Cir. 1999) (Nos. 98-3217 and 98-3304); Brief of *Amicus Curiae,* Commodity Futures Trading Commission, at 8, *Lachmund v. ADM Investor Servs., Inc.*, 191 F.3d 777 (7th Cir. 1999) (No. 98-3467).

[4] CFTC *Amicus* Brief, *Grain Land Coop*, at 5; CFTC *Amicus* Brief, *Lachmund*, at 4.

[5] *Nagel v. ADM Investor Services, Inc.*, 65 F. Supp. 2d 740, 754 (N.D. Ill. 1999) (Easterbrook J., sitting by designation), *aff'd Nagel v. ADM Investor Services, Inc.*, 217 F.3d 436 (7th Cir. 2000) ("*Nagel II*").

[6] *Nagel II,* 217 F.3d at 441.

relate to the parties' conduct *after* they entered into their agreements with Grain Land.[7] While such a perspective may suit our administrative needs, "[h]indsight is not a luxury afforded to those living in the present."[8] An approach that holds that the outcome cannot be determined until "both the parties' mental states and the course of their performance" has been investigated does not readily lend itself well to the kind of *ex ante* determination that is required.[9] As Judge Easterbrook explains:

> It is essential to know *beforehand* whether a contract is a futures or a forward. The answer determines who, if anyone, may enter into such a contract, and where trading may occur. Contracts allocate price risk, and they fail in that office if it can't be known until years after the fact whether a given contract was lawful. Nothing is worse than an approach that asks what the parties "intended" or that scrutinizes the percentage of contracts that led to delivery *ex post*. What sense would it make--either business sense, or statutory-interpretation sense--to say that the same contract is either a future or a forward contract depending on whether the person obliged to deliver keeps his promise? . . . Such uncertainty is the worst possible outcome.[10]

The Commission maintains that a "facts and circumstances" approach allows us to "look behind" any self-serving labels the parties may give to their agreement and to discern its "underlying purpose." While such an endeavor may be well meaning, it creates evidentiary burdens of proof that the Division of Enforcement must satisfy in order to establish the intentions of the counterparties to a transaction. Inevitably, the courts are forced to engage in an examination of the parties' actions *ex post* to make a determination, and this undermines the weight given to the substance of contractual provisions in a relative sense. These shortcomings are so self-evident[11] that even the

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[7] These factors include whether delivery actually occurred and to what extent; the reasons for any non delivery; the frequency by which the HTA contracts were rolled over; the extent to which cancellations occurred; how such cancellations were used; and the rationale for such actions. The *ex post* perspective is also reflected by the significance that the Commission attaches to evidence relating to how various contractual provisions "were used," and to evidence relating to *actual* deliveries as a proxy for determining whether the parties *contemplated* delivery.

[8] *In re Grain Land Coop,* 978 F. Supp. 1267, 1280 (D. Minn. 1997) (holding that Grain Land's HTA contracts were cash forward contracts excluded from regulation under CEA). While such an *ex post* perspective may be suitable for determining whether a contract has been breached, it is much less helpful for determining the legal nature of a contractual relationship in the first place--something that usually turns upon an *ex ante*, objective analysis of the contract at its inception.

[9] *Nagel,* 65 F. Supp. 2d at 750.

[10] *Id.* at 752.

[11] A concise summary of those shortcomings was described by one of our administrative law judges, who noted that such an inquiry "is notably fact intensive and *ad hoc* in nature, involving few safe harbors or bright line standards, unclear lines of demarcation, an unbounded scope of

Commission has acknowledged that its approach "is somewhat imprecise and often raises difficult issues of interpretation."[12]

Even though this approach lacks clarity and spawns legal uncertainty, the Commission, nevertheless, insists that the presence of such deficiencies "does not justify elevating form over substance."[13] This rationale, while initially intuitive, is contrary to the way such a determination is made in securities law where form is respected.[14] Since "securities laws are *about* form, and one can say much the same about the commodities laws,"[15] there is little reason to look beyond a financial instrument's formal characteristics to determine whether it is a forward or a future.

While previous courts have employed an approach similar to ours, the outcomes in those cases are almost uniformly at odds with the position advanced by our enforcement posture,[16] and in at least one case, the court declined to follow our reasoning.[17] Indeed, the Seventh Circuit, whose multi-factor approach in *Lachmund* the Commission points to for support, has since moved considerably away from it.[18] As the

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inquiry, and an express, but not very useful, set of policy imperatives." *Palomares v. Bradshaw,* [1999-2000 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 28,268 at 50,634 n.115 (ALJ Oct. 2, 2000).

[12] *Motzek,* ¶ 26,095 at 41,626.

[13] *Id.*

[14] *See Landreth Timber Co. v. Landreth,* 471 U.S. 681, 688-692 (1985) (no need to look beyond formal characteristics of instrument to determine whether it is a security subject to federal securities laws). *See also, Nagel,* 65 F. Supp.2d at 752 (arguing for a simplified approach to determining whether an HTA contract is a future based upon the contract's form).

[15] *Nagel,* 65 F. Supp.2d at 752.

[16] *See e.g., The Andersons, Inc. v. Horton Farms, Inc.,* 166 F.3d 308, 317-22 (6th Cir. 1998) ("we hold that these HTA contracts fit within the cash forward contract exclusion to the CEA and fall outside of CFTC regulation."); *Haren v. Conrad Coop.,* 198 F.3d 683, 683 (8th Cir. 1999) ("we believe the district court correctly determined the HTAs were not subject to regulation under the CEA."); *Grain Land Coop v. Kar Kim Farms, Inc.,* 199 F.3d 983, 996 (8th Cir. 1999) ("To sum up: we agree with the district court that Grain Land's HTAs . . . were contracts for the sale of a cash commodity for deferred delivery and therefore not subject to the CEA."); *Lachmund v. ADM Investor Servs., Inc.,* 191 F.3d 777, 790 (7th Cir. 1999) ("[we] hold, therefore, that the HTA contracts at issue in this case are cash forward contracts exempt from the purview of the CEA."); *Nagel v. ADM Investor Services, Inc.,* 217 F.3d 436 (7th Cir. 2000) (affirming the trial court's dismissal of a complaint on grounds that the flexible HTAs in question were cash forward contracts); *In re Grain Land Coop,* 978 F. Supp. 1267, 1272-77 (D.Minn. 1997) ("In short, . . . the HTA contracts exemplify what Congress intended to exclude from the CEA.").

[17] *Nagel,* 65 F. Supp. 2d at 754 ("CFTC's reasoning is unpersuasive").

[18] *See Nagel II,* 217 F.3d 436 (condensing the "totality of circumstances" approach into an objective three-part test). The Commission's failure to include either Judge Easterbrook's or

courts have recognized the deficiencies in the approach and made practical refinements to reduce the *ex post* nature of its application, the Commission has yet to acknowledge these concerns and has clung to a standard whose outcome, when variously applied by different Commissions, is unpredictable.[19]

Perhaps this incongruity can be explained by the much broader scope of inquiry we engage in as compared with that of the courts, or perhaps it reflects our concern with aspects surrounding these transactions that the judiciary declines to find significant. Whatever the reason, it appears that the real danger today in our application of this

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Judge Posner's analysis of the forward/futures distinction in *Nagel* in its review of the case law is a concern since this case is both recent and relevant to the matter considered here. This omission, at best, renders the Commission's discussion incomplete.

[19] *Compare 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). Although the administrative case involved contracts with option-like features, the settlement order noted that Andersons used "the same one sided two-page form for *all* of its HTA contracts." ¶ 27,526 at 47,416 n.4 (emphasis added). *See also, Harter v. Iowa Grain Co.*, 220 F.3d 544, 548 (7th Cir. 2000) (observing that while several courts have concluded that HTA contracts are cash forwards that may be sold off-exchange, "the CFTC has leaned towards characterizing HTAs as futures contracts that must be sold on designated exchanges").

I am also not sanguine about how slow we have been in recognizing the legal validity and economic significance of the rolling forward and cancellation features found in many HTA contracts, something the courts figured out long before we did. *See, e.g., Johnson v. Land O'Lakes, Inc.,* 18 F. Supp.2d 985, 996 (N.D. Iowa 1998):

> The only reasonable inference to arise from an assertion that the contract could be deferred by rolling or as part of a multi-year plan, or extinguished by a buyout, is that there was indeed a recognized obligation to deliver grain on the contract that had to be deferred by rolling or extinguished by buying it out.

See also, See Oeltjenbrun v. CSA Investors, Inc., 3 F. Supp.2d 1024, 1040-45 (N.D. Iowa 1998) (rolling feature does not transform HTAs into illegal futures contracts but are similar to "bookout" agreements sanctioned in Ninth Circuit's *Bybee* decision); *Maynard Coop. Co. v. Recker*, 2001 WL 1502602 at *2 (Iowa Ct. App. Nov. 28, 2001) ("The authorities conclusively hold HTA contracts with roll forward provisions are legal cash forward contracts, exempt from the CEA."); *Andersons,* 166 F.3d at 321 n.20 ("mere possibility of infinite rolling is not dispositive"); *Grain Land,* 199 F.3d at 992 (neither rolling nor cancellation provisions "transform the HTAs into futures contracts"); *Patten Farms, Ltd. v. Farmers Coop. Co.,* 4-97-CV-90599, 2000 U.S. Dist. LEXIS 21650, at *4, *9 (S.D. Iowa June 1, 2000) (fact that HTA contracts allow for rolling and permit cancellation upon proof of inability to deliver do not take them out of unregulated futures contract exception); *Nagel II,* 217 F.3d at 442 (rolling fee places "practical limit on how long delivery can be deferred.").

methodology is less that an illegal futures scheme will be missed than that normal forward contractual relationships will be wrongly classified as futures and suppressed.

An Alternative Approach

Before suggesting an alternative method to analyze these contracts, let me be clear about my premise. The debate here is not only about how to distinguish between forwards and futures, it is also about the scope of our regulatory authority, in particular, our *discretionary* authority. Our preference for a generalized "facts and circumstances" approach is not dictated by the analytical complexity involved in distinguishing between these contracts.[20] The Seventh Circuit in *Nagel* demonstrated that such a distinction can be made with much less effort, primarily on the basis of the contract's written language. Again, the greater concern is that the traditional approach leaves the resolution of such questions as much as possible to our discretion.

While discretion maximizes our administrative self-interest, it does create costs and uncertainty for both market participants and the legal community who look to us for guidance on such questions. Our goal should be to articulate a more dispositive formula that would simplify our inquiry and at the same time provide parties with more meaningful guidance. As alluded to in the discussion above, the Seventh Circuit has formulated an approach that gives clear guidance, while preserving our authority over illegitimate activity. In *Nagel,* Chief Judge Richard Posner laid out a three-part standard for determining when a contract constitutes a forward:

> (1) The contract specifies idiosyncratic terms regarding place of delivery, quantity, or other terms, and so is *not fungible* with other contracts for the sale of the commodity, as securities are fungible . . .
>
> (2) The contract is between industry participants, such as farmers and grain merchants . . .
>
> (3) Delivery cannot be deferred forever, because the contract requires the farmer to pay an additional charge every time he rolls the hedge.[21]

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[20] Indeed, there appears to be an implacable continuity of eschewing a clearly defined standard throughout our case law, seemingly no matter what the issue. *See e.g., In re Nikkhah,* [1999-2000 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 28,129 at 49,892 (CFTC May 12, 2000) (applying a multi-factor formula to the calculation of civil penalties); *Motzek,* ¶ 26,095 at 41,626 (endorsing holistic "facts and circumstances" approach for determining what constitutes a futures contract); *Wirth v. T&S Commodities, Inc.*, [1990-1992 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 25,271 at 38,875 (CFTC Apr. 6, 1992) (declining to identify specific list of factors for finding agency); *Hall v. Diversified Trading Systems, Inc.*, [1992- 1994 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 26,131 at 41,751 (CFTC Jul. 7, 1994) (endorsing "holistic" interpretation of parties' submissions for determining adequacy of complaint); *Hammond v. Smith Barney, Harris Upham & Co., Inc.,* [1987-1990 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 24,617 at 36,657 (CFTC Mar. 1, 1990) (endorsing "holistic" approach for assessment of solicitation).

[21] *Nagel II,* 217 F.3d at 441 (emphasis added).

The immediate advantage of this approach is that its elements can readily "be ascertained [*ex ante*] from the contracts themselves."[22] It avoids the need to look beyond the terms of the written contracts or to get bogged down in trying to balance the myriad elements associated with our traditional approach. Judge Posner's approach also dispenses with the difficult and unnecessary problem of trying to decipher the parties' subjective intentions with respect to delivery, by focusing on whether fungible promises were made.[23]

Had we applied this approach in the Grain Land decision, we could have avoided getting entangled in extraneous concerns. The first element establishing that this is a forward contract is satisfied by the absence of any fungible features in Grain Land's contracts. The second is made clear by the patent commercial character of the parties. Finally, the fact that farmers could not defer delivery or cancel their obligations without incurring a fee not only satisfies the court's third element, but it also makes our scrutiny of the parties' intentions and conduct with respect to delivery unnecessary.

The Seventh Circuit has made an important contribution to the debate on this issue by recognizing that the true defining characteristic of forwards is their lack of fungibility.[24] More fundamentally, Judge Posner's approach protects "forward contracts

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[22] *Id.*

[23] While I recognize that evidence relating to the parties' intentions regarding delivery is viewed as the "touchstone" of our analysis, and that the "contemplation" of physical delivery is considered by most courts to be the "hallmark" of unregulated forward contracts, using this element to differentiate between forwards and futures is conceptually misplaced since "it treats as the dividing line something [delivery] the two forms of contract have in common . . . in the statutory text." *Nagel,*65 F. Supp. at 751. *See also, Haren*, 198 F.3d at 684 (obligation to deliver not necessary to place a contract within cash-forward exception). It also suffers from the fact that it requires us to inquire into the *subjective* intentions of the parties. *Id.* (holding that farmer's lack of subjective intent to deliver corn irrelevant in face of contractual provision "unequivocally requir[ing]" him to do so).

By contrast, fungibility serves as a more useful marker for differentiation, because while "futures are standardized, fungible instruments . . . [b]y contrast, forwards are not fungible." Mark D. Young & William L. Stein, *Swap Transaction Under the Commodity Exchange Act: Is Congressional Action Needed?* 76 Geo. L.J. 1917, 1923-24 (Aug. 1988) (noting that the while futures are "standardized, fungible instruments," forwards "are not fungible"). *See also, Salomon Forex, Inc. v. Tauber*, 8 F.3d 966, 971 (4th Cir. 1993) (noting that cash forwards are generally individually negotiated sales of commodities between principals that are not readily transferable "[i]n contrast to the fungible quality of futures"); *Chicago Mercantile Exchange v. S.E.C.*, 883 F.2d 537, 542 (7th Cir. 1989) (noting that futures contracts are fungible because they have standard terms and that trading occurs in "the contract," not in "the commodity" as with forwards); *Nagel*, 65 F. Supp. 2d at 753

[24] Indeed, as Judge Easterbrook points out, the fact that the contract at issue in *Co-Petro*--the case responsible for our traditional approach--was fungible "should have been enough [by itself] to resolve th[at] case." *Nagel*, 65 F. Supp. 2d at 752 (observing that flexible HTA agreements are

from the sword of Damocles that . . . plaintiffs [often] wish to wave above the defendants' heads, yet at the same time . . . prevent[s] evasion of the Commodity Exchange Act by mere clever draftsmanship."[25] As an added benefit, it vastly reduces the need to impose regulatory invasive procedures upon parties trying to contend with the ambiguous legal markers that plague this area of our law.[26]

In conclusion, while I am encouraged by the outcome that the Commission reaches here, I am concerned that our devotion to the traditional standard runs counter to our efforts, both legislatively and in our regulation, to provide clarity and legal certainty in the over-the-counter markets. The purpose of changes to our statute, including most recently those enacted in the Commodity Futures Modernization Act of 2000, is to provide meaningful guidance to those contemplating innovation in the markets regarding the legal status of the transactions they undertake. It is in this spirit that I concur with the outcome, while noting that there is a better approach that should be given our consideration.

Commissioner Sharon Brown-Hruska

11/19/03
Date

not fungible because they can't be settled by buying offsetting positions). *Accord Sack Bros. v. Great Plains Coop., Inc.*, 616 N.W.2d 796, 808 (Neb. 2000) (citing *Nagel*).

[25] *Nagel II*, 217 F.3d at 441.

[26] *See, e.g., Andersons*, ¶ 27,526 (requiring firm to establish a committee to review all new product offerings involving HTA contracts "for the legality of such contracts under the Act and Commission Regulations").