U.S. COMMODITY FUTURES TRADING COMMISSION
Three Lafayette Centre
1155 21st Street, NW, Washington, DC 20581

In the Matter of

CARGILL, INC.,

Respondent.

CFTC Docket No. 99-16

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INITIAL DECISION

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Before: Bruce C. Levine, Administrative Law Judge

Table Of Contents

Overview

> "[A] financial regulator needs to pursue its public interest mission -- as defined by law, rule and custom -- in a manner that promotes innovation, enhances efficiency, maintains competitiveness and reduces systemic risk . . . . [Those goals] represent a significant departure from an approach to market regulation that placed 'prevention' -- with a commensurately detailed and prescriptive structure to accomplish that -- as the top regulatory objective."[1]

Background

Cargill, Inc. ("Cargill") buys agricultural products from those who produce them and sells them to others who can use them.[2] In order to compete in the grain market, Cargill offers a number of ways for producers to sell it the grain that it requires. Some contracts let the producer lock in a price early on, so that the producer is sheltered from later price

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[1] William J. Rainer, Chairman, Commodity Futures Trading Commission, <u>Remarks Before the Bond Market Association's Sixth Annual Legal and Compliance Conference</u> (New York, NY, Oct. 25, 2000).

[2] Cargill is an international marketer, processor and distributor of agricultural, food, financial and industrial products. It operates grain elevators in 21 states. Cargill's Grain Division purchases corn, soybeans, and wheat, among other agricultural products, from farmers and sells grain to processors. Cargill is not registered with the Commodity Futures Trading Commission ("Commission") in any capacity. <u>See</u> Joint Stipulations, dated July 7, 2000, at ¶1. <u>See also</u> Complaint and Notice of Hearing Pursuant to Sections 6(c) and 6(d) of the Commodity Exchange Act, as Amended, dated August 26, 1999 ("Complaint"), at ¶2.

fluctuations.[3] Other contracts allow the producer to set its price at any time before the delivery date, so that it may try to take advantage of later price fluctuations.[4] Cargill's purchase contracts take on many variations. In fact, Cargill has a team of its employees whose job it is to create and test new arrangements for buying grain.[5]

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[3] The simplest example of such a contract is the "Priced Purchase Contract."

> "A Priced Purchase Contract is where a producer sells a fixed quantity of bushels for either nearby or future delivery at a specific price."

Division of Enforcement's Prehearing Memorandum, dated February 7, 2000 ("Division's Prehearing Memorandum"), Exhibit L, Examination of Dennis Inman, dated January 11, 1999 ("Inman Examination") at 18. Inman heads Cargill's North American grain purchasing marketing team. See id. at 9-10. See also Transcript of Proceedings, dated July 24-25, 2000 ("Tr.") at 138-39 (Inman) (Inman is Cargill's "Customers Solutions Leader.").

[4] An example of such a contract is the "No-Price-Established Contract."

> "A No-Price-Established Contract is a contract where a producer agrees to deliver a specific quantity and quality of grain, with the final price to be established at a later time, which is negotiated at the time the contract is written. Sometimes there are fees for that contract, sometimes not."

Inman Examination at 26.

[5] See Tr. at 139 (Inman's "duties are looking for innovative ways in which we can try to originate more grain for our country elevator assets."). See also Inman Examination at 35 ("Well, the

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One of those marketing creations is at issue in this litigation. The challenged arrangement works like this. The producer enters into one of Cargill's typical forward contracts to deliver grain at a specified time under some pricing scheme.[6] The Court will call this the "underlying contract." Next, the producer enters into an addendum agreement to the underlying contract,[7] which the Court shall refer to as the "Premium Offer Contract" ("POC"). Under the POC, Cargill offers to accept delivery of additional bushels at a later specified period, and pay a premium on all bushels committed in the underlying contract for the nearby period, if the producer agrees to deliver those additional bushels for a "strike price" selected by the

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opportunity for us in all of our risk management products is to originate more grain. We want to offer contracts that our customers find attractive in the hopes that we can buy more grain."). His group's efforts are supported by Cargill's Commodity Risk Management Products Department, headed by Vice President David E. Dines ("Dines"). Dines' department prices, structures and hedges the new contracts. See Tr. at 222-24 (Dines). See also Division's Prehearing Memorandum, Exhibit M, Examination of David E. Dines, dated March 5, 1999 ("Dines Examination") at 15.

[6] These contracts include: Priced Purchase, Basis, No Basis Established, Minimum Price and Minimum-Maximum Price. See Joint Stipulations at ¶3.

[7] Id. at ¶4.

producer.[8] Here is the catch. The producer only delivers those additional bushels and Cargill only accepts them, if the exchange-traded futures price for the grain is at or above the specified strike price on the pricing date set forth in the contract.[9] If the futures price for the grain is below the strike price then neither party performs, the producer keeps both the additional bushels and the premium, and Cargill gets squat.

There is one more wrinkle to the POC. If Cargill is required to accept delivery, it pays the strike price minus the basis for the delivery location. Basis is the difference between the exchange-traded futures reference price and the market price at the delivery location.[10] In this manner, Cargill adjusts the price it pays for grain at each location to reflect location-

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[8] Id. at ¶5. The producer selects the pricing date and the strike price (which in turn determine the premium) from a list of as many as three pricing dates and five strike prices for each commodity. See Answer, dated September 14, 1999, at 2-3; Division's Prehearing Memorandum at 3. See also Division's Prehearing Memorandum, Exhibit O, Examination of James M. Larson, dated January 12, 1999 ("Larson Examination") at 50-52. Larson is a Cargill Location Manager. Id. at 7.

[9] See Joint Stipulations at ¶5.

[10] See Division's Prehearing Memorandum, Exhibit T, Declaration of Stephen Craig Pirrong, dated February 1, 2000 ("Pirrong Declaration") at 5-6. Dr. Pirrong testified as the Division of Enforcement's economic expert. He is an Assistant Professor of Finance at the Olin School of Business, Washington University. Id. at 2-3 & attached curriculum vitae.

specific differences in storage and shipping costs. As these costs change, so does the basis. The POC lets the producer lock in the basis price for its location at any time between entering into the POC and the pricing date.[11] Thus, the producer gets to attempt to exploit fluctuations in the basis in order to obtain the maximum price for its crop.

In the nearly three years that Cargill has offered the POC prices have predominantly moved downward.[12] As a result, prices have not reached the strike price as of the pricing date under any of the POCs and, as a further result, Cargill has never accepted delivery of any additional bushels.[13] These circumstances have made the producers happy since they have gotten to keep the premium, without undertaking additional deliver. Cargill too remains happy with the POC, despite the

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[11] Although Cargill's Inman testified that the producer is able to set the basis at any time up to delivery, see Tr. 143-144; see also Division's Prehearing Memorandum, Exhibit G (Cargill Promotional Brochure), at least one POC specified that the basis was to be established on the pricing date. See Tr. at 67-68 (Pirrong).

[12] See Tr. at 149-150 (Inman); Division's Prehearing Memorandum at 4.

[13] See Joint Stipulations at ¶16; Inman Examination at 75; Larson Examination at 50. See also Division's Prehearing Memorandum, Exhibit N, Examination of Amy R. White, dated January 12, 1999 ("White Examination") at 20. White is a Cargill Product Specialist. Id. at 8.

fact that no producer has yet to deliver under it. From Cargill's perspective, the POC has drawn producers to Cargill to sell their grain under the underlying contracts (36,000,000 bushels), while it has functioned and continues to function as a tool in its management of price risk.[14] Accordingly, Cargill continues to offer the contract and is fighting in this proceeding so that may keep doing so.

This brings us to the Division of Enforcement ("Division"). Although all of the commercial parties to the POC are happy, the Division is not. On August 26, 1999, the Commission filed a one-count complaint in which the Division alleges that the POC is (or operates like) an agricultural call option prohibited under Section 4c(b) of the Commodity Exchange Act ("Act") and Commission Regulation 32.2.[15] The Division argues that because

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[14] See Tr. at 194-195 (Inman).

[15] See Complaint at ¶1.

Section 4c(b) of the Commodity Exchange Act, 7 U.S.C. §6c(b), provides in relevant part:

> "No person shall offer to enter into, enter into or confirm the execution of, any transaction involving any commodity regulated under this Act which is of the character of, or is commonly known to the trade as, an 'option', 'privilege', 'indemnity', 'bid', 'offer', 'put', 'call', 'advance guaranty', or 'decline guaranty', contrary to any rule, regulation, or order of the Commission

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> prohibiting any such transaction or allowing any such transaction under such terms and conditions as the Commission shall prescribe."

Commission Regulation 32.2, 17 C.F.R. §32.2, which applies only to off-exchange transactions, provides in relevant part:

> "[N]o person may offer to enter into, confirm the execution of, or maintain a position in, any transaction in interstate commerce involving wheat, cotton, rice, corn, oats, barley, rye, flaxseed, grain sorghums, mill feeds, butter, eggs, solanum tuberosum (Irish potatoes), wool, wool tops, fats and oils (including lard, tallow, cottonseed oil, peanut oil, soybean oil and all other fats and oils), cottonseed meal, cottonseed, peanuts, soybeans, soybean meal, livestock, livestock products, and frozen concentrated orange juice if the transaction is or is held out to be of the character of, or is commonly known to the trade as an 'option,' 'privilege,' 'indemnity,' 'bid,' 'offer,' 'put,' 'call,' 'advance guarantee,' or 'decline guarantee,' except as provided under §32.13 of the part."

The effect of Regulation 32.1(a), 17 C.F.R. §32.1(a), is to generally prohibit the offer or sale of commodity options except on designated contract markets. Commission Regulation 32.13, 17 C.F.R. §32.13, however, contains an exemption -- subject to a host of conditions -- from this ban for "trade options" on the agricultural commodities listed in Regulation 32.2. Trade options are off-exchange options "offered by a person having a reasonable basis to believe that the option is offered to" a person or entity within the categories of commercial users specified in the rule, where such commercial user "is offered or enters into the commodity option transaction solely for purposes related to its business as such." Regulation 32.4(a), 17 CFR §32.4(a). Few, if any, parties, however, have taken advantage of the exemption contained in Regulation 32.13. <u>See</u> <u>Trade Options</u>

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the POC only "obligates" Cargill to accept delivery when the market price equals or exceeds the strike price, it has the economic characteristics of an illegal call option.[16] Other factors such as the way the POC is priced also lead the Division

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on the Enumerated Agricultural Commodities, [1998-1999 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶27,738 at 48,470 (CFTC Aug. 31, 1999). Responding to concerns that the terms of the regulatory exemption were "too onerous, thereby discouraging participation" id., the Commission recently revised the exemption in the hope that the amendments would "increase the commercial utility of agricultural trade options while maintaining basic customer protections.". See Trade Options on the Enumerated Agricultural Commodities, [Current Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶27,918 at 48,872 (CFTC Dec. 6, 1999).

The Commission's current rule banning agricultural trade options has its remote origins in the Commodity Exchange Act of 1936. See Pub. L. No. 74-675, 49 Stat. 1491 (1936). In the 1936 Act, Congress responded to a history of large price movements and disruptions in the futures markets attributed to speculative trading in options, by completely prohibiting the offer or sale of options contracts then under regulation both on and off exchange. See H. Rep. No. 421, 74th Con., 1st Sess. 1, 2 (1934); H. Rep. No. 1551, 72 Cong. 1st Sess. 3 (1932). Although the statutory ban applicable to non-enumerated options was lifted in the Commodity Futures Trading Act of 1974, the prohibition on the offer or sale of enumerated agricultural options remained until 1982 when it was repealed as part of the Commission's reauthorization. See Public L. No. 97-444, 96 Stat. 2294, 2301 (1983). For a fuller statement of the rather complex statutory and regulatory history governing the offering and sale of options in general, and agricultural trade options in particular, see Trade Options on the Enumerated Agricultural Commodities, [1996-1998 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶27,178 at 45,594-95 (CFTC Nov. 4, 1997).

[16] See Complaint at ¶¶5, 9.

to that conclusion.[17] Accordingly, the Division wants the Court to prohibit Cargill from marketing the POC.[18]

On September 15, 1999, Cargill answered.[19] Although Cargill does not dispute the Division's understanding of the terms of the POC or how it is marketed, it denies that the POC operates as an option contract, and furthermore, asserts that its contract is a forward contract excluded from the Act's regulatory jurisdiction.[20]

After a brief and collegial period of discovery,[21] both parties submitted their prehearing memorandum, witness lists, proffered expert testimony, documentary evidence[22] and

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[17] Id. at ¶7.

[18] See Division of Enforcement's Post-Hearing Brief, dated September 8, 2000 ("Division's Post-Hearing Brief"), at 25-26. The Division also seeks the assessment of a token civil monetary penalty against Cargill ($110,000). Id. at 26-28.

[19] See Answer.

[20] Id. at 5-6. See also Cargill's Post-Hearing Memorandum, dated October 2, 2000 at 2 ("Rather than being disciplined, Cargill should be commended by the Commission for introducing an innovative forward contract that has benefited the farm community in times of low commodity prices.").

[21] See Tr. at 6, 350-51 (Court's comments commending counsel).

[22] See Division's Prehearing Memorandum, with Exhibits A-U; Cargill's Prehearing Memorandum, dated March 3, 2000, with Exhibits 1-11. The Court received all expert testimony and documentary submissions into evidence. See Order, dated April 17, 2000; Tr. at 6-7.

stipulations.[23] On July 24 and 25, 2000, the Court conducted a two-day hearing at the United States District Court for the Northern District of Illinois in Chicago, Illinois.[24] Both the Division and Cargill have filed their post-hearing briefs, making this matter ripe for decision.[25]

The Court's discussion below contains its factual findings and sets forth its reasons for concluding that Cargill's POC is not an option as that term "is commonly known to the trade," nor is it "of the character of" an option.[26] Rather, it is a forward contract excluded from the Commission's regulatory jurisdiction.[27] Accordingly, the Complaint is dismissed.

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[23] See Joint Stipulations. See also Tr. at 7.

[24] See Transcript of Proceedings, dated July 24-25, 2000; Notice of Change Of Hearing Site, dated June 26, 2000.

[25] See Division's Post-Hearing Brief; Division of Enforcement's Proposed Findings of Fact and Conclusions of Law, dated September 8, 2000; Cargill's Post-Hearing Memorandum.

[26] 7 U.S.C. §4c(b); 17 C.F.R. §32.2.

[27] See Sections 1a(11), 2(a)(1)(A), 4(a) of the Act, 7 U.S.C. §§1a(11), 2, 6(a).

Cargill has never offered the POC except as an addendum to the underlying contract, although there would appear to be no inherent reason why the POC could be not marketed on its own (just as restaurants sometimes decide to separately retail their recipes and cooking sauces). Thus, "with the lawyer's enthusiasm for technicalities," see Richard A. Posner, The Problems of Jurisprudence 400 (1990) ("Most laypeople believe this is the lawyer's *only* enthusiasm."), the parties have led themselves into

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<u>The Premium Offer Contract Is Not An Option And Is Not "Of The Character Of" One</u>

The POC Is Not An Option

The POC simply does not fit the trade definition of an option. As it is known in the trade, an "option" means an instrument that confers upon the holder the right, but not the

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a spirited debate over whether the underlying contract and the POC form one contract (Cargill's view, <u>see</u> Answer at 2) or two (the Division's view, <u>see</u> Division's Prehearing Memorandum at 12). This particular dispute leads nowhere.

The Division agrees with Cargill that the underlying contract, standing alone, is an unregulated, non-option, forward contract. <u>See</u> Division's Post-Hearing Brief at 16 (calling the underlying contract "a valid forward contract"). Therefore, the Division's case must rest on establishing that the POC is a separate contract that operates as an option, or in the alternative, that if the POC and underlying contract form one contract, the option portion of that contract renders the combined arrangement illegal. This line of argument attempts to show that the POC is not excluded from the regulatory provisions of the Act as a forward contract, either by itself or coupled with the underlying contract. <u>See</u> Division's Prehearing Memorandum at 6-7. Cargill, of course, disputes both theories. <u>See</u> Cargill's Prehearing Memorandum at 4-14.

Throughout this opinion, the Court assumes, <u>arguendo</u>, the Division's view that the POC by itself (that is, the addendum to the underlying contract) is a separate contract. Nonetheless, we find it to be a non-option, forward contract. Therefore, whether the underlying contract and POC are viewed as one or two contracts is not determinative of the issues in this case. If those contracts are separate, then neither is an option and both are forward contracts equally excluded from the Act. If they form one contract, then the result is one non-option, forward contract.

obligation, to buy (or sell) a specified amount of a commodity within a certain period of time at a given price.[28] In short, an option is something that is "optional."[29]

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[28] See Characteristics Distinguishing Cash and Forward Contracts and "Trade" Options ("1985 Interpretative Statement"), [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶22,718 at 31,027-28 (CFTC Sept. 30, 1985). (Although the 1985 Interpretative Statement was issued by the Commission's General Counsel, it has been consistently cited by both the Commission and the courts as persuasive authority on the topics that it addresses. See, e.g., Trade Options on the Enumerated Agricultural Commodities, ¶27,178 at 45,598; Statutory Interpretation Concerning Forward Transactions, [1990-1992 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶24,925 at 37,364 n.2 (CFTC Sept. 25, 1990); Regulation of Hybrid and Related Instruments, [1987-1990 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶23,995 at 34,492 n.18 (CFTC Dec. 11, 1987); Trading in Foreign Currencies for Future Delivery, [1984-1986 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶22,750 at 31,123 n.7 (CFTC Oct. 23, 1985); Lachmund v. ADM Investor Servs., 191 F.3d 777, 787 (7th Cir. 1999); Nagel v. ADM Investor Servs., 65 F. Supp.2d 740, 755 (N.D. Ill. 1999); MG Ref. & Mktg, Inc. v. Knight Enters., 25 F. Supp.2d 175, 181 (S.D.N.Y. 1998); The Andersons, Inc. v. Crotser, 7 F. Supp.2d 931, 934 (S.D. Mich. 1998); In re Grain Land Coop, 978 F. Supp. 1267, 1276 (D. Minn. 1997); In re Bybee, 975 F.2d 309, 313-314 (9th Cir. 1991); Transnor (Bermuda) Ltd. v. BP North Amer. Petroleum, 738 F. Supp. 1472, 1491 (S.D.N.Y 1990).). See also Salomon Forex, Inc. v. Tauber, 8 F.3d 966, 971 (4th Cir. 1993) (stating that options are defined by traditional contract principles); Yosha v. Commissioner, 861 F.2d 494, 496 (7th Cir. 1988) (Posner, J.); CFTC v. Crown Colony Commodity Options, Ltd., 434 F. Supp. 911, 913-14 (S.D.N.Y. 1977); The CFTC Glossary: A Layman's Guide To The Language Of The Futures Industry (1997) at 29 (defining "commodity option" as "a unilateral contract which gives the buyer the right to buy or sell a specified quantity of a commodity at a specific price within a specified period of time, regardless of the market price of that commodity").

[29] See Inman Examination at 63 (Inman defining an option as "[s]omething that the holder has the right but not the obligation to do, something that's optional").

Thus, the trade definition of an option excludes instruments such as the POC that obligate both parties and does not confer anything analogous to a "right" on either.[30] From the time that Cargill enters into a POC, it has no right or ability to control its performance under that contract. It cannot demand the producer's performance before the agreed upon strike date, and on that date, if the market price is above the strike price, it cannot allow the POC to lapse with the hope of gaining a lower price in the near future.[31] As a result, the POC lacks the fundamental characteristic of free choice that makes an option

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[30] Black's Law Dictionary defines a right as "taken in a concrete sense, a power, privilege, faculty, or demand, inherent in one person and incident upon another. Rights are defined generally as 'powers of free action.'" Black's Law Dictionary 1189 (1979) (cited by Stupak-Thrall v. United States, 89 F.3d 1269, 1285 (6th Cir. 1996)).

[31] Compare with the 1985 Interpretative Statement,

> "An option is necessarily a unilateral contract which binds the optionee to do nothing but grants him the right to accept or reject the offer in accordance with its terms within the time and manner specified in the option. The outstanding factor is that the optionee is not bound until he acts on the option one way or another."

1985 Interpretative Statement, ¶22,718 at 31,027 (emphasis added) (quoting In re Precious Metals Associates, Inc., [1977-1980 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶20,882 at 23,596 n.8 (CFTC Aug. 14, 1979)) (citing 1 Williston, Contracts §61B at 199-200 (3rd ed. 1957)).

optional. Unlike an option, the parties' performance under the POC is determined by market forces wholly beyond their control. Without the characteristic of choice or the ability to offset, Cargill cannot assure itself that it will only be obligated to take delivery when it is in its best interest.[32]

Finding that Cargill's POC is not an option -- as that term "is commonly known to the trade" -- does not, however, necessarily resolve the case in favor of its legality. After all, both the Act and the Commission's regulations generally ban

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[32] As the Commission has stated:

> "Much of the attractiveness and character of an option arises from the absence of any obligation on the part of the grantee to exercise the option and purchase or sell the underlying commodity or commodity futures contract, the attribute which limits risk to the purchase price of the option itself. This is consistent with the commonly accepted meaning of the word and recent judicial pronouncements."

Precious Metals Associates Inc., ¶20,882 at 23,596 (emphasis added) (citing CFTC v. British American Commodity Options Corp., [1977-1980 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶20,662 (S.D.N.Y. Aug. 31, 1978). See also British American Commodity Options Corp. v. Bagley, 552 F.2d 482, 484-5 & nn. 2-5 (2d Cir. 1977), cert. denied 434 U.S. 938 (1977); SEC v. Commodity Options Int'l, Inc., 553 F.2d 628, 629-31 (9th Cir. 1977); Ware v. Pearsons, 173 F. 878, 880-81 (8th Cir. 1909); CFTC v. U.S. Metals Depository, 468 F. Supp. 1149, 1154-1155 (S.D.N.Y. 1979); Crown Colony Commodity Options, 434 F. Supp. at 913-14; CFTC v. J.S. Love & Assocs. Options Ltd., 422 F. Supp. 652, 658-60 (S.D.N.Y. 1976).

agricultural instruments that are "of the character of" an option as well.[33]

The POC Is Not "Of The Character Of" An Option

What is -- or is not -- "of the character of" an option? Read broadly, this language could cover most any commodity contract that has elements that resemble those of an option. The Commission, however, has not given it such an expansive reading.[34] Instead, the Commission examines "the economic reality of the transaction" to determine if a particular instrument possesses characteristics that materially distinguish its operation and use from that of an option, for purposes of regulation.[35] To determine how the POC stacks up under this standard, we must first understand the regulatory purposes behind the general prohibition on agricultural trade options. The ban was perpetuated out of both a sense of paternalism and a concern about market failure: that is, that the marketing of options might lead to excessive risk-taking on the part of

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[33] See 7 U.S.C. §6c(b); 17 C.F.R. §32.2. See also Complaint at ¶16. The Division's expert concedes that the POC is not "a garden variety 'vanilla' call option." Pirrong Declaration at 16.

[34] See infra note 47.

[35] 1985 Interpretative Statement, ¶22,718 at 31,028 (quoting CFTC v. Precious Metals Assoc., 620 F.2d 900, 908 (1st Cir. 1980)).

unsophisticated individuals, a harm which would be exacerbated by the opportunities for fraud.[36]

The 1985 Interpretative Statement identifies three criteria indicative of an option. First, the instrument gives the buyer the right to take or make delivery of the commodity but does not obligate him to do so. Second, the buyer's losses are limited to a premium paid as consideration for the option seller's performance. Third, the instrument is purchased by offering a premium as opposed to a down payment on the eventual delivery

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[36] The Second Circuit explained it this way.

> "Options were an especially hospitable environment for abuse because a naked option could be created out of nothing, if the writer was willing to run the risk of not covering his obligation by acquiring an offsetting position in the futures market. Thus, entry into the business of options required little capital. In addition, options bear lower price tags than the futures contracts underlying them, so the options market may be peculiarly attractive to individual investors of relatively modest means and with a propensity for taking risks."

British American Commodity Options Corp, 552 F.2d at 485 (note omitted). See also U.S. Metals Depository Co., 468 F. Supp. at 1155 ("Since options are 'limited risk' investments the buyer is under no obligation to exercise his option and will, at most, lose the initial fee, they are attractive to unsophisticated investors; but options are subject to abuse because of their speculative nature and the tendency of sellers to downplay the 'limited profit' aspect (the nonrefundable fee).") (cited in the 1985 Interpretative Statement, ¶22,718 at 31,028.

price.[37] We will now evaluate the POC in light of these elements and the regulatory purposes underlying the Commission's option ban.

First of all, the POC does not give Cargill the right, but instead gives Cargill the obligation to take physical possession. The POC confers obligations on the producers as well: to make delivery. Therefore, the POC is not a unilateral contract. This determination as to the bilateral nature of the contract is in

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[37] The 1985 Interpretative Statement takes these three criteria from U.S. Metals Depository Co. See 1985 Interpretative Statement, ¶22,718 at 31,028.

> "Functionally, options are distinguishable from futures contracts and margin sales in at least three significant respects: (1) the initial charge for an option, sometimes called a 'contango fee,' is a nonrefundable premium covering the seller's commission and costs, in contrast to the 'down payment' paid in a futures contract or a margin sale, which is applied against the ultimate sale price; (2) the option contract gives the purchaser the right to take physical possession of the commodity but does not obligate him to do so, as a futures or margin contract would; (3) a profit in an option contract accrues only if the price of the commodity rises enough to cover the contango fee (but losses are limited to the contango fee), while the futures or margin buyer profits if the sale price of his right to future delivery exceeds the purchase price (and suffers a loss if the former price is less than the latter price)."

U.S. Metals Depository, 468 F. Supp. at 1155.

fact a simple one. But because the POC offers the illusion of complicating the inquiry with "conditional" obligations, the Court provides a more detailed analysis and explanation.

A unilateral contract is one in which only one party is obligated.[38] Under the POC, the parties will not have to perform unless the conditions are met. However, the conditional performance does not change the nature of the parties' obligations. Once the parties execute a POC, both are obligated under its terms. That is, both parties must prepare to perform should the price for grain reach the strike price.[39]

The conditional delivery terms of the POC only mean that the parties might not have to perform, it does not mean that both parties are not obligated to perform once they sign the contract.

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[38] See Black's Law Dictionary 294 (1979) defining unilateral contract as "one in which one party makes an express engagement or undertakes a performance without receiving in return any express engagement or promise of performance from the other." See also Hyatt v. Robb, 114 F.3d 708, 711 (8th Cir. 1997) ("A unilateral contract, by its very nature, is one where only one of the parties makes a promise; and the consideration for such a promise is not another promise, but performance . . . . A unilateral contract becomes enforceable upon performance, and the promisee is then entitled to his full bargain."); Precious Metals Associates Inc., ¶20,882 at 23,596 n.8.

[39] Cargill cites Woodbridge Place Apartments v. Washington Square Capital, Inc., 965 F.2d 1429, 1437 (7th Cir. 1992) to support the argument that the POC as a "conditional contract" obligates the parties bilaterally rather than unilaterally. See Cargill's Prehearing Memorandum at 7-8; Cargill's Post-Hearing Memorandum at 19.

Under the POC, neither party performs if the grain price does not hit the strike price and both parties perform if the grain price does reach the strike price. As result, Cargill and the producers must structure their affairs accordingly. Cargill is obligated to account for the probability (however high or low) that it will have to take the additional grain at the specified delivery locations and must allot storage space, shipping costs and potential end users accordingly. Likewise, the producer must allocate the agreed upon portion of grain from amounts that it sells under other contracts for futures commitments so that it may fulfill its contingent obligation. In fact, the contingencies and risks associated the POC are not fundamentally different than those associated with traditional bilateral forward contracts.[40]

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[40] Of course, the parties to the POC might chose to hedge their obligations as they might under similar forward contracts. Nothing in the POC keeps the producer from further reducing the price risk inherent in its cash crop and POC positions by acquiring positions in related futures and options markets.

The Court also notes that there are circumstances where the producer may choose to sell the crop committed to Cargill under the POC to someone else. If the price for grain is rapidly declining as the strike date approaches, the producer may arrange to sell its grain elsewhere, betting on the probability that the price will not hit the strike price. Similarly, if the market price soared above the strike, then the producer may choose to breach the contract by committing its grain elsewhere and paying damages to Cargill. Cargill too might chose to act differently depending on the probability of performance under the POC. But

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But is this really the case? The Division retorts that the differences between the POC and an option contract are more "illusion" than reality. The Division explains:

> "Cargill relies heavily on the POC language that if the futures price closes higher than or equal to the strike price at a specified date, the producer 'shall have the obligation to sell to Cargill and Cargill shall have the obligation to purchase' the specified amount of grain. Because Cargill is required to take delivery if the condition occurs, it asserts that its POC is a 'conditional contract rather than an option.'
>
> An analysis of Cargill's 'obligations' under the POC establishes that they are illusory . . . . Thus, the obligation that Cargill claims is enforceable by the option grantor (producer) is to require Cargill to take delivery when the futures price is at or above the strike price. Although delivery is purportedly mandated by the terms of the POC when the specified

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this does not change the fact that both parties are <u>obligated</u> to perform should the price hit the strike price on the strike date. If one party does not fulfill its obligations, then it would pay damages.

This is similar to how the parties would act under other forward contracts for which they have inescapable obligations to make and accept delivery, but conditions are such that delivery will be unlikely. For example, if Cargill entered into a contract that bound the producer to deliver a specified amount of grain and itself to accept that grain unless that grain were destroyed by drought, Cargill would plan its actions around the probability of drought. If drought conditions set in, then Cargill might not make all of the arrangements necessary to take delivery, expecting drought to destroy the crop. This does not mean that Cargill is not obligated to take delivery (and the producer is not obligated to deliver) if drought does not consume the crop, only that performance might not occur.

> conditions are met, Cargill has an economic incentive to take delivery under those circumstances, regardless of any mandate. When futures prices are above the strike price, the holder of the option (Cargill) would, at those times, have a profitable position and typically would want to exercise the option requiring the producer to deliver . . . .
>
> In sum, the underlying economic reality of Cargill's POCs is identical to that of prohibited off-exchange agricultural call options contracts. Cargill is motivated by a desire to limit its risk from future adverse price changes, and the producers are willing to give Cargill a firm offer to sell grain at a set price in exchange for a non-refundable premium. Moreover, by obligating delivery only if Cargill's cost is below market, the POC appears to have a primary purpose of protecting Cargill against adverse price changes. The limited risk aspect of the POC distinguishes it from the standard purpose contract Cargill enters into with the producer in which both parties have an obligation to perform and face the full risk of loss from adverse price changes."[41]

Thus, the Division argues that Cargill's obligations under the POC are bunk, since the POC serves to obligate only when the opportunity to take delivery is in-the-money thus benefiting Cargill. Another way of stating this argument is that the POC fails to distinguish itself from an option under the Commission's second criterion, because the POC effectively limits Cargill's losses to only its premium.[42]

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[41] Division's Prehearing Memorandum, at 15, 17 (citations to the record omitted).

[42] This factor gets at the heart of what an option is under the economic reality test:

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The Division's own expert, however, undermines its position. Dr. Pirrong explained that Cargill may lose more than its premium depending on when the producer decides to set the basis under the POC.[43] Again, the basis is the difference between the cash price at the contract's location for delivery and the reference futures

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

<u>1985 Interpretative Statement</u>, ¶22,718 at 31,028 (citing <u>Precious Metals Associates</u>, 620 F.2d at 908). <u>See also</u> <u>CFTC v. Morgan, Harris & Scott, Ltd</u>., 484 F. Supp. 669, 675 (S.D.N.Y. 1979).

[43] In his written testimony, Dr. Pirrong analyzed the payoffs of the POCs under two groupings: those in which the basis is set on the pricing date (basis to-be-determined) and those in which the producer has the discretion to set the basis at anytime prior to the pricing date (fixed basis). <u>See</u> Pirrong Declaration at 5-17. The evidence, however, supports a finding that Cargill marketed its POC almost exclusively on a fixed basis, permitting the basis to be set up to the date of delivery. <u>See</u> Tr. at 143-44 (Inman); Division's Prehearing Memorandum, Exhibit G (Cargill Promotional Brochure); Cargill's Prehearing Memorandum, Exhibit 11, Declaration of Vernon W. Pherson, dated Mar. 3, 2000 ("Pherson Declaration") at 5. Dr. Pherson testified as Cargill's economic expert. Dr. Pherson is a retired President of Comex Clearing Association, Inc. <u>See</u> <u>id.</u> at 1 & attached curriculum vitae.

price.[44] Under the POC, the basis is subtracted from the strike price and that final total is paid to the producer. But the POC allows the producer to lock in the basis price (which is subject to market fluctuation) on any day up until the date of delivery.[45] Thus, Cargill will lose money under the POC when the basis price selected by the producer is less than the basis on the date of delivery and that difference is greater than the difference between the market price and strike price. Dr. Pirrong describes this situation in the following example:

> "Consider a fixed basis corn POC with a strike price of $3.00 per bushel, and a basis fixed at $.30 per bushel under the March futures price . . . . [Assume that] the March futures price is $3.25 per bushel, but the basis is $.60 under the March futures price [on the pricing date]. Cargill is obligated to purchase corn under the contract, and pays the producer $2.70 per bushel. The firm receives corn that is worth only $2.65 (the futures price of $3.25 minus the current basis of $.60). This imposes a loss of $.05 per bushel on the firm. Thus, the firm would not buy corn under this scenario if it had the option to do so at the strike price and basis specified in the POC."[46]

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[44] See Pirrong Declaration at 5-6.

[45] See supra note 43.

[46] Pirrong Declaration at 11. See also Tr. at 68 (Pirrong).

Dr. Pirrong suggested that Cargill's aggregated basis risk may be "unimportant" (small) because he "sees no evidence that Cargill explicitly valued the conditional basis position" in the pricing of its POC. Pirrong Declaration at 15. To explain this conclusion, the Division sought, but failed, to adduce evidence that Cargill's basis risk was fully diversified and offset (in a (continued..)

Thus, Dr. Pirrong concedes that under some circumstances Cargill's losses are not limited to the premium.[47]

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static sense) due to the multiplicity of delivery locations called for in the contracts. See Tr. 173-177 (Inman); id. at 236 (Dines); id. at 333 (Pherson). Quite to the contrary, Cargill's basis risk can not be diversified, in the short run, since price movements are "strongly correlated" between Cargill's locations. Id. at 173 (Inman). It may well be that, in the long run, basis risk is offset by oscillating price movements occurring over a course of years (a point not explored at the hearing). But this tells us nothing about the unique nature of the POC. After all, in the long run, the price risk associated with the use of any financial instrument is offsetting. Moreover, there are other plausible explanations, besides "unimportance," for Cargill's failure to explicitly account for basis risk in either its pricing models or hedging activities. For example, the costs of developing a more precise pricing model for the POC to account for idiosyncratic price fluctuations in each delivery market could be cost prohibitive -- particularly given Cargill's limited experience with the contract. See Oliver E. Williamson, Economic Organization: Firms, Markets and Policy Control 106-113 (1986) (Reoccurrence in contractual relationships erodes opportunistic behavior, and leads to the development of efficient terms, including pricing, as the parties "consult their own experiences in deciding to continue the trading relationship.").

[47] The Division would minimize the significance of this result by "decomposing" the POC into two components. It repeats its expert's conclusion that the POC gives Cargill the economic equivalent of "a portfolio consisting of: 1) a futures call option with a strike price and expiration corresponding to the strike price and firm offer date specified in the POC, and 2) a conditional position in the basis." Division's Prehearing Memorandum at 16. See also Pirrong Declaration at 12. Thus, according to the Division, "[t]o the extent that Cargill loses money by exercising the call option, the loss results from the conditional position, not the call option." Division's Prehearing Memorandum at 16 (emphasis in the original). Here the Division's approach is tautological, not analytical. In effect, it simply defines away a difference between the POC and a call
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option, by identifying it as a separate element to be disregarded. The commercial reality is, however, that if Cargill takes possession of the commodity under the POC, it does so with all the risks appurtenant to possession, including basis risk. The Division's argument ignores the fact that the option and basis features of the POC are not separable from the conditional performance. The fact that Cargill only loses on the only terms of the POC that can ever be negative, does not show that the contract as a whole loses no more than the premium. The Court must interpret the contract as a whole, not individual portions piece by piece. See Mastrobuono. v. Shearson Lehman Hutton, Inc., 514 U.S. 52, 59 (1995)(quoting Restatement (Second) of Contracts §202(2) (1979)). The Division does not argue that Cargill marketed the option-like portions of the POC separately from the basis portions, nor does it argue how that would occur since basis is inextricably linked to an obligation to make or take delivery.

It is noteworthy that in evaluating other novel forward contracts, the Commission's staff has consistently declined to employ the Division's "decompositional" approach, instead evaluating the complete transaction. See 1985 Interpretative Statement, ¶22,718 at 31,029-31 (the Commission's General Counsel finds minimum price contacts to be forward and spot contracts even though they each contained the element of a "cash settled put option"); Minimum Price Guarantee Contracts 1989 CFTC Ltr. Lexis 4, at *7 (May 19, 1989) (the Commission's General Counsel viewed minimum price contract as being within the forward contract exclusion where the contract contained elements equivalent to two put options); CFTC Interpretative Letter No. 96-23, [1994-1996 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶26,646 at 43,697-98 (CFTC Mar. 14, 1996) (Commission's Division of Economic Analysis considering contract "in its entirely," regarded "producer option contract" as a forward contract, although it contained provisions whereby the elevator buys an exchange-traded call option for the benefit of the producer); CFTC Interpretative Letter No. 98-13, [1996-1998 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶27,264 at 46,152-53 (CFTC Dec. 3, 1997) (Division of Economic Analysis viewed contract that establishes a minimum and maximum price and "includes characteristics of an option" to be a forward contract "based upon the nature of the instrument as a whole").

In addition to the losing situation described above, the POC's inescapable delivery obligations -- contingent as they may be -- subject Cargill to other risks associated with actually taking delivery of a commodity, including risks from post-delivery price fluctuations.

Cargill's expert, Dr. Pherson, describes one such situation in which Cargill would stand to lose more than its premium. For example, if Cargill owns an option and anticipates that the price for grain will drop below the strike price after the day it is obligated to take delivery, it would forgo its option to buy and hope to buy cheaper grain on the spot market.[48] Although the Division's expert, Dr. Pirrong, failed to address this scenario in his direct written testimony, under cross-examination, he

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[48] See Pherson Declaration at 7. As Cargill established, there are times when an option holder chooses not to exercise an in-the-money option or chooses to exercise an out-of-the-money option. As Cargill's Trading Manager in the Commodity Risks Management Product Department, Jeffrey Seeley, explained, under different Chicago Board of Trade ("CBOT") contracts "holders of options will override the standard contract terms which will automatically exercise any option that's in-the-money and/or leave unexercised any option that is not in-the-money." Tr. at 246, 248. See also Cargill's Prehearing Memorandum, Exhibit 10 (CBOT data). Although some of those instances may have been mistakes, Cargill succeeded in identifying options in which over one-half of the in-the-money option holders chose to override the automatic exercise of their option, thereby abandoning them. See Tr. at 296-97 (Seeley). Indeed, the risk that a party will chose to abandon an in-the-money option or exercise an out-of-the money option is common enough to have its own trade term: "Pin Risk." Id. at 298.

acknowledged its existence.[49] In contrast, under the POC, Cargill is obligated to take delivery under the same circumstances, despite anticipated post-delivery price fluctuations.[50]

Moreover, there are other obvious commercial reasons why Cargill might not want the grain on the pricing day, even if the market price exceeds the strike price. Cargill might not have the requisite storage space to take delivery at that location and the cost of obtaining additional storage space may outweigh the benefit of taking the grain.[51] Alternatively, Cargill may not

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[49] Dr. Pirrong conceded that there are rational reasons to exercise an out-of-the-money option, and reasons that one may abandon an in-the-money option. _See_ Tr. at 77-80.

[50] This of course further undercuts Dr. Pirrong's conclusion that Cargill does not _really_ lose more than its premium because any other losses are caused by the conditional nature of the basis -- not Cargill's delivery obligations under the contract. _See supra_ note 47.

[51] This outcome would not necessarily be wholly (or even partially) captured in the basis loss adjustment. Basis loss, after all, is a reflection of the _average_ storage and delivery costs currently prevailing within a localized market. Such a measure does not, however, reflect the reality that a _particular_ firm can suffer unique setbacks that are not systematically borne by other firms in the narrowly defined market. _See_ Richard Brealey and Stewart Meyers, _Principles of Corporate Finance_ 153-156 (5th ed. 1996). For example, Cargill could encounter higher than average storage costs due to unforeseen facility breakdowns, mismanagement of reserve capacities, or the untimely default of manufacturers. Likewise, a firm employing a unique technology (where the term "technology" refers to the particular combination of raw materials, capital assets and labor inputs that a firm

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wish to take delivery because of its own transportation difficulties dealing with unforeseen railway disputes or fuel shortages.[52] All of these losses are related to the risks of actually taking the grain and -- since an option holder normally does not take delivery.[53] -- further differentiate the POC from an instrument of the character of an option. Cargill loses when it is forced to take grain but will not be able to sell it elsewhere at a higher price -- losses that could far exceed those reflected in the premium alone.

Among the reasons for regulating options trading in the first place was the fact that they were financial instruments

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uses to complete a task) can find itself (and its production costs) disproportionately vulnerable -- relative to other players in the market -- to a specific type of systematic shock. See Williamson, supra note 46, at 108-110. For example, a firm which relies more heavily on automated capital assets, would find itself in a relatively worse position if the cost of manual labor drops.

[52] See supra note 51.

[53] See British American Commodity Options Corp, 552 F.2d at 485 ("Exercising the option means buying the underlying futures contract. Since the customer normally has no interest in actually receiving the commodity on the delivery date, the clearing member then sells a futures contract short for the customer. The difference between the price at which the option is exercised plus the cost of purchasing the option (premium and commission) and the price at which the futures contract is sold is the customer's profit.").

entered into by parties who did not bear the risks of actually producing and using the grain.[54] The POC is far removed from the Commission's concerns about naked options speculation supported by boiler rooms. The POC is a grain marketing instrument negotiated between commercial parties for a commercial purpose. As we have seen, the POC differs from commodity options contracts because it is not merely a financial instrument that, if exercised, results in the buyer realizing profits, by offsetting transactions, equal to the difference between the strike price and the market price. The POCs are individually negotiated and require custom quantities and qualities of grain that can not be offset (although, like any financial instrument, they can be hedged). The contract gives neither Cargill nor the producer the ability to cancel, roll forward or otherwise effect this delivery obligation.[55] This difference is fundamental. Even if the conditions for delivery are met under a POC, Cargill's profit (if any) is only realized when it sells the grain to a third party.[56]

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[54] Id.

[55] See Inman Examination at 55.

[56] Id. at 66 ("The risks are essentially the same in any kind of grain purchase we make. We have the risk of not being able to sell it for something more than we paid for it.").

After of all of this, what is left of the Division's case that the POC is an option or "of the character of" one? Not much. It is true that Cargill pays the producer a premium to enter into a POC.[57] This is a necessary condition of an option, and is set forth as the third factor in the 1985 Interpretative Statement for assessing the character of an instrument.[58] It is a necessary condition because the payment of a premium is what makes an option enforceable: the buyer of an option contract typically gives money (and only money) as consideration for the seller's obligation to perform.[59] However, Cargill supplies more than the premium for the producer's obligation under the POC. Unlike an option, Cargill supplies consideration in addition to the premium by obligating itself to take delivery under certain conditions. Therefore, while a premium is involved, it is not the only consideration that makes a POC an enforceable contract.

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[57] Cargill admits that it pays producers a premium in exchange for their obligation to deliver the additional bushels. Joint Stipulations at ¶5.

[58] See 1985 Interpretative Statement, ¶22,718 at 31,028.

[59] See Doctor's Assocs. v. Distajo, 66 F.3d 438, 451 (2d Cir. 1995) ("Option contracts, for example, are unquestionably valid under this modern rule despite their lack of 'mutuality of obligation.' That is, one party's promise to honor a future offer to purchase an item is valid if supported by the other party's present payment of a sum of money."). See also Tauber, 8 F.3d at 971; Reinach v. Commissioner, 373 F.2d 900, 901 (2d Cir. 1967).

As the above analysis suggests, the payment of a premium is not a sufficient condition of an option. Premiums are present in many types of contracts that are not considered options. For example, under Cargill's crop failure protection contract, the farmer pays Cargill a premium for the option to cancel its delivery obligation in the event of crop failure.[60] Also, premiums are involved in Cargill's minimum price contracts and minimum-maximum price contracts,[61] neither of which has been regarded as subject to the Act as an option.[62]

The Division draws the Court's attention to other traits shared by the POC and options, in the hopes of tagging the former with the labeling of the latter. In this regard, the Division's expert, Dr. Pirrong, addressed the "asymmetric nature" of the option payoff.

> "A key feature of options is the asymmetric nature of the payoff at expiration. That is, the seller of an option faces unlimited downside risk, but his profit is no larger than the premium collected at the sale of the option. Similarly, the buyer of an option has unlimited upside potential, but can suffer a loss no greater than the premium he originally pays."[63]

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[60] See White Examination at 24-25.

[61] See Tr. at 41-43 (Pirrong); id. at 223-24 (Dines).

[62] See supra note 47.

[63] Pirrong Declaration at 5. See also Division's Post-Hearing Brief at 7; Division's Prehearing Memorandum at 6.

It is true that the risks undertaken by the parties to a POC are not perfectly symmetrical (although, as we have seen, they differ from an option). The POC's risks remain asymmetrical in the sense that Cargill's potential loss is limited (to its premium and the price of the delivered crop), while its potential for gain is, at least theoretically, unlimited (the market price for delivered crop minus the strike price). Conversely, the producer's potential for gain is limited to the premium, while its potential lost opportunity to sell the grain at a higher strike price is unbounded. Stated in terms of unlimited risk, under the POC, the producer faces unlimited downside risk because its earnings (aside from the premium) may only be as great as the strike price, and Cargill faces unlimited upside risk because it captures any difference between the strike price and the market price. What the Division's expert first fails to mention is that many non-regulated instruments share these risk elements, including all plain vanilla fixed price forward contracts.[64] Moreover, it is misleading to examine these risk elements without regard to the commercial context.

In a fixed price term forward contract, the producer agrees to sell to the elevator grain at a definite price without regard

[64] See Tr. at 54-56 (Pirrong).

to the prevailing market price on the day of delivery.[65] Thus, the producer's profits are capped by the fixed price term and the buyer captures all profits above that price. Under such a contract, the elevator would capture any profits above the fixed price (subject to its hedges) and the producer (hedged by its crop) is protected from any losses from a drop in market prices. This contract (like all freely entered and fully informed transactions) presumably benefits both parties: in this case, by reducing overall price risk.

The POC works in the same way.[66] The producer faces less risk because it is assured of the premium regardless of

[65] See Inman Examination at 18.

[66] Indeed, the Division's expert readily admits to the commercial utility of this contract for both parties.

> The Court: "[C]ould you theorize as to why Cargill would keep offering this [POC] contract?"
>
> Pirrong: "Well, again, presumably that this, they're getting something in return. They're giving up a cash payment and, again, the appropriate, the appropriate time frame to evaluate the rationality of their decision is not ex post but ex ante. So, from an ex ante perspective presumably buyer and seller are both satisfied with the transaction. Ex post as it's turned out, the farmers have achieved a benefit and Cargill has not. Although I should note to the extent that the, that Cargill hedges the risk in these

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performance[67] and a fixed price for its grain should delivery occur.[68] Cargill faces less risk because it protects its supply and its costs against the possibility of skyrocketing prices.[69]

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> transactions. You know, that has some effect on their payoffs as well."

Tr. at 128. See also infra note 134.

[67] The premium may be regarded as the producer's capitalization of the expected profits above the strike price, creating more certain payoffs to the producer. See Tr. at 126-27 (Pirrong)

[68] Id. at 127-128 (Pirrong).

[69] Id. at 125 (Pirrong).

The Division's expert directs the Court's attention to another trait shared by the POC and the typical exchange-traded option: they are both priced by use of the Black-Scholes pricing model. See Division's Post-Hearing Brief at 7, 9. See also Pirrong Declaration at 10. But this trait too is similarly shared by all sorts of financial instruments.

The Black-Scholes model revolutionized the options market in 1973 by providing an accurate method for pricing options. See Henry T.C. Hu, Misunderstood Derivatives: The Causes of Informational Failure and the Promise of Regulatory Incrementalism, 102 Yale L.J. 1457, 1474 (1993). However, since that time, the Black-Scholes model has been applied outside of the options market to price other instruments such as over-the-counter derivatives, warrants, pricing swaps and other unregulated devices. Id. Cf. Jason D. Gordon, Robert T. Ladd and Arthur Anderson, Black-Scholes: A Claimant's Tool for Valuing Recovery in a Plan of Reorganization, Am. Bankr. Inst. J., Nov. 1998, at 14. Indeed, Dr. Pirrong readily admitted to the diverse uses of the Black-Scholes model beyond options. See Tr. at 125 ("I've even seen people use the model to price what an electricity plant is worth.").

Lastly, the Division points to the price contingency of the delivery obligations as a key feature of an option.[70] In this regard, the Division's expert opined:

> "Another key feature of options is that ownership of the asset or commodity is not transferred from the call seller to the call buyer under all circumstances. Instead, delivery is price contingent; delivery occurs if the underlying price at expiry exceeds the strike price, and does not occur if the underlying price at expiry is below the strike price."[71]

As previously discussed, the "conditional" nature of the POC does not make it per se "of the character of" an option, since every contract is in some sense conditional.[72] We will now elaborate further.

Fundamentally, all contracts are contingent -- contingent upon performance. In any contract it may be in a party's best interest to forgo performance and instead pay damages. In fact, in most instances, the law encourages this.[73] As Chief Judge Posner has observed "it is not the policy of the law to compel

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[70] See Division's Post-Hearing Brief at 7.

[71] Pirrong Declaration at 5.

[72] See supra note 40 & accompanying text.

[73] The exception is when a court decrees specific performance. See Richard A. Posner, Economic Analysis of Law 130 (4th ed. 1992).

adherence to contracts but only to require each party to choose between performing in accordance with the contract and compensating the other party for any injury resulting from a failure to perform."[74]

The 1985 Interpretative Statement recognizes this attribute of contracts, and expressly reasons that the placement of conditions on the performance of a forward contract does not necessarily change its character to that of an option -- at least as long as those conditions are beyond the parties' control (as is the case with the POC).

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

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[74] Id. at 118. See also Oliver Wendell Holmes, The Path of the Law, 10 Harv. L. Rev. 457, 462 (1897) ("The duty to keep a contract at common law means a prediction that you must pay damages if you do not keep it -- nothing else."); Nagel v. ADM Investor Servs., 65 F. Supp.2d 740, 748 (N.D. Ill. 1999) (Easterbrook, J., sitting by designation) ("all a contract does is oblige the parties to perform or pay"), aff'd Nagel v. ADM Investor Servs., 217 F.3d 436 (7th Cir. 2000)) ("Nagel II").

> of such clauses in a contract does not change the analysis of the nature of the contract"[75]

Under the POC, if the price conditions are met, delivery is intended.[76]

To sum up, the POC is not an option, and is not "of the character of" one. It obligates both parties, not one, to deliver and accept grain. As a consequence, it places Cargill at risk for commercial loss in excess of the premium it pays to producers under the contract. While the POC does share some similarities with options, in terms of pricing, premiums, contingencies and payoff patterns, these are weak indicia of the nature of the contract, since these features are shared by other instruments, including some forward contracts.

Most importantly, the POC is -- at its economic heart -- an individually negotiated merchandising contract which reduces overall commercial price risk to both parties. Unlike exchange-traded options, it is not an instrument conducive to speculative trading. For these reasons, as discussed below, the POC is a forward contract, and as such, is excluded from the Commission's regulatory jurisdiction.

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[75] 1985 Interpretative Statement, ¶22,718 at 31,029 n.35 (emphasis added).

[76] *See infra* notes 119-120 & accompanying text.

The Premium Offer Contract Is A Forward Contract

"Futures" Versus "Forwards"?

Cargill raises an affirmative defense wholly separate from the issue of whether the POC constitutes an option. It claims that the POC is a forward contract excluded from the regulatory jurisdiction of the Act.[77] The Court agrees.

With certain exceptions not relevant here, the Act confers exclusive jurisdiction on the Commission to regulate transactions involving "contracts of sale of a commodity for future delivery,"[78] and prohibits such transactions unless they are conducted on or subject to the rules of a board of trade designated by the Commission as a "contract market."[79] However, the Act excludes from the definition of "future delivery" any "sale of any cash commodity for deferred shipment or delivery."[80] Thus, contracts for the sale of a cash commodity for deferred shipment or delivery -- commonly known as "cash forward contracts" or simply "forward contracts" -- are excluded from regulation under the Act, while contracts for "future delivery"

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[77] Answer at 5-6.

[78] 7 U.S.C. §2.

[79] 7 U.S.C. §6(a).

[80] 7 U.S.C. §1a(11).

are not. The Act itself provides no further discussion of this less than self-evident distinction, so we look to the case law and agency interpretation for guidance.

The Multi-Factor Approach

The underlying purpose of the forward contract exclusion and the distinctions between forwards and futures are explained in this often cited Fourth Circuit passage:

> "Because the Act was aimed at manipulation, speculation, and other abuses that could arise from the trading in futures contracts and options, as distinguished from the commodity itself, Congress never purported to regulate 'spot' transactions (transactions for the immediate sale and delivery of a commodity) or "cash forward" transactions (in which the commodity is presently sold but its delivery is, by agreement, delayed or deferred). Thus §2(a)(1)(A) of the Act, 7 U.S.C. §2, provides that 'futures' regulated by the Act do not include transactions involving actual physical delivery of the commodity, even on a deferred basis. Transactions in the commodity itself which anticipate actual delivery did not present the same opportunities for speculation, manipulation, and outright wagering that trading in futures and options presented. From the beginning, the [Act] thus regulated transactions involving the purchase or sale of a commodity 'for future delivery' but excluded transactions involving 'any sale of any cash commodity for deferred shipment or delivery.' 7 U.S.C. §2. The distinction, though semantically subtle, is what the trade refers to as the difference between 'futures,' which generally are regulated, and 'cash forwards' or 'forwards,' which are not . . . .
>
> A 'futures contract,' or 'future,' never precisely defined by statute, nevertheless has an accepted meaning which brings it within the scope of

transactions historically sought to be regulated by the [Act].

It is generally understood to be an executory, mutually binding agreement providing for the future delivery of a commodity on a date certain where the grade, quantity, and price at the time of delivery are fixed. To facilitate the development of a liquid market in these transactions, these contracts are standardized and transferable. Trading in futures seldom results in physical delivery of the subject commodity, since the obligations are often extinguished by offsetting transactions that produce a net profit or loss. The main purpose realized by entering into futures transactions is to transfer price risks from suppliers, processors and distributors (hedgers) to those more willing to take the risk (speculators). Since the prices of futures are contingent on the vagaries of both the production of the commodity and the economics of the marketplace, they are particularly susceptible to manipulation and excessive speculation.

In contrast to the fungible quality of futures, cash forwards are generally individually negotiated sales of commodities between principals in which actual delivery of the commodity is anticipated, but is deferred for reasons of commercial convenience or necessity. These contracts are not readily transferable and therefore are usually entered into between parties able to make and receive physical delivery of the subject goods."[81]

The Commission and courts cases distinguishing "deferred" cash contracts from "futures" contracts generally instruct that the determination requires a full assessment of the transaction

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[81] Tauber, 8 F.3d at 970-71 (note omitted). Other Courts of Appeals have recently cited this passage. See Grain Land Coop. v. Kar Kim Farms, Inc., 199 F.3d 983, 991 (8th Cir. 1999); Lachmund v. ADM Investor Servs., 191 F.3d 777, 786 (7th Cir. 1999); The Andersons, Inc. v. Horton Farms, Inc., 166 F.3d 308, 318 (6th Cir. 1998).

as a whole, with a critical eye toward its underlying purpose, overall effect and the parties' intent.[82] To this end, we are provided with a laundry list of characteristics or factors which are to provide only some guidance in this assessment -- for the list is neither exhaustive nor definitive.[83] Those distinguishing characteristics suggestive of a forward contract include:

> (1) If the contract was 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;

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[82] See Statutory Interpretation Concerning Forward Transactions ("1990 Statutory Interpretation"), [1990-1992 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶24,925 at 37,366 (CFTC Sept. 25, 1990).

[83] The Commission has stated that:

> "The question of whether a transaction is a 'contract of sale of a commodity for future delivery,' 'a spot transaction,' or a 'cash forward' depends on the facts and particular circumstances of each case. The Act does not define 'futures contract.' Indeed, there is 'no bright-line definition or list of characteristics' which determines what constitutes a futures contract; instead, 'the transaction must be viewed as a whole with a critical eye toward its underlying purpose.'"

Motzek v. Monex Int'l Ltd., [1992-1994 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶26,095 at 41,625-26 (CFTC June 1, 1994) (note omitted) (citing CFTC v. CoPetro Mktg Group, Inc., 680 F.2d 573, 581 (9th Cir. 1982)). See also Haekel v. Refco, Inc., No. 93-R109, slip op. at 8 (CFTC Sept. 29, 2000) (citing Motzek, ¶26,095 at 41,625-26).

(2) If the contract was entered to shift future price risks incident to commercial operations and other forward commitments;

(3) If the counterparties have the capacity to make or take delivery;

(4) If the contract was an individually and privately negotiated principal-to-principal transaction;

(5) If the contract could not be assigned without the consent of the parties, and did not provide for exchange-style offset;

(6) If the contract was not subject to variation margining or to clearinghouse and settlement systems; and

(7) If the contract was entered into "with the expectation that delivery of the actual commodity will eventually occur through performance on the contract."[84]

First a word (actually more than a word) about this "multi-factor approach," before we proceed to apply it. Although the Commission recognizes that the approach's "holism" lacks clarity in application, it has continued (as recently as September 2000) to steadfastly defend it.[85] The resulting uncertainty of the

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[84] See 1990 Statutory Interpretation, ¶24,925 at 37,367-68.

[85] See Haekel, No. 93-R109, slip op. at 8 ("The fact that this holistic approach is somewhat imprecise and often raises difficult issues of interpretation does not justify elevating form over substance."). See also Motzek, ¶26,095 at 41,626.

In another context, Chief Judge Posner has described the holistic approach as "a visceral mixing of incommensurables." See Posner, supra note 27, at 447. See also In re Dixon, [Current Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶28,111 at 49,774-76 (CFTC Apr. 12, 2000) (discussing the shortcomings of the (continued..)

approach leaves in question the enforceability of all new contracts not specifically approved, thus increasing the costs of experimentation. This is something more than an academic concern.

The recent waive of lawsuits arising out of Hedge-To-Arrive ("HTA") contracts demonstrates the high costs associated with experimenting under the uncertain law surrounding the forward contract exclusion. Over the last few years, producers who entered into HTA contracts have attempted to eliminate their obligations under these contracts by claiming that they are unenforceable as unregulated futures contracts in violation of the Act.[86] Although the courts have been thwarting the producers' opportunistic behavior,[87] the social costs associated with the commercial disruption and the eruption of litigation spawned by the producers' efforts are unrecoverable.

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Commission's holistic approach to the assessment of civil monetary penalties); Palomares v. Bradshaw, [Current Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶28,268 at 50,634 n.115 (CFTC Oct. 2, 2000) (discussing the shortcomings of the Commission's holistic approach to the determination of agency).

[86] See Edward M. Mansfield, Texualism Gone Astray: A Reply to Norris, Davison, and May on Hedge to Arrive Contracts, 47 Drake L. Rev. 745, 754 (1999).

[87] See Nagel, 65 F. Supp.2d at 743-44 (collecting cases).

The HTA lesson has prompted some harsh criticism of the Commission's approach to distinguishing forwards from futures,[88] and not just from the commentators. Although the courts have generally continued to employ the "multi-factor approach,"[89] it has met with pointed criticism (and in one case, rejection) in the Seventh Circuit.

In Nagel, Judge Easterbrook, sitting be designation as a district judge, rejected the popular multi-factor approach to distinguishing forwards from futures. In the context of examining HTA contracts, he wrote:

> "[T]he multi-factor balancing approach . . . produces undesirable uncertainty -- as the CFTC's tergiversation about flex HTA contracts demonstrates. 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 futures or a forward contract depending on whether the person obliged to deliver keeps his

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[88] See Jerry W. Markham, Regulation of Hybrid Instruments under the Commodity Exchange Act: A Call for Alternatives, 1990 Colum. Bus. L. Rev. 1, 21.

[89] See Grain Land Coop., 199 F.3d at 991; Lachmund, 191 F.3d at 787; Andersons, 166 F.3d at 319-21.

> promise? Then the flex HTA agreements for soybeans in 1995 would be forward contracts, while the identically worded flex HTA contracts for corn would be futures contracts; the only difference would be that after the contracts were signed the price of corn rose and farmers elected to defer, while the price of soybeans did not and farmers elected to deliver. Such uncertainty is the worst possible outcome: it puts the grain elevators at the farmers' mercy (for if prices are stable or fall farmers deliver and keep the profit, while if prices rise the contracts become illegal) and effectively kills the market for forward contracts."[90]

Opting out of the multi-factor test, Judge Easterbrook articulates a new method of distinguishing between forward and futures contracts, that is simple, clear and predictable. It relies on the plain language of the Act's Section 1a(11) forward contract exclusion. In this regard, Judge Easterbrook notes that the plain language does not emphasize delivery as a distinguishing factor between these contracts; in fact, Section 1a(11) indicates that delivery is an attribute of both forwards and futures. Rather, the plain language of the exclusion distinguishes between the <u>sale of the underlying commodity</u> in a forward contract and the <u>sale of a contract</u> in a futures

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[90] <u>Nagel</u>, 65 F. Supp.2d at 752 (emphasis added). <u>See</u> Juliet P. Kostritsky, <u>Illegal Contracts and Efficient Deterrence: A Study in Modern Contract Theory</u>, 74 Iowa L. Rev. 115, 116 (1998). In our own case, can there be any doubt that, if under the POC, prices had shot well beyond the strike price, the producers would have claimed illegality and unenforceability of the contract to likewise exploit the ambiguity in the law?

contract. Therefore, he asserts that the proper distinction between futures and forward contracts should revolve around whether the contract involves the sale of an underlying commodity (forward) or simply the sale of a contract itself (futures).[91]

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[91] As explained by Judge Easterbrook:

> "To separate futures from forwards it is necessary to recall the text of §1a(11): 'The term "future delivery" does not include any sale of any cash commodity for deferred shipment or delivery.' This language departs from the definition of a futures contract by emphasizing sale for deferred delivery. A futures contract, by contrast, does not involve a sale of the commodity. It involves a sale of the contract. In a futures market, trade is 'in the contract.'
>
> In futures markets, people buy and sell contracts, not commodities. Terms are standardized, and each party's obligation runs to an intermediary, the clearing corporation. Clearinghouses eliminate counterparty credit risk. Standard terms and an absence of counterparty-specific risk make the contracts fungible, which in turn makes it possible to close a position by buying an offsetting contract. All contracts that expire in a given month are identical; each calls for delivery of the same commodity in the same place on the same day. Forward contracts under §1a(11), by contrast, call for sale of the commodity; no one deals 'in the contract'; it is not possible to close a position by buying an offsetting position, because there are no fungible promises; delivery is idiosyncratic rather than centralized. CoPetro, the case that invented the multi-factor approach, dealt with a fungible contract and trading did occur 'in

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In his affirming opinion, Chief Judge Posner joined with Judge Easterbrook in agreeing that:

> "[T]he 'totality of the circumstances' approach invites criticism as placing a cloud over forward contracts by placing them at risk of being reclassified as futures contracts traded off-exchange and therefore illegal. Of course, if the illegality of a contract cannot easily be determined in advance, that might be a factor rebutting the presumption noted earlier that illegal contracts are unenforceable."[92]

Although declining the invitation to ditch the multi-factor test completely, Chief Judge Posner responded to the test's weakness by collapsing it (for the most part) into a handful of objective and readily ascertainable circumstances.[93]

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> the contract.' That should have been enough to resolve the case."

Nagel, 65 F. Supp.2d at 751-52 (emphasis in original, citations omitted).

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

[93] Chief Judge Posner's test specifies only three factors:

> "[W]hen the following circumstances are present, the contract will be deemed a forward contract:
>
> (1) The contract specifies idiosyncratic terms regarding place of delivery, quantity, or other terms, and is not so fungible with other contracts for sale of the commodity, as securities are

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> fungible. But there is an exception for the case in which the seller of the contract promises to sell another contract against which the buyer can offset the first contract, as in In re Bybee, 945 F.2d 309, 313 (9th Cir. 1991), and CFTC v. CoPetro Mktg Group Inc., 680 F.2d at 580. That promise could create a futures contract.
>
> (2) The contract is between industry participants, such as farmers and grain merchants, rather than the arbitrageurs and other speculators who are interested in transacting in contracts rather than actual commodities.
>
> (3) Delivery cannot be deferred forever, because the contract requires the farmer to pay an additional charge every time he rolls the hedge.
>
> As long as all three features that we have identified are present, eventual delivery is reasonably assured, unlike the case of a futures contract -- and remember that the Commodity Exchange Act is explicit that a contract for delivery in the future is not a futures contract. If one or more of the features is absent, the contracts may or may not be futures contracts."

Id. (citations omitted).

Note that Chief Judge Posner's test does not eliminate all uncertainty associated with a "totality of the circumstances" approach. Although, his test is adequate for prospectively addressing the legality of the type of contact at issue in Nagel (HTAs), it is less so in addressing the legality of the type of contract before this Court (POCs).

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Placing these criticisms of the Commission's approach to the side, we now turn to our assessment of the POC.

Applying The Multi-Factor Approach

As already discussed, under the "totality of the circumstances" approach, no feature standing alone is determinative of the nature of the instrument. The Division ignores this precept, however, by arguing that the contingent delivery requirement of the POC alone transforms what would otherwise be a forward contract into something else.[94]

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> "This refinement of the 'totality of the circumstances"' approach that we adopt today, while it will not resolve every case, will protect forward contracts from the sword of Damocles that these plaintiffs would wish to wave about the defendants' heads, yet at the same time will prevent evasion of the Commodity Exchange Act by mere clever draftsmanship."

Id.

[94] Remember, the Division acknowledges that Cargill's underlying contract is a forward contract. See Division's Post-Hearing Brief at 16. The only difference between the underlying contract and the POC is the latter's price contingency. Id. at 16-18. (This section of the Division's brief is entitled "Because delivery under the POC is price contingent and not mandatory, the POC does not fall within the protection of a cash forward contract as defined by legal precedent.").

Whether the parties and the contract anticipate delivery has long been recognized as a general difference between futures and forwards.[95] Under the POC, delivery is in fact almost certain to

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[95] For example, the 1985 Interpretative Statement states that to be a forward contract:

> "First, the contract must be a binding agreement on both parties to the contract: one must agree to make delivery and the other to take delivery of the commodity. Second, because forward contracts are commercial, merchandizing transactions which result in delivery, the courts and the Commission have looked for evidence of the transactions' use in commerce. Thus, the courts and the Commission have examined whether the parties to the contracts are commercial entities that have the capacity to make or take delivery and whether delivery, in fact, routinely occurs under such contracts."

1985 Interpretative Statement, ¶22,718 at 31,026 (citations omitted). See also Grain Land Coop., 199 F.3d at 990 ("Thus, it is the contemplation of physical delivery of the subject commodity that is the hallmark of an unregulated cash-forward contract"); Lachmund, 191 F.3d at 787-88 ("both courts and the Commission have required that the contract's terms and the parties' practice under the contract indicate that both the buyer and seller deal in and contemplate future delivery of the actual commodity") (internal quotation marks and citation omitted); Andersons, 166 F.3d at 318 ("in determining whether a particular commodities contract falls within the cash forward exception, courts must focus on whether there is a legitimate expectation that physical delivery of the actual commodity by the seller to the original contracting buyer will occur in the future."); CFTC v. Noble Metals Int'l., Inc., 67 F.3d 766, 772 (9th Cir. 1995); Oeltjenbrun v. CSA Investors, Inc., 3 F. Supp. 2d 1024, 1039-40 (N.D. Iowa 1998); CoPetro, 680 F.2d at 578 ("Most importantly, both parties to the contracts deal in and contemplate future delivery of the actual grain."); Bybee, 975 F.2d at 313-314; In re Stovall, [1977-1980 Transfer Binder] Comm. Fut. L. Rep. (CCH)

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occur, albeit infrequently.[96] Occasional delivery, however, is a feature common to all futures and forwards contracts.[97] Therefore, the Division seems to be suggesting the following

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¶20,941 at 23,778 (CFTC Dec. 6, 1979) ("the desire to acquire or dispose of a physical commodity is the underlying motivation for entering such a contract").

[96] The Division's expert testified that the most of the POCs that he examined were written to be "deep-out-of-the money." That is, the strike price was set such that the probability of the futures price rising above the strike price by the pricing date for any given contract was low. See Pirrong Declaration at 19-20. He confirms this observation with the fact that to date the POCs' price conditions have never been triggered so as to require delivery. Id. at 20.

Although in some cases, a history of non-delivery would tend to demonstrate that the parties did not contemplate delivery, see Andersons, 166 F.3d at 320 (citing In re Grain Land Coop., 978 F. Supp. 1267, 1273-74 (D. Minn. 1997)), no one suggests that such an inference may be drawn in this case. The reason no producer has delivered under the POC has been falling commodity prices. Any event of non-delivery under this contract only shows that prices have not risen to or above the strike price, not that the contract fails to anticipate delivery. Indeed, the premium paid under the POC, reflects that fact that, over time, we can confidently expect that delivery will be required under some of these contracts. See Tr. at 58 (Pirrong) (the premium capitalizes the expected opportunity cost of the futures price exceeding the strike price).

[97] See Nagel, 65 F. Supp.2d at 748, 751 ("Every [forward] contract . . . can be canceled by agreement, which may be contingent on a side payment . . . . 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.").

bright line test: with every forward contract delivery is intended and occurs most of the time, with every futures contract the opposite is true. But as discussed before, the Commission has consistently rejected bright line tests in this area. More importantly, it has rejected the one specifically suggested by the Division.

Starting in the 1980s commercial parties began experimenting with a variety of new risk management instruments, including contracts which combined forward elements with option and security-like components in varied and complex ways.[98] New "hybrid" contracts emerged to fill market needs not met by existing forward and futures contracts.[99] Since these contracts

[98] See William P. Albrecht, Regulation of Exchange-Traded and OTC Derivatives: The Need for a Comparative Institution Approach, 21 J. Corp. L. 111, 124 (1995) ("The instruments were hybrids, swaps and certain energy contracts. Rulings by the CFTC that they were futures contracts subject to CFTC regulation and the exchange-trading requirement would have effectively prevented their sale and use, thereby removing some very useful risk management instruments from the U.S. market. In each case the CFTC permitted the financial innovation.") Albrecht was a Commissioner of the Commodity Future Trading Commission from 1988-1993, and its Acting Chairman from January through August 1993. See also; Markham, supra note 88, at 21; Regulation of Hybrid and Related Instruments [1987-1990 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶23,995 (CFTC Dec. 11, 1987).

[99] A "hybrid" contract is a contract that combines certain elements of futures or commodity option contracts with interests that are not subject to regulation under the Act such as forward contracts and debt obligations. See Regulation of Hybrid and Related Instruments, ¶23,995 at 34,485-86. See also Albrecht,
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broke the old molds, they raised new challenges for the Commission and the courts as they struggled to place them in the proper regulatory pigeonholes.[100]

In the context of examining one of these new instruments, the 15-day Brent contract, the Commission squarely rejected the notion that with every forward contract delivery must be intended and occur most of the time. The Brent crude oil distribution system depended on a complicated chain of interrelated contracts which passed legal title to a shipment through many of the market

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supra note 98, at 124 n.31. Since hybrid instruments contain both regulated and unregulated elements, the Commission has frequently been required to assess the overall economic nature of a contract to determine whether the contract as a whole is a forward or a future (since it cannot be both). In other cases, the Commission promulgated rules exempting certain hybrids from regulation where they contained equity, interest or debt features. See, e.g. 17 C.F.R. Parts 34-35.

[100] See Transnor (Bermuda) Ltd. v. BP North Amer. Petroleum, 738 F. Supp. 1472, 1489 (S.D.N.Y 1990) ("Once distinguished by unique features, futures and forward contracts have begun to share certain characteristics due to increasingly complex and dynamic commercial realities.").

participants, but actual delivery to only one.[101] The pass-through transactions resulted in paper closings, known as "book-

[101] To get a sense of the complexity of these arrangements, one need only read the following Commission description.

> "Each month's production of Brent system crude oil is allocated among the various producers of the crude oil which make up the Brent system, and the system's terminal operator identifies both a producer and a three-day range within each month for each cargo to be lifted. If a producer chooses to apply a particular cargo against its obligations under a contract for the sale of 15-day Brent, it must give the requisite 15-days notice to its purchaser who in turn must provide timely notice to its purchaser. This notification process is repeated forming a chain of buyers and sellers until notice is received by a buyer who elects not to pass the notice further or who has insufficient time to pass on the notice. Participants in the chain effect delivery as the cargo allocated to the particular producer initiating the chain is loaded onto a qualifying vessel designated by the ultimate F.O.B. purchaser of the cargo and nominated in turn by each buyer in the chain to its seller. Title to the cargo passes through each intermediate participant in the chain as the crude oil passes the designated vessel's flange at the loading terminal. Each seller in the delivery chain must provide a bill of lading for the cargo to its purchaser. A seller that fails timely to produce an original bill of lading is obligated to provide its purchaser with a letter of indemnity."

1990 Statutory Interpretation, ¶24,925 at 37,365-66. See also Alton B. Harris, Symposium On Derivative Financial Products: The CFTC And Derivative Products: Purposeful Ambiguity And

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outs," "close-outs" or "by-passes."[102] This type of arrangement was not unique to the Brent market. As the Commission noted,

> "In addition to the market in 15-day Brent contracts, U.S. commercial entities participate in other similar markets, both domestic and foreign. Certain participants have represented that these markets use delivery processes analogous to those described above."[103]

The participants regarded these types of contracts as unregulated cash forward contracts.[104] In 1990, however, the use of these contracts was jeopardized by a District Court decision that held the Brent contracts to be illegal off-exchange futures.[105] In so holding, the Transnor (Bermuda) court relied heavily on the fact that actual delivery under the contracts was the exception, not the rule.[106] The resulting cloud over these

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Jurisdictional Reach, 71 Chi.-Kent. L. Rev. 1117, 1130 n.78 (1996).

[102] See 1990 Statutory Interpretation, ¶24,925 at 37,368.

[103] Id. at 37,366.

[104] See also Albrecht, supra note 98, at 124 n.33.

[105] See Transnor (Bermuda), 738 F. Supp. 1472.

[106] Id. at 1490 (commenting on "the high ratio between barrels traded and barrels delivered); id. at 1491 ("15-day Brent oil contracts were routinely settled by means other than delivery, most typically through the clearing techniques of offset and (continued..)

types of instruments prompted the Commission to undertake its own evaluation of their nature.

Five months after the Transnor (Bermuda), the Commission issued an interpretative statement disagreeing with the District Court.[107] The 1990 Statutory Interpretation wrestled in general terms with the significance of delivery as a feature of the new hybrid instruments. It considered a record of comments that it had solicited three years earlier "concerning the appropriateness of a no-action position for certain commercial-to-commercial transactions that resembled traditional forward contracts but for

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bookout."); id. at 1492 (Indeed, only a minority of the transactions in the Brent market resulted in delivery.") (internal quotation marks omitted); id. at 1493 ("Defendants acknowledge that the volume of Brent contract trading greatly exceeded the amount of physical oil available to satisfy such contracts.").

[107] See 1990 Statutory Interpretation, ¶24,925. Like the 1985 Interpretative Statement, see supra note 28, and unlike Transnor (Bermuda), the 1990 Statutory Interpretation, has been frequently cited by the courts as persuasive authority. See, e.g., Nagel, 65 F. Supp.2d at 755; MG Refining & Mktg, 25 F. Supp.2d at 182; Johnson v. Land O' Lakes, Inc., 18 F. Supp.2d 985, 995 (N.D. Iowa 1998); Barz v. Geneva Elevator Co., 12 F. Supp.2d 943, 956 (N.D. Iowa 1998); Top of Iowa Coop. v. Schewe, 6 F. Supp.2d 843, 856 (N.D. Iowa 1998); Oeltjenbrun, 3 F. Supp.2d at 1037; Grain Land Coop, 978 F. Supp. at 1276; Salomon Forex Inc. v. Tauber, 795 F. Supp. 768, 776 (E.D. Va. 1992); Bybee, 945 F.2d at 314. Cf. Section 4(c) Contract Market Transactions; Swap Agreements, [1994-1996 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶26,243 at 42,068 n.15 (CFTC Oct. 28, 1994); Tauber, 8 F.3d at 976.

the lack of delivery as the normal culmination of the transactions."[108]

In short, the Commission reasoned that it was the contract's economic function in the delivery process, not the regularity of actual delivery itself, that was the key to the contract's nature.

> "Despite the breadth of the amendments to the Act it has passed since 1922, Congress has not addressed the reach of the section 2(a)(1) exclusion in the content of today's commercial environment, including with regard to the concept of what constitutes delivery for purposes of the exclusion. Against this background, since 1974 and with increasing frequency, there have evolved in the commercial segments of the economy a diverse variety of transactions involving commodities, examples of which have been described above. These transactions, which are entered into between commercial counterparties in normal commercial channels, serve the same commercial functions as did those forward contracts which originally 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."[109]

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[108] <u>1990 Statutory Interpretation</u>, ¶24,925 at 37,364 n.2. <u>See also</u> <u>Regulation of Hybrid and Related Instruments</u>, ¶23,995 at 34,491-92.

[109] <u>1990 Statutory Interpretation</u>, ¶24,925 at 37,368 (citation omitted).

The Commission stressed that in addition to the "emphasis on delivery":[110]

> "Certain other distinguishing characteristics of [forward] contracts have been identified. In this regard, forward contracts have been described as 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. Thus forward contracts may be used to acquire raw material, to purchase and sell inventory or for other merchandising or commercial purposes and, concomitantly, to shift future price risks incident to commercial operations and other forward commitments. Forwards also typically have been described by reference to the commercial nature of the counterparties which have the capacity to make or take delivery. In addition, forward contracts generally are individually and privately negotiated principal-to-principal transactions. The contracts are generally not assignable without the consent of the parties, and do not provide for exchange-style offset. In addition, there is no clearinghouse and no variation margining or settlement system involved."[111]

It then proceeded to reason that since the Brent contract, and commercial instruments similar to it, were at heart merchandising transactions, they met the statutory exclusion as forwards.[112] In other words, if the contract created "delivery

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[110] Id. at 37,367.

[111] Id. at 37,368 (note omitted).

[112] The Commission explained:

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> "Just as there is no definitive list of the elements of a futures contract, there is no definitive list of the elements of those transactions which are excluded from regulation under Section 2(a)(1) of the Act. However, . . . in considering whether a particular instrument falls within the Section 2(a)(1) exclusion for forward contracts, the Commission and courts traditionally have considered various factors, predicated primarily on the congressional intent underlying the original enactment of the exclusion. The underlying postulate of the exclusion is that the Act's regulatory scheme for futures trading simply should not apply to private commercial merchandising transactions which create enforceable obligations to deliver but in which delivery is deferred for reasons of commercial convenience or necessity."

Id. at 37,367 (note omitted).

As to the Brent contracts, the Commission noted:

> "[I]t is significant that the transactions create specific delivery obligations. Moreover, the delivery obligations of these transactions create substantial economic risk of a commercial nature to the parties required to make or take delivery thereunder. These include the risks of demurrage, damage, theft or deterioration of the commodity as well as other risks associated with owning the commodity delivered. All parties entering into these contracts must have the capacity to bear such risks and cannot discharge these obligations through exchange-style offset."

Id. at 37,368.

obligations that impose substantial economic risks of a commercial nature," the fact of actual delivery was immaterial.[113] This approach builds upon the past multi-factor test that distinguishes forward and futures contracts, and is consistent with cases decided since the 1990 Statutory Interpretation.[114]

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[113] Id. at 37,369. In Bybee, the Ninth Circuit nicely summed up the 1990 Statutory Interpretation.

> "The real innovation contained in the Statutory Interpretation is its treatment of the delivery obligation. [continuing in the footnote] The Statutory Interpretation makes clear that its broader definition of forward contracts applies only to '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.' The CFTC also stressed the parties 'capacity to make or take delivery.'"

Bybee, 945 F.2d at 314, 314 n.5 (citation omitted). See also Oeltjenbrun, 3 F. Supp.2d at 1036-37 (discussing 1990 Statutory Interpretation).

[114] See Nagel II, 217 F.3d at 441 (even if delivery can "be deferred forever" the contract "may or may not be" a forward contract); Grain Land Coop., 199 F.3d at 992 ("[W]e disagree with Obermeyer's contention that HTAs can only fall within the cash-forward exception if obligations of the parties to make or accept delivery are inescapable."); Lachmund, 191 F.3d at 787 ("[The] list of factors characterizing cash forward contracts . . . is neither exhaustive or definite."); Andersons, 166 F.3d at 318 ("[Cash forward] contracts are not subject to the CFTC regulations because those regulations are intended to govern only speculative markets; they are not meant to cover contracts wherein the commodity in question has an 'inherent value' to the

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We can now easily see that Cargill's POC satisfies the Commission's test for the forward contract exclusion, even though it includes a price conditional delivery requirement. As discussed at length earlier,[115] the POC creates specific "delivery obligations that impose substantial economic risks of a commercial nature" on the parties.[116] The fact that the conditions under the POC may not be met does not change the fact

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transacting parties."); Top of Iowa Coop, 6 F. Supp.2d at 858 ("absolute certainty of ability to perform in the future simply is not a requirement of a cash forward contract"); Oeltjenbrun, 3 F. Supp.2d at 1036 ("[T]he grain has '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") (citation omitted); Bybee, 945 F.2d at 314 (discussing 1990 Statutory Interpretation).

[115] See supra notes 48-53 & accompanying text.

[116] 1990 Statutory Interpretation, ¶24,925 at 37,369.

The fact that under the Brent contracts some party at the end of the chain always received the commodity does not materially distinguish it from the POC. Under the Brent contract, each party in the chain had the same subjective and objective expectation of delivery under each contract (small). Nonetheless, the Commission regarded each contract in the chain to be a forward contract because each party had a legitimate subjective and objective expectation of delivery and each party had to bear the risk that it would need to take actual possession. See id. at 37,368. The same circumstances exist with the POC.

that the parties are obligated to perform from the time they execute this contract. At the time of the contract, Cargill and the producer promise that upon the occurrence of certain events beyond their control, they will make and take delivery. As a result, Cargill must be prepared to take delivery and the producer must be prepared to make it.[117]

Moreover, even the Division does not dispute that the POC has all the other recognized attributes of a forward contract.[118] Without question the POCs are entered into between commercial entities for commercial purposes. These are principal-to-principal transactions between producers who actually grow the grain and Cargill who actually uses it. Furthermore, the POC is not offered to the public at large, only to those producers whom Cargill believes can actually deliver grain.[119] Producers

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[117] Of course, the parties may gauge the likelihood of delivery and modify their actions accordingly. A party to most any contract can choose to break and pay damages rather than performing a contract at a loss. See supra note 40.

[118] See supra note 94.

[119] See Tr. at 153 (Inman). See also Inman Examination at 79-80 (Cargill corrected contracts it felt over-extended a producer's capacity); Larson Examination at 43 ("[I]t comes back to knowing your customer; and you have a general idea . . . . I know how many acres or what not that that farmer produces."). Remember, the POC is only offered to Cargill's producers who supply grain under its non-contingent contracts.

individually negotiate the material terms of the POC with Cargill's agents. The strike price, premium and commodity amounts may be different for each contract since market

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Cargill's Inman sums up the merchandising purpose of the POC in this exchange with Division counsel.

> Romaniuk: "When Cargill offered these premium-offer contracts, obviously a feature was that the farmer would be delivering their old crop grain and getting a premium for that. Was that because Cargill wanted grain immediately, or what was Cargill looking to the grain that it would get right away or the grain that it would get in the future?"
>
> Inman: "We want grain all the time. That's what we do."
>
> Romaniuk: "But could you clarify what was more important, what was its primary focus?"
>
> . . . .
>
> Inman: "The primary focus in offering this contract is we want to buy grain, whether that's old crop grain or whether that's new crop grain. Certainly the idea of having the old crop grain and the firm offer on the new grain is attractive to Cargill."
>
> Romaniuk: "But since no farmer has delivered under the premium-offer addendum, would you say that the purpose primarily would be to delivery the grain in the -- the old grain?"
>
> Inman: "No, that has just been a condition of the markets."

Inman Examination at 83-85.

conditions and individual producer preferences determine these.[120] Moreover, the contract gives neither Cargill nor the producer the ability to cancel, roll forward, offset, or otherwise effect the delivery obligation.[121]

Since the POCs meet these criteria, the Court finds that they are forward contracts not subject to regulation under the Act. While the POC is configured in a somewhat different manner than the forward contracts the Commission has discussed in the past, they serve the same beneficial economic ends as their predecessors. The whole point of the POC is that it is different from other forward contracts currently on the market; "It isn't supposed to be like something else; the [POC] was designed as a novel instrument so that it could offer attributes previously

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[120] See Joint Stipulations at ¶9-11; Inman Examination at 57-58.

The fact that the POC uses a preprinted form with blanks for dates and prices does not make it the sort of 'standardized' contract traded on exchanges. Unlike the POC, exchange-traded contracts use uniform quantities, quality, pricing and delivery conditions to create fungibility in the contract. Preprinted forms with blanks similar to the POC were used for the Brent contracts, which the Commission found to be forwards. See 1990 Statutory Interpretation, ¶24,925 at 37,365 ("While 15-day Brent contracts typically incorporate standard terms and conditions, the contract which governs transactions between particular counterparties is individually negotiated by such counterparties.").

[121] See Inman Examination at 55.

missing in the market."[122] The Act does not prohibit such innovation. Indeed, the policies that shape and inspire the law in this area of commercial regulation encourage it.

Market Innovation

We close with a word (actually -- once again -- more than a word) concerning sound public policy. Financial markets work best when they offer every possible combination of risk and return -- a condition that financial economists call "spanning" -- so that participants can construct a portfolio that addresses each need and taste. Therefore, exchanges, banks and other commercial interests continually devise financial products to fill unoccupied niches.[123] In the words of Judge Easterbrook, "[t]hese products are valuable to the extent that they do not match the attributes of instruments already available. New products, offering a new risk-return mixture, are designed to

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[122] Chicago Mercantile Exchange v. SEC, 883 F.2d 537, 546 (7th Cir. 1989) (Easterbrook, J.).

[123] See Dennis W. Carlton, Futures Markets: Their Purpose, Their History, Their Growth, Their Successes and Failures, 4 J. Futures Markets 237 (1984); William L. Silber, Innovation, Competition and New Contract Design in Futures Markets, 1 J. Futures Markets 123 (1981).

depart from today's models."[124] Such new offerings frequently gestate at the borders of the regulated sector.[125]

In the commercial context, risk -- which is nothing more than unforeseeable price changes in the firm's inputs -- adds to the cost of production. Its mitigation through financial management tools permits firms like Cargill and its competitors to lower their cost structures, which benefits the entire chain of commerce. (In this case, that means cheaper food.)[126]

Understanding this, we can now see that firms, like Cargill, approach such instruments as forwards, futures, swaps, and options not as four distinct instruments and markets, but rather as four instruments to deal with a single problem -- managing risk.[127] Indeed, Cargill's POC is only a small part of its

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124 Chicago Mercantile Exchange, 883 F.2d at 544 (emphasis in original).

125 Id.

126 See David A. Dudley, The Coase Theorem as Applied to Trade Barriers and Optimal Adjustment Strategies, 19 U. Pa. J. Int'l Econ. L. 1029 (1998) ("The two main goals of any financial legislation are efficiency which seeks wealth maximization within society, and distribution, which seeks optimal allocation of wealth. A government policy that constrains national wealth and has regressive effects would seem the height of irrationality, since it would violate notions both of efficiency and distribution.") (notes omitted).

127 "Swaps" are agreements to periodically exchange cash flows based on the price of some underlying product or instrument. See Albrecht, supra note 98, at 124 n.32. See also John Hull,
(continued..)

complex portfolio of risk management instruments and strategies.[128] Thus, to truly understand the effects of the POC, one needs to understand Cargill's interrelated structure of financial instruments. Here the record in this proceeding only scratches the surface.[129] Once again, however, the driving force

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Options, Futures, and Other Derivative Securities 19 (2nd ed. 1993) (attached to Pirrong Declaration) ("Because they were publicly introduced as recently as 1981, swaps are commonly portrayed as one of the latest financial innovations. But, as I hope to be able to convince you, a swap contract in its essence is nothing more complicated than a series of forward contracts strung together.") (note omitted).

[128] See Tr. at 222 (Dines) (Cargill's Commodity Risk Management Department "create[s] risk management products for the business units within Cargill and their customers across the spectrum"); Dines Examination at 15 ("We are a resource within Cargill for really creating derivative products in the markets, derivative products, marketing alternatives, in those core commodity markets that Cargill deals in on a daily basis. So we work very closely with our product lines, but we are kind of the hub for derivative products, structuring, marketing, and hedging.").

[129] However, we do know some things, such as the fact that Cargill hedges its upside profit potential under the POC and other forward contracts by taking positions in exchange-traded futures and options.

> Nissen: "Now, is your group involved in hedging Cargill's obligations under the premium offer contract?"
>
> Dines: "Yes, that's our responsibility."

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> Nissen: "And can you explain briefly how your group goes about hedging those obligations?"
>
> Dines: "Okay. Everyday that we enter into, Cargill enters into the premium offer contract, we will basically aggregate the contracts that we've done for that day. And we will most likely start by what we call delta hedging the contract which is basically selling futures. And there's a formula for deriving the amount of futures that you want to sell to hedge that premium offer. And then, each day we would go through that process depending on what's happened to the underlying market, we may need to buy futures or sell futures for the overall position. If we don't buy volatility or our view of volatility is changing, we may end up selling options against the position."
>
> Nissen: "Now, are there other contracts offered by Cargill which are hedged similarly to the premium offer contract?"
>
> Dines: "Yes."
>
> Nissen: "And what are they?"
>
> Dines: "Customized minimum price contract, customized min-max contract would be hedged the same way. Any product that basically has got a tailored end-date or a tailored expiry, a tailored end-date where tailored strike levels would be hedged basically in the same manner."

Tr. at 224-26. <u>See also</u> Tr. at 228 (Dines) (Cargill cannot experience unbounded upside potential of the POC "because of the way that we delta hedge ourselves"). This is an example of how a firm reduces its overall price risk by the use of an integrated mix of financial tools.

of this process is cost reduction.[130]

If there is value in permitting financial product innovation, then the converse must also be true. Costs are incurred when innovation is stifled. Markets generally do a relatively good job of allocating resources. Competition and the profit motive drive firms to produce what consumers want at the lowest possible cost and to keep up with changes in demand.[131]

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[130] See Hu, supra note 69, at 1480 ("The complexity of individual transactions is dwarfed by the complexity of entire portfolios. The portfolio effects tend to make the total credit and market risks less than the sum of the risks of individual derivative transactions. For instance some of these transactions may be with the same customer . . . . [T]he market risks of individual derivative transactions may offset each other and thus reduce overall market risk.") (citations omitted).

[131] Or in the words of Chairman Rainer:

> "Competition provides a strong incentive for market participants to perform at the lowest cost and the highest degree of integrity by giving market users the ability to choose the products and providers that best serve their individual needs."

William J. Rainer, Chairman, Commodity Futures Trading Commission, Remarks Before CFTC International Regulators Meeting (Burgenstock, Switzerland, Sept.7, 2000). See also William J. Rainer, Chairman, Commodity Futures Trading Commission, Remarks Before BOCA 2000: 25th Annual International Futures Industry Conference (Boca Raton, FL, Mar. 16, 2000); Albrecht, supra note 98, at 116-17; Posner, supra note 73, at 10 ("[A] basic principle of economics is that resources tend to gravitate toward their most valued uses if voluntary exchange -- a market -- is permitted."); Robert Cooter and Thomas Ulen, Law and Economics 17-18 (1988) (defining "productive efficiency").

Thus, in the absence of some substantial source of market failure (and quite possibly even in its presence),[132] the Division's proposed banishment of the POC from the market will force the producers and Cargill to select a less preferred alternative. This results in deadweight losses, imposing higher costs on all parties (and therefore on society as a whole).[133] Unfortunately,

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[132] As former Acting Chairman Albrecht explains:

> "[Market failure] refers to situations in which a market fails to allocate resources efficiently because of the existence of public goods, market power, externalities, or information costs. Market failure means the performance of the market is not perfect. It means too much or too little of something is being produced. It does not mean that the market fails to provide valuable goods and services or improve the welfare of those who participate in it, or that that market should necessarily be replaced by some other economic institution."

See Albrecht, supra note 98, at 117. See also David L. Weimer and Aidan R. Vining, Policy Analysis: Concepts and Practice 41-77 (2nd ed. 1992).

[133] See Posner, supra note 73, at 277; W. Kip Viscusi, John Vernon, and Joseph Harrington, Economics of Regulation and Antitrust 490-491 (1992). See also Dudley, supra note 126, at 1036 n.25 ("'Deadweight loss' refers to the amount of consumer surplus in a free trade regime that is lost in a protectionist regime."). The essence of this concept can be simply stated. Since transacting parties typically prefer transaction A to other alternatives because transaction A offers each party more value, forcing the parties to accept other alternatives causes both parties to lose those differences in value.

the Division's formalist legal arguments wholly ignore this, the ultimate "economic reality" of the POC.[134]

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[134] The Division post-hearing brief does suggest that it is concerned with one possible cost associated with the POC. It points out that the Commission's trade options pilot program excludes the writing of covered call options because they are "susceptible to abuse to the extent that producers do not appreciate the extent to which downside price protection and upside pricing potential is surrendered for a premium payment." See Division's Post-Hearing Brief at 24 (quoting Trade Options on the Enumerated Agricultural Commodities, ¶27,178 at 45,604) (emphasis added). See also Trade Options on the Enumerated Agricultural Commodities, ¶27,918 at 48,881. Putting aside the fact that the simplest sorts of forward contracts "surrender" downside price protection and upside price potential, we infer (although with a bit of a leap) from the Division's post-hearing brief, that it is concerned that possible inequalities of information between the producers and Cargill may be a source of substantial failure in the POC market. See Weimer and Vining, supra note 132, at 69-76 (addressing "information asymmetry"). Not only did the Division fail to produce any evidence in support of this hypothesized problem, but its own expert does believe it to exist.

Dr Pirrong testified that he did not believe that there is any significant market failure associated with the offering of the POC warranting Commission regulation. See Tr. at 109 ("This is a contract entered into between mutually consenting adults. The key issue would be the information that the, you know, that the farmer has in terms of whether they're fully informed about the risk of the contract. And I have no reason to believe that they don't have the requisite information; so [as to] enter into this contract on unfair terms."). See also id. at 135. In addition, Dr. Pirrong sees no indication of coercion or irrational pricing in the market, id. at 135-36, and believes that there would be a net social loss if the Division were to prevail in its effort to ban the POC. Id. at 130-134.

Moreover, even assuming (in the absence of any evidence and in the face of the Division's expert's conclusion to the contrary) that the POC market is plagued with problems of imperfect information, that still would not answer the question

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of whether prohibiting the POC would do more good than harm. Frequently, the economic failures of government regulation outstrip the corresponding failures of the market. See Dennis C. Mueller, Public Choice II (1989) (summarizing the vast body of literature concerning government failure). This leads to the conclusion that government regulation is appropriate for correcting market failure (or achieving any other social goal) only when the benefits of regulation exceed the cost. Albrecht, supra note 98, at 118-19; Cass R. Sunstein, Interpreting Statutes in the Regulatory State, 103 Harv. L. Rev. 405, 488-489 (1989). The Division undertook no such evaluation of the net consequences of its proposal to eliminate the POC. (Even as formalists, one would have thought that the Division would have undertaken such an analysis to inform the Commission in its exercise of prosecutorial discretion and -- if need be -- to inform the record for purposes of sanctioning.)

In sum, and most unfortunately, the Division's case against the POC amply demonstrates that Oliver Wendell Holmes' prophecy of 1897 still remains unfulfilled.

> "For the rational study of the law the black-letter man may be the man of the present, but the man of the future is the man of statistics and the master of economics . . . . I look forward to the time when the part played by history in the explanation of dogma shall be very small, and instead of ingenious [historical] research we shall spend our energy on a study of the ends sought to be attained and the reasons for desiring them. As a step toward that ideal it seems to me that every lawyer ought to seek an understanding of economics . . . . In the present state of political economy . . . we are called on to consider and weigh the ends of legislation, the means of obtaining them and the cost. We learn that for everything we have to give up something else, and we are taught to set the advantage we gain against the other advantage we lose, and to know what we are doing when we elect."

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Order

For the reasons set our above, the Court **CONCLUDES** that the Division of Enforcement failed to establish that Cargill violated either Section 4c(b) of the Commodity Exchange Act, 7 U.S.C. §6c(b), or Commission Regulation 32.2, 17 C.F.R §32.2, by entering into Premium Offer Contracts with producers. The Court further **CONCLUDES** that Cargill, Inc. established that the Premium Offer Contract is a contract for the sale of a "cash commodity for deferred shipment or delivery" under Section 1a(11) of the Act, 7 U.S.C. §1a(11), and, as such, is excluded from the Act's regulatory jurisdiction.

Accordingly, the Court **DISMISSES** with prejudice the Commission's Complaint and Notice of Hearing Pursuant to Sections

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Holmes, supra note 74, at 469, 474.

6(c) and 6(d) of the Commodity Exchange Act, as Amended, dated August 26, 1999, and **TERMINATES** this proceeding in its entirety.

IT IS SO ORDERED.[135]

On this 22nd day of November, 2000

Bruce C. Levine
Administrative Law Judge

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[135] Under 17 C.F.R. §§10.12, 10.102 and 10.105, any party may appeal this Initial Decision to the Commission by serving upon all parties and filing with the Proceedings Clerk a notice of appeal within 15 days of the date of the Initial Decision. If the party does not properly perfect an appeal -- and the Commission does not place the case on its own docket for review -- the Initial Decision shall become the final decision of the Commission, without further order by the Commission, within 30 days after service of the Initial Decision.