Commodity Futures Law Reporter, CFTC Interpretative Letter No. 98-13. (Re: Variation of Minimum Price Guarantee Contracts Are Cash Forward Transactions), ¶27,264, Commodity Futures Trading Commission, (Dec. 3, 1997)

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¶27,264. Commodity Futures Trading Commission. Division of Economic Analysis. December 3, 1997. Staff reply in full text.

Interpretations: Cash Forward Contracts.– Proposed contracts that would establish both a minimum and a maximum price for a set amount of the commodity to be delivered under the contract with no provision for additional delivery amounts was a cash forward contract excluded from Commission regulation under Section 1a of the CEA because the contracts were to be executed between commercial agricultural participants for a set amount of the commodity that did not vary with the price level, the price was determined at delivery and was bounded by minimum and maximum prices, and the contracts created binding delivery obligations. See ¶4003.10, "Definitions" division, Volume 1.

[*Inquiry Letter*]

One behalf of …, we respectfully request that the Division of Economic Analysis ("Division") concur in our view the contracts described below are cash forward transactions and, therefore, are not subject to the provisions of the Commodity Exchange Act ("Act") or the jurisdiction of the Commodity Futures Trading Commission ("Commission").

…with assets in excess of $…, is the country's …largest food processor, with more than 70 operating units worldwide …., operates a network of commodity merchandising offices and more than 90 grain elevators, commodity warehouses, river loading facilities, export elevators and barges. As a consequence, …is continually buying and selling cash commodities.

The Proposed Contracts

The contracts that …desires to offer its counterparts are a variation of the minimum price contracts discussed in "Characteristics Distinguishing Cash and Forward Contracts and Trade Options," issued by the Commission's Office of the General Counsel in 1985. [1] Rather than simply establishing a minimum price at which …will purchase or sell cash commodities, however, the proposed contracts also will establish the maximum price at which such transaction will occur.

For example, …may enter into an agreement with a processor, pursuant to which …will agree to sell, and the processor will agree to buy, 125,000 bushels of No. 2 Yellow Corn weekly for a period of eight weeks, beginning September 1, 1997. The price at which …will sell the commodity each week is not established at the time the contract is entered into. Rather, the price is established each week in accordance with a prescribed formula, with reference to the appropriate Chicago Board of Trade futures contract. In return for a premium that will be added to the price paid by the producer each week, …and the producer will further agree that the price to be paid will neither exceed, nor fall below, stated amounts. Similarly, …may enter into an agreement to purchase commodity from a producer, which agreement would establish a minimum and maximum price that …would be required to pay. In all cases, the agreement to purchase and sell the commodity would be binding on the parties.

Applicable Law

As you are aware, pursuant to section 2(a)(1)(A)(i) of the Act, the Commission has exclusive jurisdiction with respect to transactions involving contracts of sale of a commodity for future delivery. For purposes of defining the jurisdiction of the Commission, a contract of sale for future delivery includes an option on a commodity. [2]

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However, the term “future delivery” does not include any sale of any cash commodity for deferred shipment or delivery. Section 1(a)(11) of the Act. In distinguishing between futures contracts and so-called “forward contracts,” the Commission' Office of the General Counsel has identified three elements of forward contracts. First, the contract must be a binding agreement on both parties: one must agree to make delivery and the other must agree to take delivery. Second, the contract must be used in commerce. Third, the parties must have the capacity to make or take delivery, and delivery, in fact, must routinely occur. [3]

Analysis

We believe that the contracts that …proposes to enter into with its counterparts are forward delivery contracts: the contracts are used in commerce; the parties have the capacity to make and take delivery; and the parties have a binding commitment to make and take delivery. The provisions of the proposed contracts that establish minimum and maximum prices at which the transactions will occur do not alter the nature of the contracts. Although these provisions have characteristics of a cash-settled option, the parties nonetheless would continue to be obligated to perform. Therefore, it is our view that the proposed contracts remain predominantly forward contracts and, consistent with the Office of the General Counsel's 1985 interpretative statement, excluded from the Commission's jurisdiction in accordance with the provisions of sections 1a(11) and 2(a)(1)(A)(i) of the Act. In this connection, the proposed contracts are essentially no different from forward delivery contracts that include minimum price guarantee provisions, which similarly have characteristics of a cash-settled option.

Thank you for your consideration of this request. If you have any questions regarding the proposed contracts, please call me at 312/977-4884.

[*Staff Reply*]

By letter dated July 29, 1997, you asked the staff of the Division of Economic Analysis to concur in your view that contracts proposed to be offered by your client, [CLIENT], Inc. are cash forward transactions excluded from Commission regulation under section la of the Commodity Exchange Act. From your letter, we understand the terms of the proposed contract to be as follows.

You propose offering to enter into contracts which you represent to be a variation of minimum price guarantee contract, *See,* “Characteristics Distinguishing Cash and Forward Contracts and Trade Options,” letter of the Commission's Office of the General Counsel. [1] In addition to establishing a minimum price for the commodity delivered under the contract, the contract you propose to offer would also set a maximum price for the commodity. Specifically, the proposed contracts would be for a set amount of commodity with no provision for additional delivery amounts under the contract. For example, the contract would not call for a greater or lesser amount of commodity to be delivered if prices were at or above a specified level. Delivery from one party to another on the contract also is expected and occurs under the contract. Moreover, the contract would not permit either party to cancel the contract or otherwise relieve itself from the delivery or purchase obligation of the contract, except for events beyond the parties' control.

As an example, you state that a contract may call for the weekly delivery of 125,000 bushels of No. 2 Yellow Corn by [CLIENT] to a processor for a period of eight weeks. The price at which [CLIENT] will sell the corn to the processor is not established at the time the contract is entered into. Rather, the price is established each week in accordance with a prescribed formula, with reference to the appropriate Chicago Board of Trade futures contract. Moreover, in return for a premium payment by the processor to [CLIENT], the final price established on the contract would be determined at a level between a minimum and maximum price. These prices would be negotiated between the buyer and seller and would represent potentially binding constraints on the final price determination. [CLIENT] also anticipates offering such contracts to commodity producers in which [CLIENT] would be the purchaser of the commodity and the producer would be the seller.

The contract you have described differs from the forward contract described in example No. 1 of the 1985 interpretative statement in that a cap is placed on the price of the commodity as well as a minimum price. The Division is of the opinion that based upon the nature of the instrument as a whole, adding this feature to the

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contract does not in and of itself change the nature of the contract. Specifically, making or taking delivery of the commodity is mandatory for both parties. The amount of the commodity to be delivered does not vary depending upon the commodity's price level. The contract is used as a marketing vehicle for the commodity within the normal merchandising chain. To the extent that this contract includes characteristics of an option, those terms cannot be severed or marketed separately. In addition, the minimum and maximum prices set under the contract represent real constraints on the ultimate determination of price such that under normal expected price volatility, both prices would be expected to be realized on more than a rare occasion.

Accordingly, the Division is of the view that the contract viewed in its entirety is consistent with the analysis of contracts in the 1985 interpretative statement and is not subject to Commission regulation. The views expressed in this letter are those of the Division of Economic Analysis and do not necessarily reflect the views of the Commission or any other office or division of the Commission. Moreover, our position is based upon the representations that have been made to us. Any different, changed or omitted facts might require us to reach a different conclusion.

Sincerely,

John Mielke

Acting Director

Division of Economic Analysis

Footnotes

1 50 Fed.Reg. 39656 (September 30, 1985), [1984-1985 Transfer Binder] Comm.Fut.L.Rep. (CCH) ¶22,718.

2 In the exercise of its authority under section 4c(b) of the Act, the Commission, pursuant to the provisions of rule 32.4, has authorized over the counter ("OTC") options where such options are

offered by a person which has a reasonable basis to believe that the option is offered to a producer, processor, or commercial user of, or a merchant handling, the commodity which is the subject of the commodity option transaction, or the products or by-products thereof, and that such producer, processor or merchant is offered or enters into the commodity option transaction solely for purposes related to its business as such.

The provisions of the so-called "trade option" exemption set forth in Commission rule 32.4 are specifically subject to the provisions of rule 32.2 which, in turn, prohibit all options involving agricultural commodities.

The Commission has recently published for comment an advance notice of proposed rulemaking with respect to the prohibition on agricultural trade options. 62 Fed. Reg. 31375 (June 9, 1997). …has submitted comments in response to this notice in which …has encouraged the Commission to remove this prohibition.

3 "Characteristics Distinguishing Cash and Forward Contracts and Trade Options," Id.

1 50 FR 39656 (September 30, 1985), [1984-1985 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶22,718.

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