

Case Study in Violation of CFTC Regulations When Using the Futures and Options Markets to Hedge

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Problem

- **Individual producers signed a statement that allowed a marketing firm to hedge their physical positions in corn.**
- **After 13 months, a lawsuit was brought against the firm by producers alleging financial losses.**

- **The Commodity Futures Trading Commission (CFTC), Division of Enforcement (DOE) suspected fraud, but**
- **Could not reasonably determine which positions were hedges and which were speculative.**

Commodity Futures Trading Commission definition:

(z) Bona fide hedging transactions and positions--

- (1) General definition. Bona fide hedging transactions and positions shall mean transactions or positions in a contract for future delivery on any contract market, or in a commodity option,
- where such transactions or positions normally represent a substitute for transactions to be made or positions to be taken at a later time in a physical marketing channel,
- and where they are economically appropriate to the reduction of risks in the conduct and management of a commercial enterprise, and where they arise from:

- (i) The potential change in the value of assets which a person owns, produces, manufactures, processes, or merchandises or anticipates owning, producing, manufacturing, processing, or merchandising,
- (ii) The potential change in the value of liabilities which a person owns or anticipates incurring,
- hedging transactions and positions in paragraph (z)(1) of this section includes,

- (i) Sales of any commodity for future delivery on a contract market which do not exceed in quantity:
- (A) Ownership or fixed-price purchase of the same cash commodity by the same person; and
- (B) Twelve months' unsold anticipated production of the same commodity by the same person provided that no such position is maintained in any future during the five last trading days of that future.

Essential Question

- **How to determine if positions or transactions result in a hedge of the customers physical ownership?**
- **Explain and demonstrate so members of the jury can understand.**
- **Assume a 12th grade level of comprehension!!**

April statement from Futures Commission Merchant

DATE	AT	LONG/BUY	SHORT/SELL	DESCRIPTION	EX	PRICE/LEGND	CC	DEBIT	CREDIT
***** YOUR ACTIVITY THIS MONTH *****									
4/15/2	F1	38		PUT JUL 02 CORN	200	01	NET PREM US	14,324.10	
4/15/2	F1		38	PUT DEC 02 CORN	200	01	NET PREM US		11,375.90
4/22/2	F1	76		PUT JUL 02 CORN	180	01	NET PREM US	6,304.45	
4/22/2	F1						BENKDEP US		4,000.00
				BRANCH BANK DEPOSIT					

April 2002										
Date	Long/ Buy	Short/ Sell	Option type	Contract month		Strike price	Option price	bushels	Total Cost/ Revenue	Wt Ave Cost/bu
LONG PUTs										
4/15/02	38		PUT	JUL02	CORN	200	\$0.07000	190,000	\$13,300.00	\$0.0700
SHORT PUTs										
4/15/02		34	PUT	DEC02	CORN	200	\$0.06500	170,000	\$11,050.00	Wt Ave
4/15/02		4	PUT	DEC02	CORN	200	\$0.06750	20,000	\$1,350.00	Rev/bu
		38						190,000	\$12,400.00	\$0.0653
LONG PUTs										
4/19/02	3		PUT	JUL02	CORN	180	\$0.01000	15,000	\$150.00	Wt Ave
4/19/02	73		PUT	JUL02	CORN	180	\$0.01125	365,000	\$4,106.25	Cost/bu
	76							380,000	\$4,256.25	\$0.0112

Long Puts - April 15, 2002

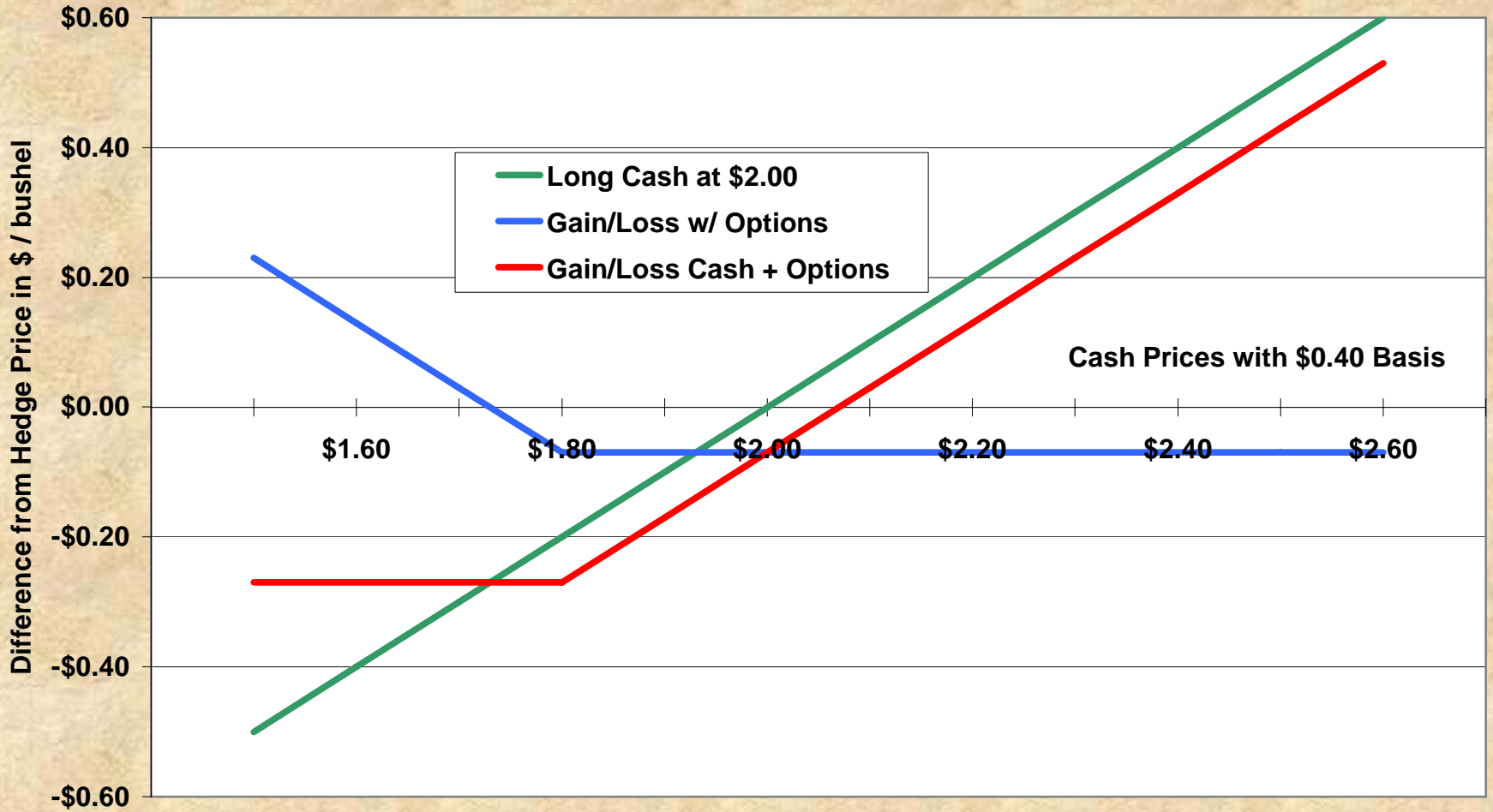


Figure 1. Long 38 PUTs Jul02 at \$2.00 - April 15, 2002



Short Puts - April 15, 2002

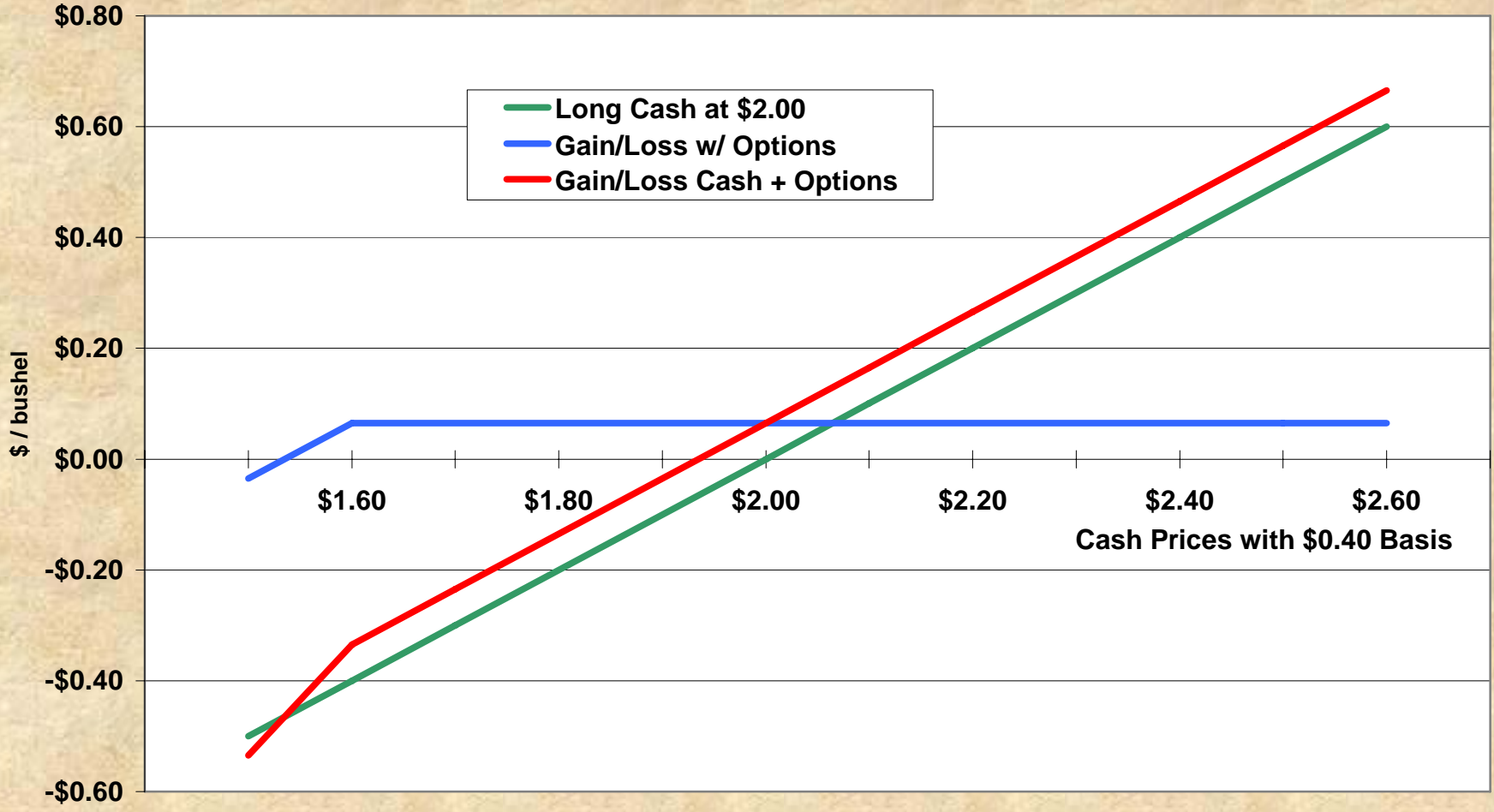
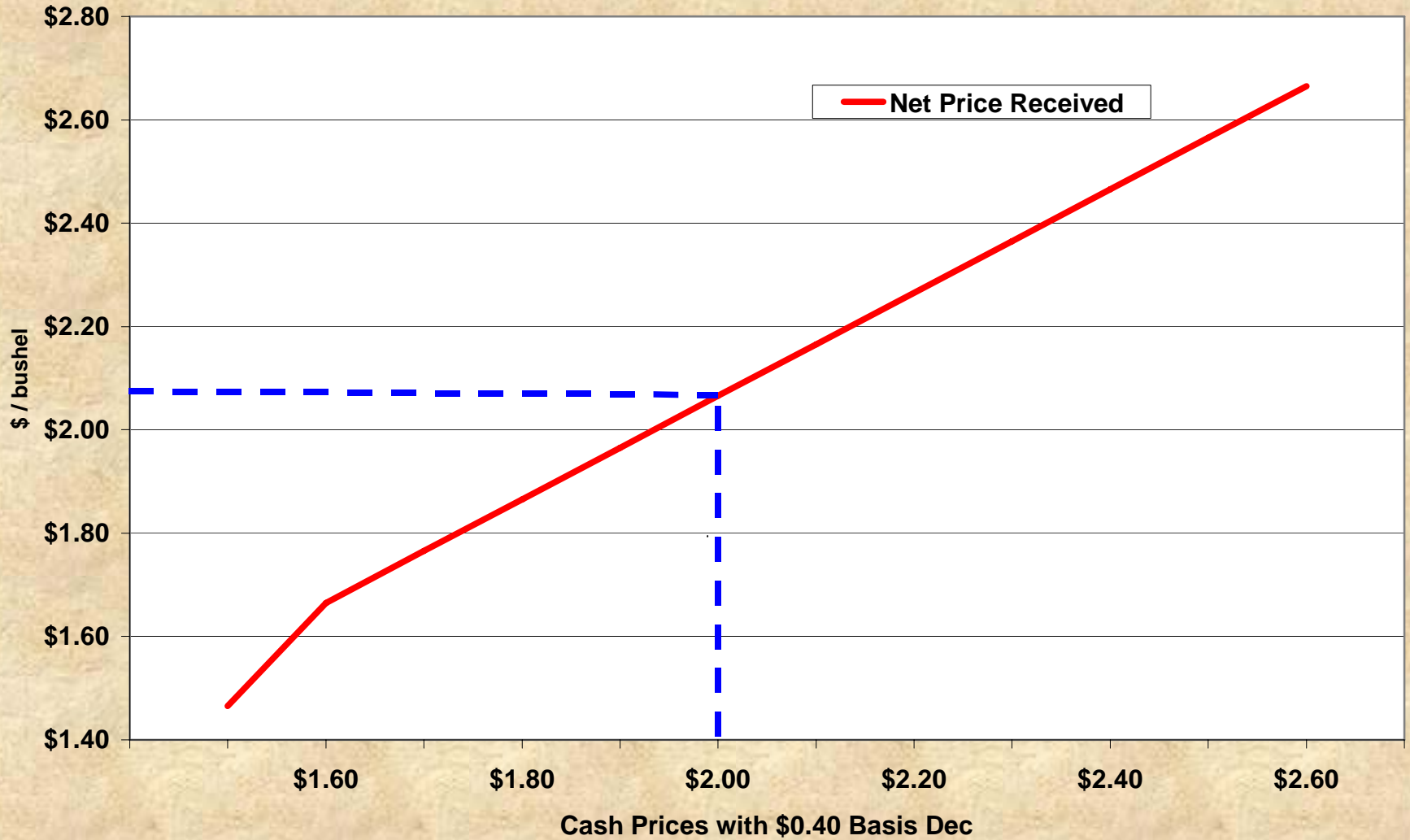


Figure 2. Short 38 PUTs Dec02 at \$2.00 - April 15, 2002



Long PUT - April 19, 2002

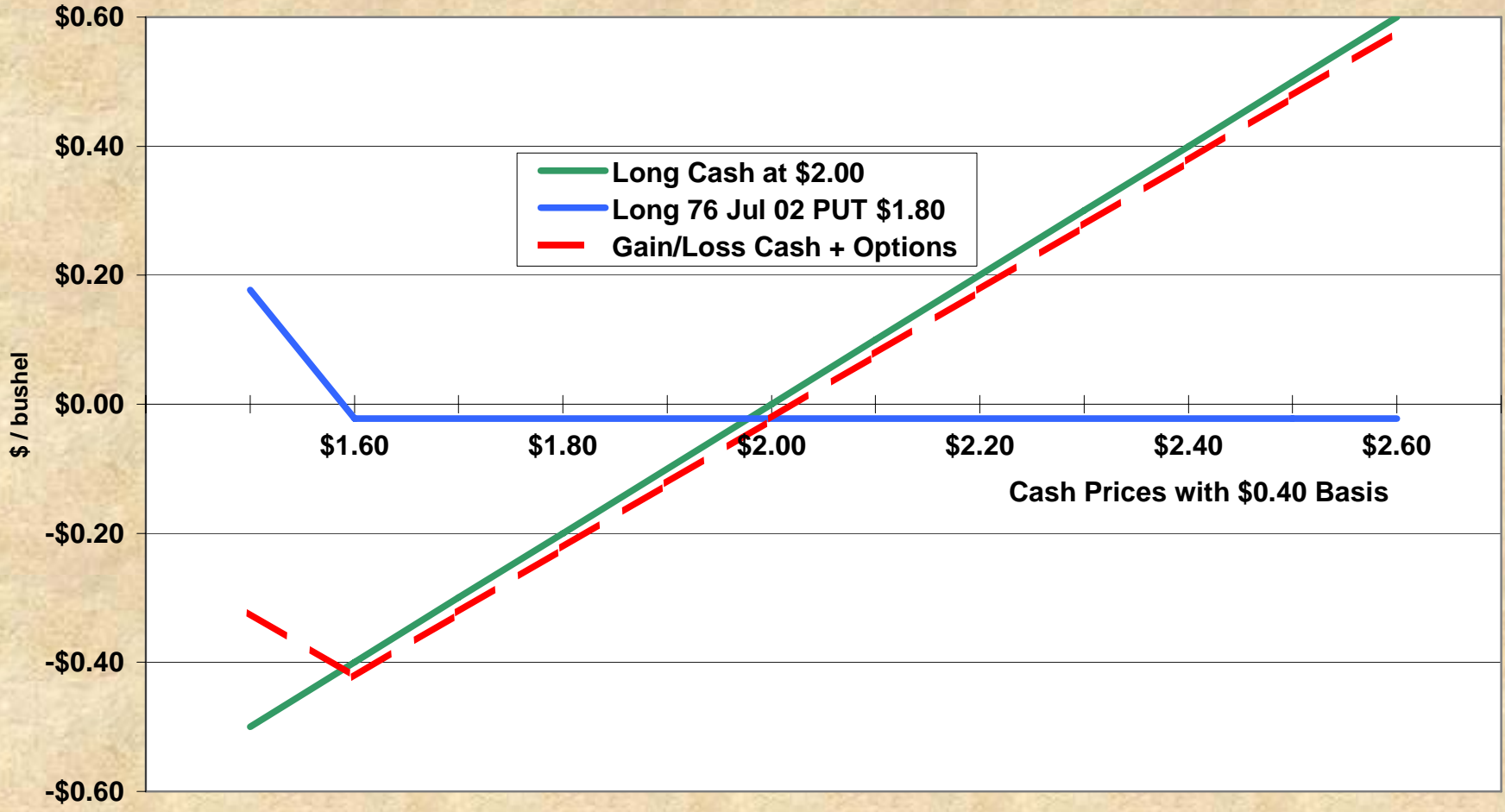
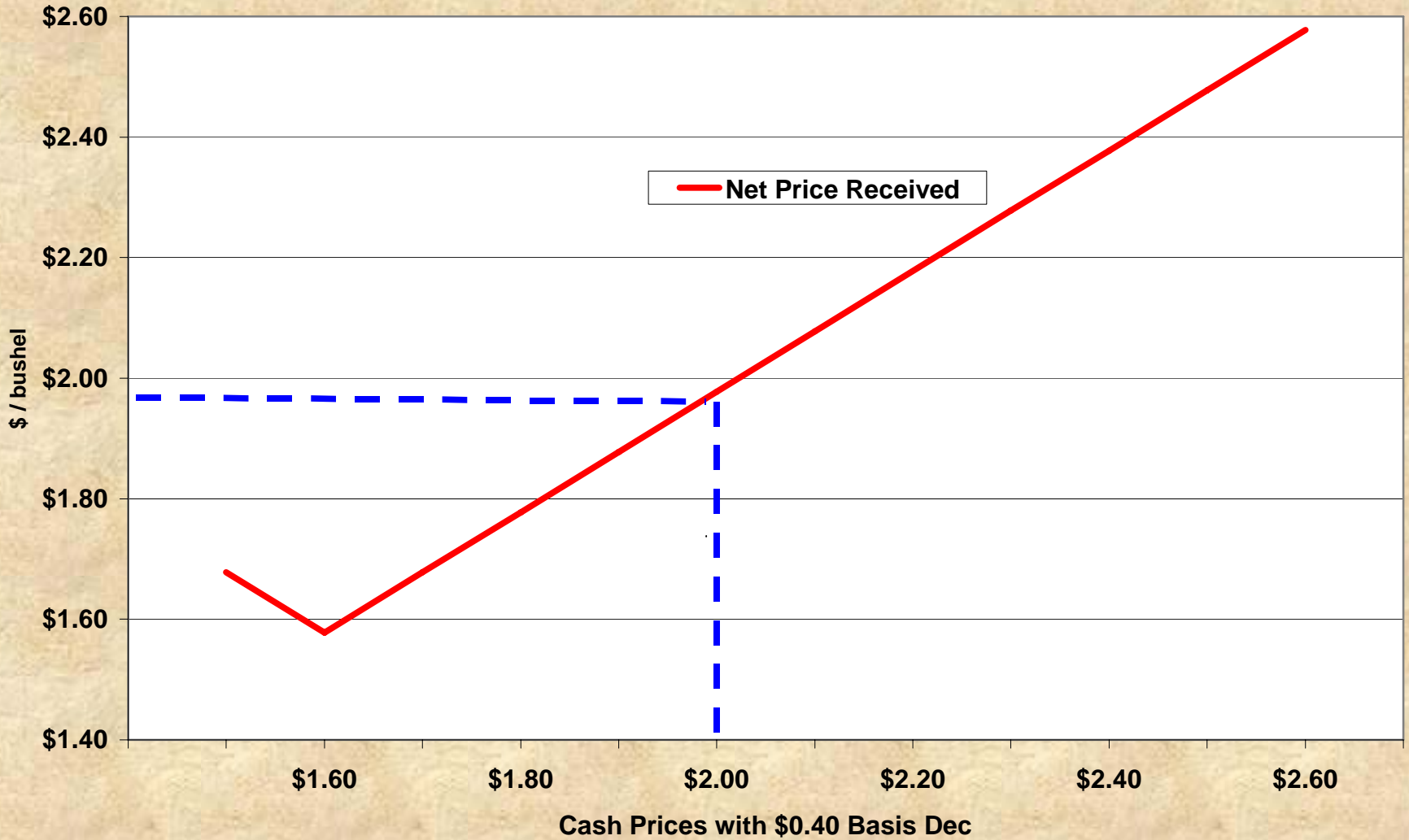


Figure 3. Long 76 PUTs Jul02 at \$1.80 - April 19, 2002



May statement from Futures Commission Merchant

DATE	AT	LONG/BUY	SHRT/SELL	DESCRIPTION	EX	PRICE/LEGND	CC	DEBIT	CREDIT
***** YOUR ACTIVITY THIS MONTH *****									
5/06/2	F1			BRANCH BANK DEPOSIT		BENKDEP	US		3,100.00
5/10/2	F1			BRANCH BANK DEPOSIT		BENKDEP	US		1,800.00
5/13/2	F1	22		CALL SEP 02 CORN	210	01	NET PREM	US	20,817.90
5/13/2	F1		46	CALL DEC 02 CORN	260	01	NET PREM	US	16,422.80
5/14/2	F1	16		CALL SEP 02 CORN	210	01	NET PREM	US	16,281.20
5/14/2	F1		30	CALL DEC 02 CORN	260	01	NET PREM	US	11,154.00
5/20/2	F1			BRANCH BANK DEPOSIT		BENKDEP	US		13,800.00

Testimony from the marketing firm

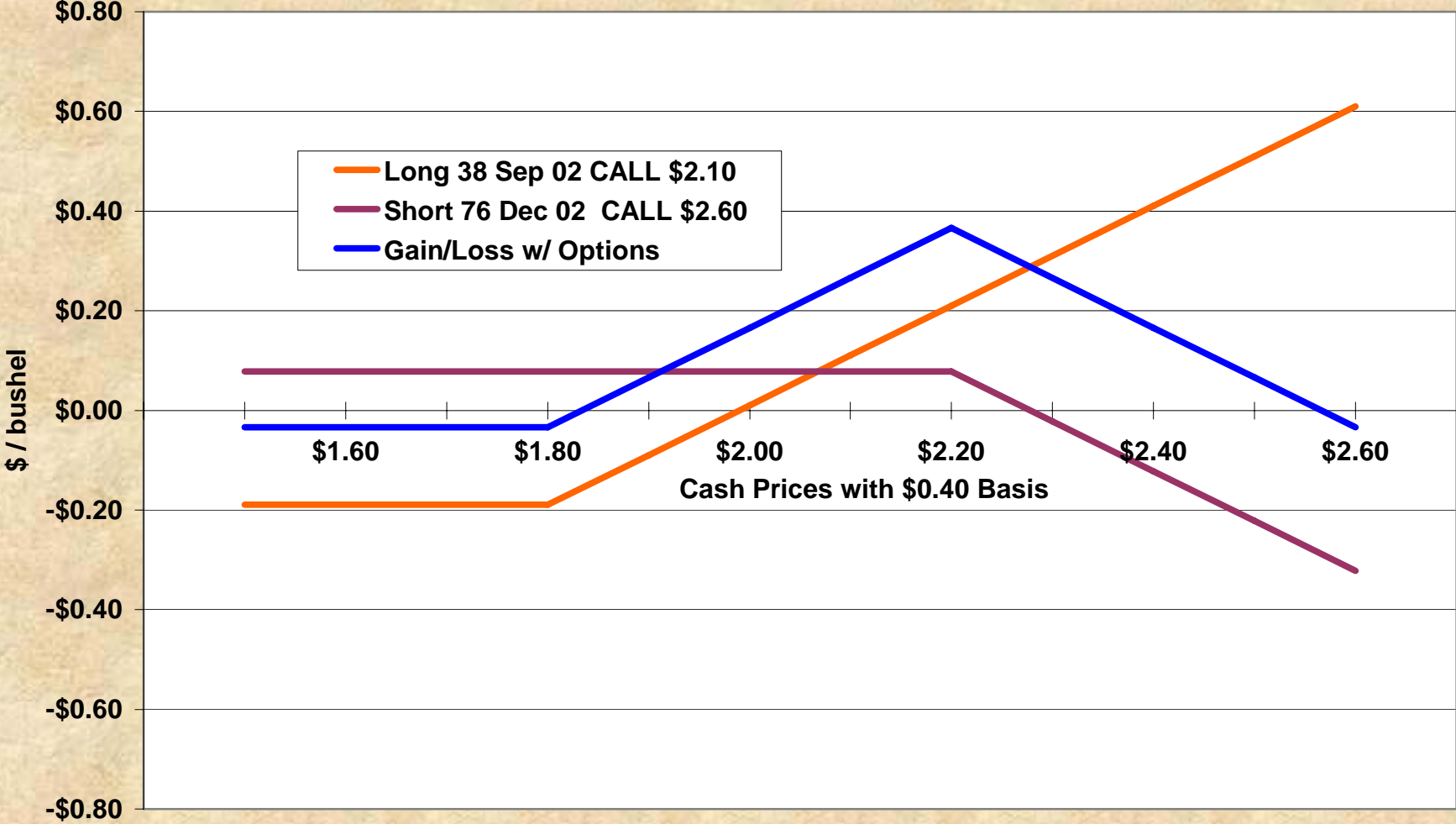
1 5/13/02 Bot call spreads:

Bot 1 Sep 210 Call	19.23	open
Sold 2 Dec 260 Calls 7.25	<u>-14.50</u>	open
Net premium paid	4.73	

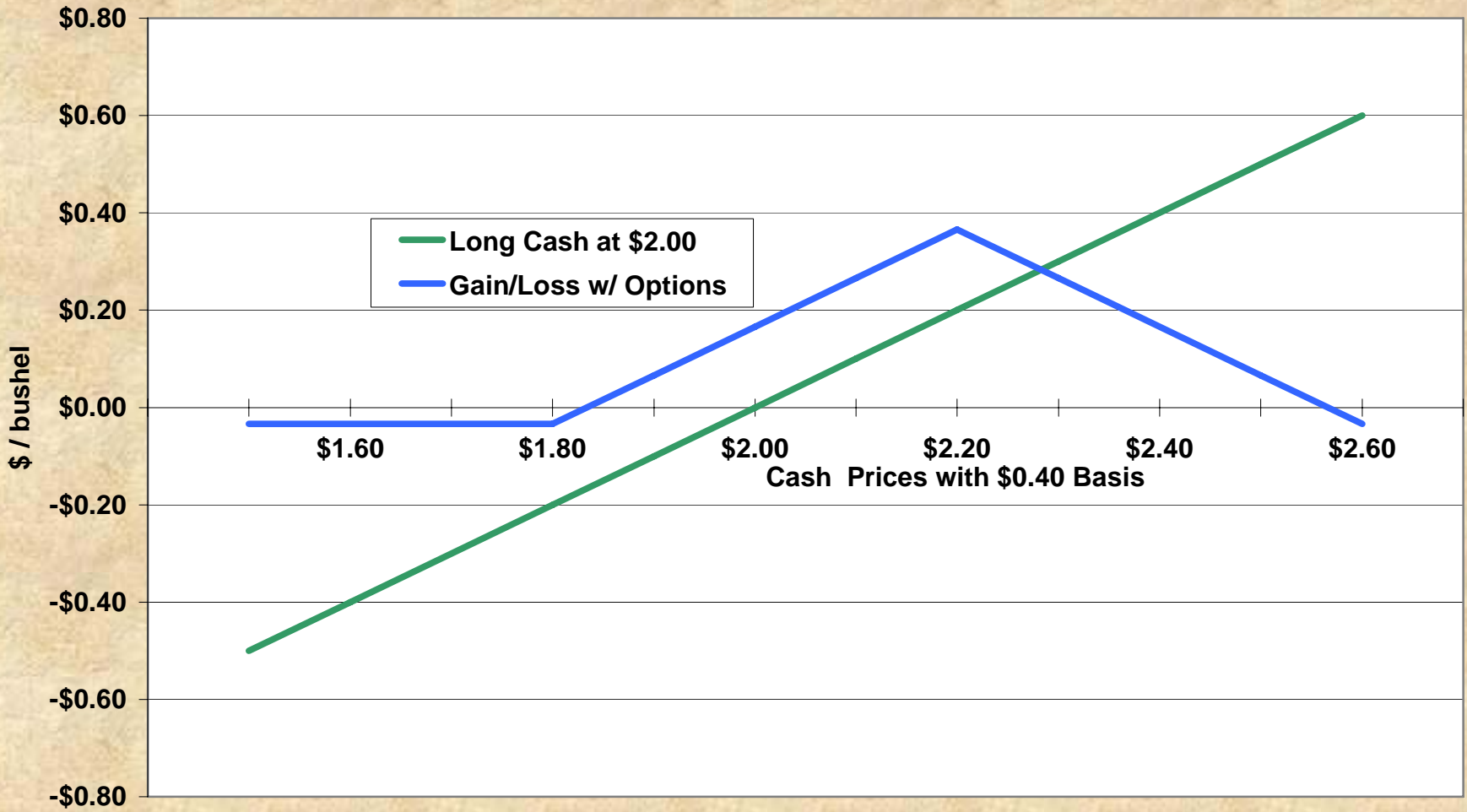
Our strategy to be aggressive buyers of put options/put spreads if and when the market goes higher. We will use these calls to mitigate losses on puts as we try to “roll” long put options to a higher strike price in a rallying market.

May 2002											
	Long/	Short/	Option	Contract		Strike	Option		Total Cost/		
Date	Buy	Sell	type	month		price	price	bushels	Revenue		
RATIO CALL SPREAD											
5/13/02	1		CALL	SEP 02	CORN	210	\$0.1775	5,000	\$887.50		
5/13/02	6		CALL	SEP 02	CORN	210	\$0.1800	30,000	\$5,400.00		
5/13/02	13		CALL	SEP 02	CORN	210	\$0.1850	65,000	\$12,025.00		
5/13/02	1		CALL	SEP 02	CORN	210	\$0.1900	5,000	\$950.00		
5/13/02	1		CALL	SEP 02	CORN	210	\$0.1925	5,000	\$962.50		
5/14/02	2		CALL	SEP 02	CORN	210	\$0.1850	10,000	\$1,850.00		
5/14/02	7		CALL	SEP 02	CORN	210	\$0.2000	35,000	\$7,000.00		Wt Ave
5/14/02	<u>7</u>		CALL	SEP 02	CORN	210	\$0.2000	<u>35,000</u>	<u>\$7,000.00</u>		Cost/bu
	38							190,000	\$36,075.00		\$0.1899
5/13/02		13	CALL	DEC 02	CORN	260	\$0.0750	65,000	\$4,875.00		
5/13/02		33	CALL	DEC 02	CORN	260	\$0.0775	165,000	\$12,787.50		
5/14/02		3	CALL	DEC 02	CORN	260	\$0.0775	15,000	\$1,162.50		Wt Ave
5/14/02		<u>27</u>	CALL	DEC 02	CORN	260	\$0.0800	<u>135,000</u>	<u>\$10,800.00</u>		Rev/bu
		76						380,000	\$29,625.00		\$0.0780

Ratio CALL Spread - May 13 & 14, 2002



Gains/ Losses from Cash & Options - May 13 & 14, 2002



Ratio CALL Spread - May 13 & 14, 2002

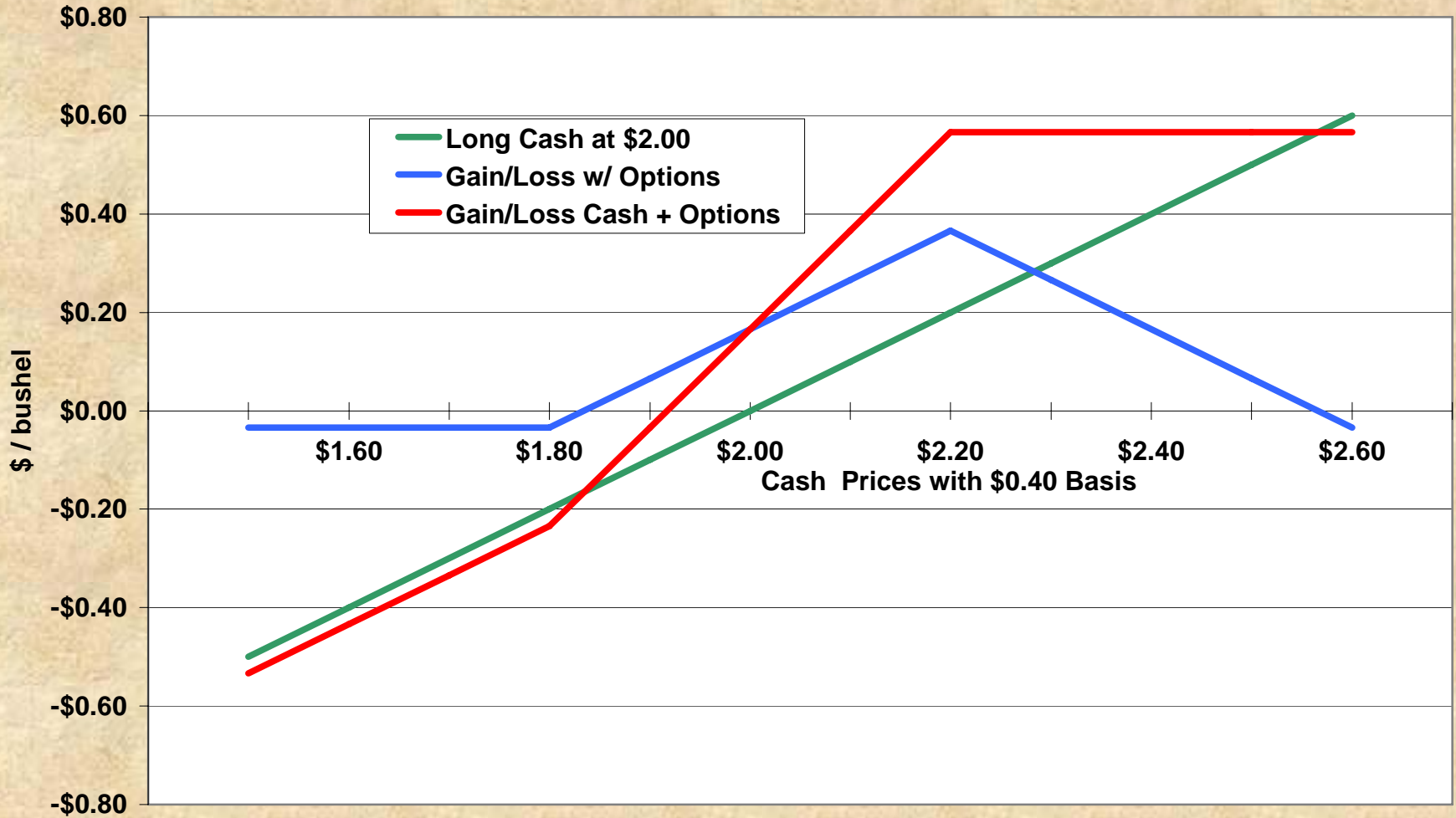
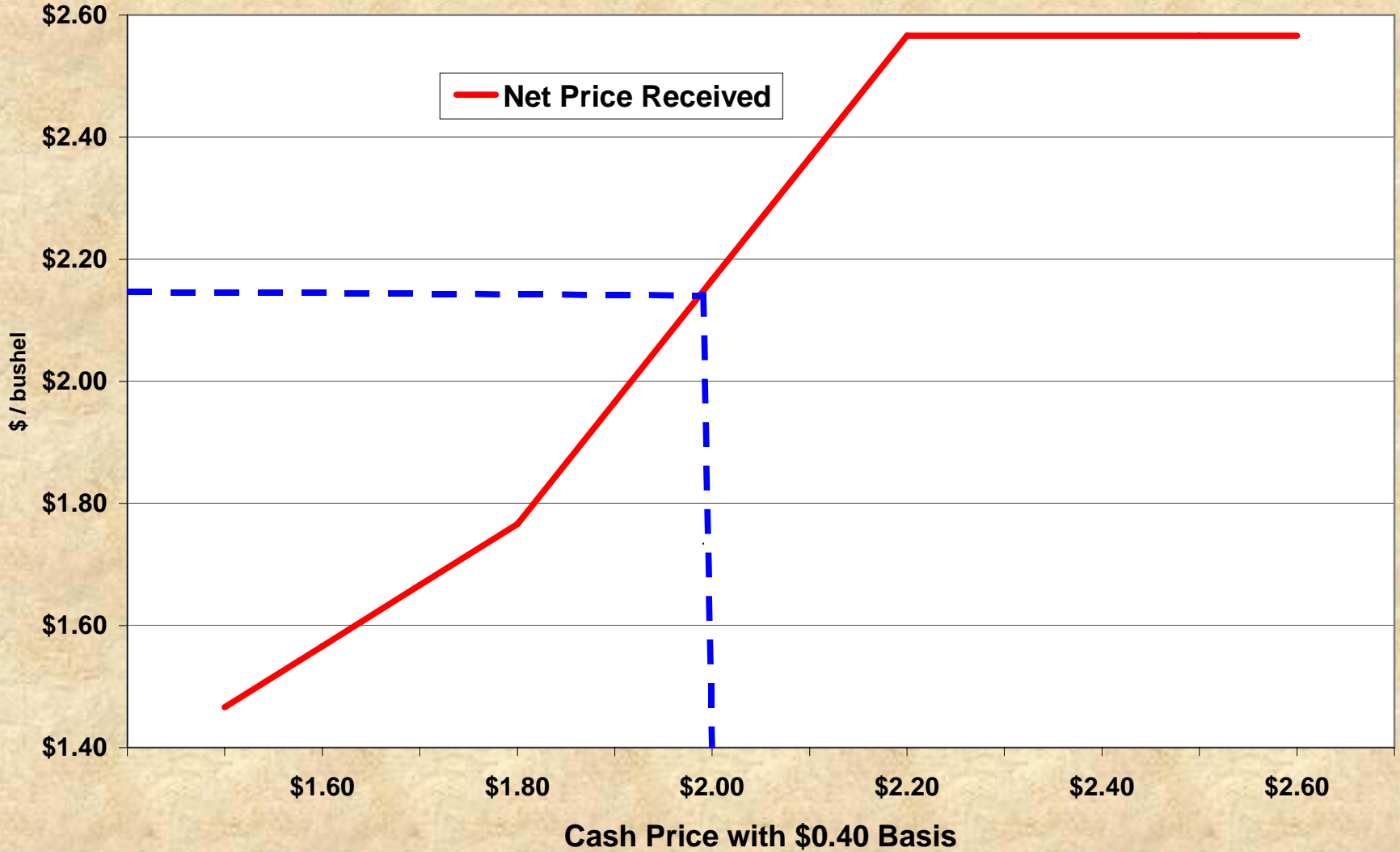


Figure 4. Ratio CALL Spread (Long 38 Sep02 CALLs at \$2.10, Short 76 Dec02 CALLs at \$2.60) - May 13 & 14, 2002



Questions to answer

- **Are all of the transactions hedges (Y/N)?**
- **If NO, which ones are hedges?**
- **Which one are speculative?**

Positions in your account April & May 2002

April 2002

Date	Long/ Buy	Short/ Sell	Option type	Contract month		Strike price	Option price	bushels	Total Cost/ Revenue	Wt Ave Cost/bu
4/15/02	38		PUT	JUL02	CORN	200	\$0.07000	190,000	\$13,300.00	\$0.0700
4/15/02		34	PUT	DEC02	CORN	200	\$0.06500	170,000	\$11,050.00	Wt Ave
4/15/02		<u>4</u>	PUT	DEC02	CORN	200	\$0.06750	<u>20,000</u>	<u>\$1,350.00</u>	Rev/bu
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4/19/02	<u>73</u>		PUT	JUL02	CORN	180	\$0.01125	<u>365,000</u>	<u>\$4,106.25</u>	Cost/bu
	76							380,000	\$4,256.25	\$0.0112

May 2002

Date	Long/ Buy	Short/ Sell	Option type	Contract month		Strike price	Option price	bushels	Total Cost/ Revenue	Wt Ave Cost/bu
5/13/02	1		CALL	SEP 02	CORN	210	\$0.1775	5,000	\$887.50	
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5/13/02	13		CALL	SEP 02	CORN	210	\$0.1850	65,000	\$12,025.00	
5/13/02	1		CALL	SEP 02	CORN	210	\$0.1900	5,000	\$950.00	
5/13/02	1		CALL	SEP 02	CORN	210	\$0.1925	5,000	\$962.50	
5/14/02	2		CALL	SEP 02	CORN	210	\$0.1850	10,000	\$1,850.00	
5/14/02	7		CALL	SEP 02	CORN	210	\$0.2000	35,000	\$7,000.00	Wt Ave
5/14/02	<u>7</u>		CALL	SEP 02	CORN	210	\$0.2000	<u>35,000</u>	<u>\$7,000.00</u>	Cost/bu
	38							190,000	\$36,075.00	\$0.1899
5/13/02		13	CALL	DEC 02	CORN	260	\$0.0750	65,000	\$4,875.00	
5/13/02		33	CALL	DEC 02	CORN	260	\$0.0775	165,000	\$12,787.50	
5/14/02		3	CALL	DEC 02	CORN	260	\$0.0775	15,000	\$1,162.50	Wt Ave
5/14/02		<u>27</u>	CALL	DEC 02	CORN	260	\$0.0800	<u>135,000</u>	<u>\$10,800.00</u>	Rev/bu
		76						380,000	\$29,625.00	\$0.0780

April & May 2002

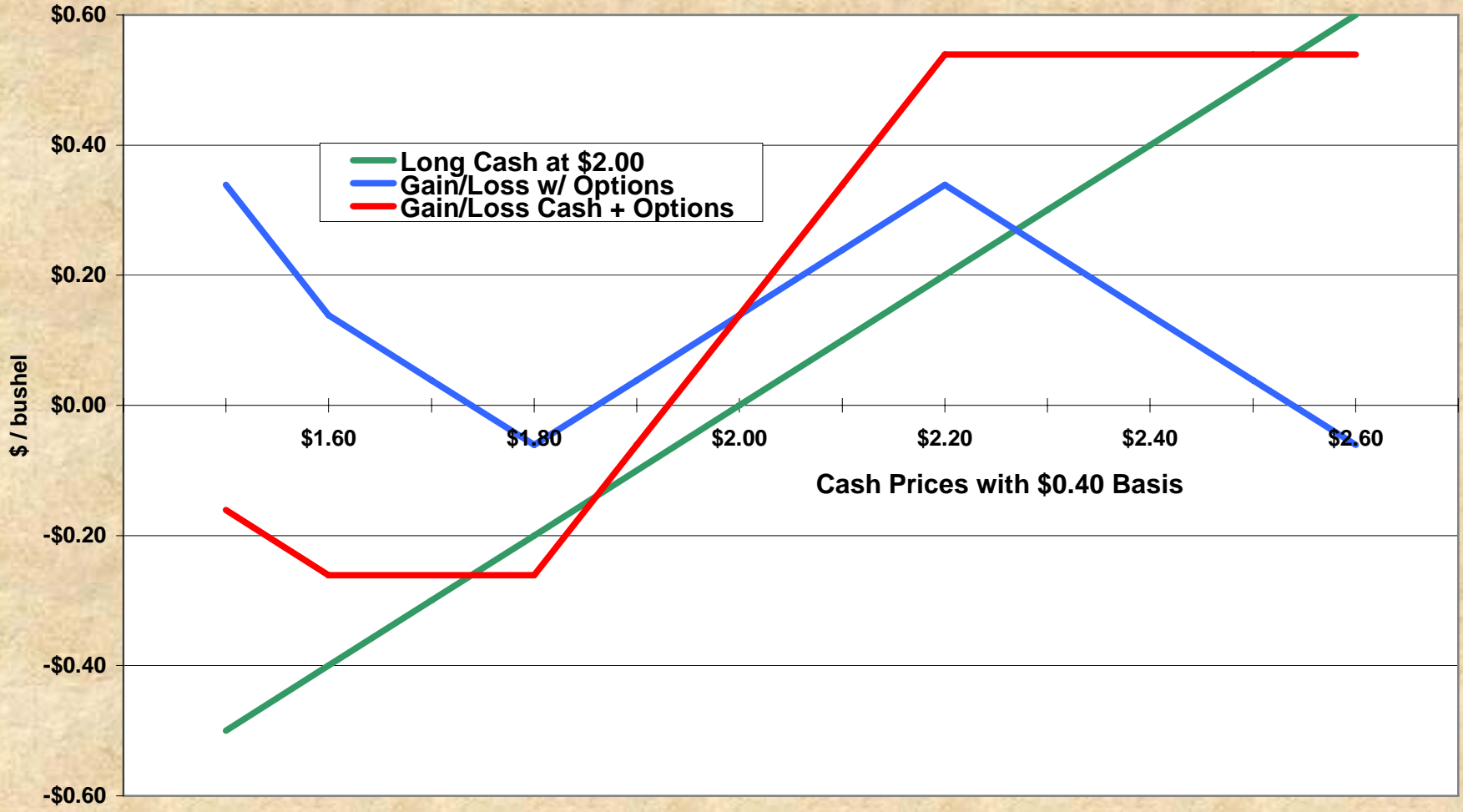
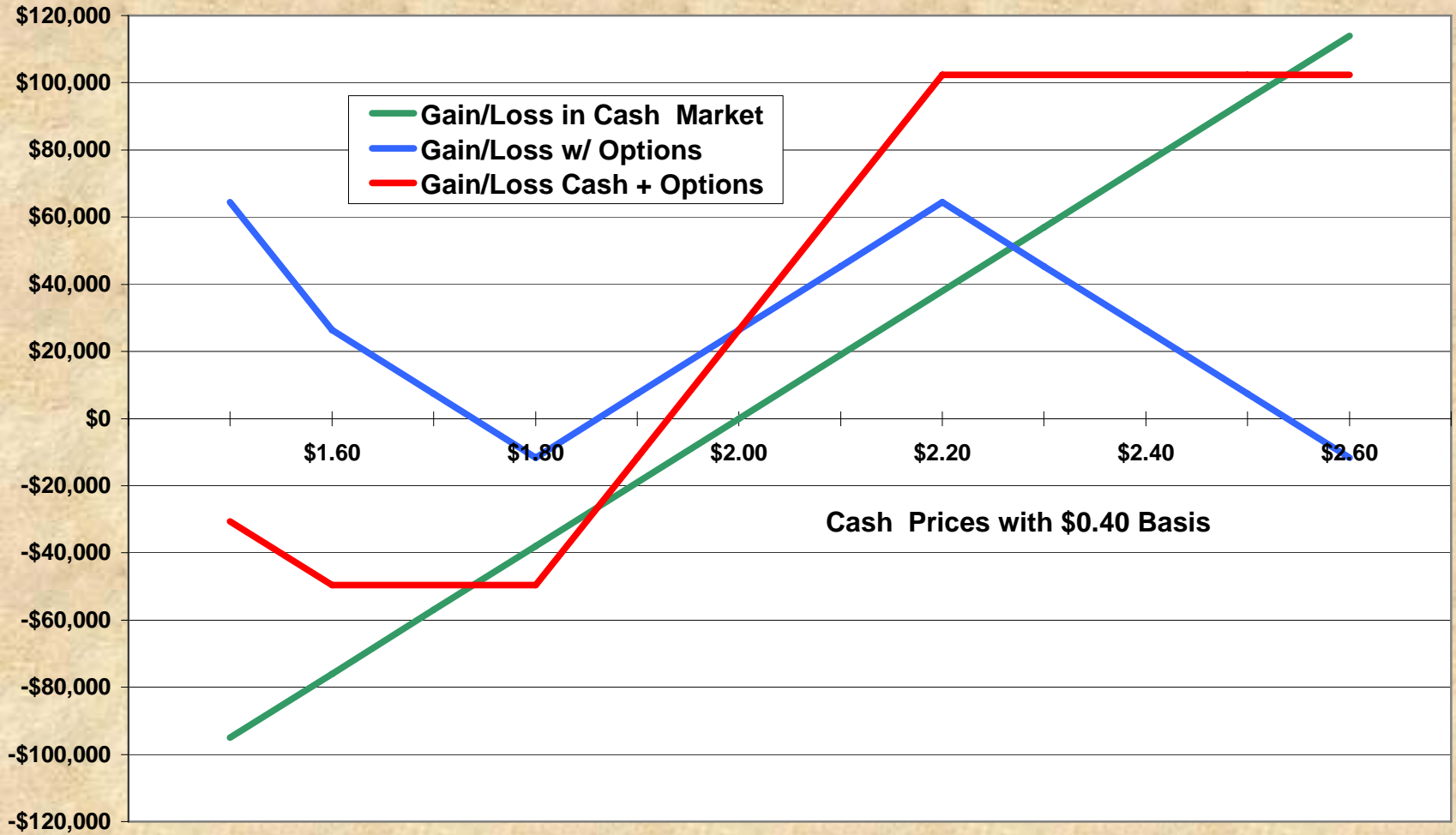


Figure 2. All Positions, End of May 2002



April & May 2002



Questions and Comments