

FINAL REPORT

**HEDGE TO ARRIVE CONTRACTS
STUDY COMMITTEE**

Presented to the Legislative Council
and the Iowa General Assembly
March 1997

Prepared by the Legislative Service Bureau



Legislative
Service
Bureau

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Hedge to Arrive Contracts Study Committee

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AUTHORIZATION AND APPOINTMENT

The Hedge to Arrive Contracts Study Committee was established by the Legislative Council for the 1996 Interim to "review the potential effects of 'hedge to arrive' (HTA) contracts on farmers, grain elevators, and the Grain Indemnity Fund". The Committee was also charged to "assess the role of the state in addressing the potential effects" of these contracts.



Hedge to Arrive Contracts Study Committee

1. Overview.

The Hedge to Arrive Contracts Study Committee was established following the 1996 Session of the General Assembly in response to a number of cases involving disputes between grain elevators and agricultural producers who were parties to hedge to arrive contracts for the sale of grain, and specifically corn.

Hedge to Arrive (HTA) contracts refer to a wide variety of hybrid contracts that combine some of the features of a forward cash contract and futures trading. The contracts usually allow a producer to set a price based on the futures market and to choose the basis at a later date when the grain is delivered to the elevator.

In a common case, a farmer and an elevator execute a contract in which the farmer promises to deliver grain to the elevator in a future month (reference month) at an agreed-upon price. The farmer assumes responsibility for the basis. The elevator hedges the sale in the futures market on behalf of the farmer. The elevator then makes any required margin calls on the farmer's behalf until the contract matures. Importantly, the contract allows the farmer to select a later delivery month (a new reference month) and adjust the price accordingly. Specifically, the price of the contract is adjusted by adding to the old contract price, the difference between the price of the later reference month and the price of the original reference month less any fees for changing the delivery and pricing dates. This arrangement is referred to as "rolling" the contract. In cases where grain is in storage or has been harvested but not yet priced, farmers may roll the reference price of the contract to a reference month within the same crop year. In other cases, grain is promised for delivery in a subsequent crop year, allowing the farmer to sell grain which is not currently stored or in production and locking in a price for grain to be harvested during a subsequent year.

In 1995 and 1996, an unusually sharp run-up in the July corn futures price meant that the cost of "rolling" an HTA contract from one period to another (e.g. July to December) reached up to \$1.60 per bushel, many times greater than the usual 20-cent to 30-cent differential. This caused financial distress to producers who experienced a short crop in 1995 and either decided to roll into the next crop year, deliver next fall instead of the spring as originally specified, or who had entered into multiyear contracts.

2. Committee Proceedings.

The Study Committee met on three days in order to receive testimony and make recommendations.

a. First Meeting. The first meeting of the Study Committee was held on November 19, 1996, in Room 334, Vocational Technical Building, Iowa Central Community College, Fort Dodge, Iowa. The testimony received by the Study Committee is summarized as follows:

(1) Attorney General's Office - Legal Overview. Mr. Eric Tabor, Assistant Attorney General, Farm Division, Iowa Attorney General's Office, discussed the

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legal issues involved in the use of HTA contracts. Mr. Tabor stated that the primary legal issue is whether the HTA contracts in question are illegal and unenforceable under the federal Commodity Exchange Act (CEA), and raised the question regarding whether HTA contracts which can be extended for multiple years fall within the cash-forward contract exception to federal regulation or whether they are illegal "off-exchange" futures transactions. Mr. Tabor explained that the federal Commodity Futures Trading Commission (CFTC) regulates HTA contracts governed by federal law, and discussed pending administrative actions and investigations related to HTA contracts.

(2) *Grain Warehouse Bureau - State Regulatory Issues.* Ms. Donna Gwinn, Bureau Chief, Grain Warehouse Bureau, Department of Agriculture and Land Stewardship, discussed regulatory issues involved in HTA contracts. Ms. Gwinn stated the Grain Warehouse Bureau does not regulate HTAs since the Bureau regulates transactions involving the delivery of grain. She stated that a recent survey by the Bureau of grain dealer licensees shows that no licensees have failed due to the use of HTA contracts; however, she acknowledged there have been some reorganizations due to the use of HTA contracts.

(3) *Views of Producers.* Mr. Scott Buchanan, an attorney representing producers involved in litigation, introduced a panel of three producers who entered into multiple-year HTA contracts. Producers Karen Davids, Paul Harrington, and Janice Hoover all discussed how they were introduced to the use of HTA contracts, how much information was provided to them regarding the risks involved prior to entering into the contracts, and how the use of these contracts eventually led to significant liabilities. Ms. Davids stated that increased education regarding HTA contracts is important and encouraged the Committee to consider legislation recently enacted in Indiana regulating grain marketing contracts.

Mr. Rueben Skow, producer shareholder member of the Farmers Co-op Society at Wesley, Iowa, is not involved in litigation. Mr. Skow stated the shareholder members will suffer financially due to problems some cooperative associations are experiencing with multiple-year HTA contracts, and expressed the belief that there is no legislative solution to the problem and that education is the answer to preventing this problem from occurring in the future.

(4) *Views of Commodities Firms.* Two representatives of different commodities firms gave their respective views on multiple-year HTA contracts. Mr. Harold Richard, President and CEO of Farmers Commodities Corporation, stated that the usage of multiple-year HTA contracts involves a very small fraction of elevators and producers in the grain business. Mr. Richard indicated the industry is attempting to alleviate problems with HTA contracts through education, limiting rolling, and monitoring commodity trading advisors. Mr. Richard expressed his belief that no legislation is necessary. Mr. C. Richard Stark, President of Iowa Commodities Ltd., stated the problem is not the use of HTA contracts, but the abuse of such contracts. Mr. Stark suggested that the



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current problems caused by HTA contracts could place a strain on the Iowa Grain Depositors and Sellers Indemnity Fund. Mr. Stark suggested the use of multiple-year HTA contracts could be improved by requiring the following:

- ◊ That elevators provide collateral for the contracts.
- ◊ That HTA contracts be fully margined like futures on the Chicago Board of Trade.

(5) *Views of Elevator Managers.* Mr. Ron Amundson, General Manager of the Central Iowa Cooperative, stated that most of the recent problems concerning HTA contracts are the result of an unprecedented price increase combined with sellers rolling forward HTA contracts. Mr. Amundson expressed a belief that there is no legislative solution to the problem. Mr. Amundson stated that education is important. Mr. John Peterson, Manager of Farmers Cooperative Company, Woolstock, Iowa, discussed the effects of multiple-year HTA contracts on cooperative associations. Mr. Peterson noted that multiple-year HTA contracts have caused problems for producers entering into the contracts, in addition to the producers who have invested equity in cooperative associations. Mr. Peterson stated that he does not believe legislation would solve the problem, but stressed more education is needed.

(6) *Views of the Industry.* Mr. David Reiff, President of Reiff Grain and Feed, Inc., discussed why some privately owned elevators have experienced problems with HTA contracts. Mr. Reiff stated that regulation is not the answer since he believes the problems have been caused by isolated instances of abuse and market forces. He stated flexible contracting and rolling are useful tools and can be used for the benefit of producers. Mr. Reiff stated the CFTC has been acting within its authority and is the proper agency to be reviewing whether some agreements violated the CEA.

(7) *Accounting.* Mr. Dan Gardiner, accountant with Gardiner & Co., discussed the accounting methods associated with the use of HTA contracts. Mr. Gardiner stated that an important accounting determination is the materiality of an HTA receivable.

b. **Second Meeting.** The second meeting of the Study Committee was held on December 20, 1996, in the Campanile Room of the Iowa State Memorial Union in Ames, Iowa. The testimony of the meeting is summarized as follows:

(1) *Commodity Futures Trading Commission.* Mr. Paul Architzel, Chief Counsel, Division of Economic Analysis, Commodity Futures Trading Commission, discussed the problem created by HTA contracts, implications of the Commodity Exchange Act (CEA), the role of the Commodity Futures Trading Commission (CFTC), CFTC staff actions, CFTC enforcement activities, and the role of states in regulating HTA contracts. Mr. Architzel criticized HTA contracts which allow producers to continually roll the delivery date and pricing provisions of the contract into the future. Mr. Architzel noted that many HTA contracts are poorly written and accounting practices have not kept pace with

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the use of these HTA contracts. In addition, Mr. Architzel explained that states have standing under the CEA to bring civil actions in federal court against persons for a violation of any provision of the CEA or any rule or regulation of the CFTC. He stated that the "open-season" provision of the CEA authorizes states to invoke any relevant state law or regulation against off-exchange or unregistered commodity transactions.

(2) *Dr. Neil E. Harl.* Dr. Neil E. Harl, Charles F. Curtiss Distinguished Professor in Agriculture and Professor of Economics, Iowa State University, discussed HTA contracts and contractual and tax implications, and suggested possible remedial measures. Dr. Harl stated that HTA contracts are at a high risk of being considered an off-exchange transaction if they include the following:

- ◊ Several years of production.
- ◊ The ability to roll the contract into future contract months.
- ◊ No expectation of delivery.

Some of the remedial measures suggested by Dr. Harl include the following:

- ◊ More CFTC guidance on the scope of the cash-forward contract exception.
- ◊ More patrolling of the exception.
- ◊ State regulators taking steps to identify risks with HTA contracts, including the surveillance of contracts being used and the regulation of the level of disclosure required between the parties.
- ◊ Adding discipline to the process by requiring commodity sellers to meet margin calls directly.
- ◊ More adequate, standardized contracts.
- ◊ Education on the consequences of risk management strategies.
- ◊ Testing every contract under worst case scenarios before signing.

Dr. Harl suggested there should not be a prohibition against certain types of trades or risk management instruments. Dr. Harl stated the line between hedging and speculating has not been clearly defined. In responding to questions by members of the Committee, Dr. Harl's remarks included the following:

- ◊ While Iowa could prescribe a specific contract, a more prudent measure might be to prescribe a list of minimal elements each contract must have and to allow the parties to have some room for innovation.
- ◊ Protecting innocent shareholders of cooperatives could be best accomplished by focusing on the contractual relations between the elevators and the producers.



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- ◊ There are a few well-drafted HTA contracts being used.
- ◊ Few HTA contracts include a provision for disclosure of margin calls.
- ◊ Many HTA contracts provide no guidance on the issue of a party being released from the contract.
- ◊ Bankruptcy laws will not provide a significant amount of protection.

(3) *Legal Issues.* Mr. Stephen Moline, Mr. Eric Tabor, and Mr. Stephen Reno, Assistant Attorneys General, discussed CFTC regulations and enforcement, laws adopted in Indiana related to the use of HTA contracts, and the status of laws in other states related to the use of HTA contracts. Mr. Moline discussed what elements the CFTC appeared to be looking for when they filed their enforcement actions. These elements include:

- ◊ A lack of intent or capacity to deliver grain.
- ◊ Indefinite delivery because of unlimited rollover provisions.
- ◊ Peculiar cancellation clauses.

Mr. Tabor discussed the legislation enacted in Indiana in response to the HTA contracts issue. Legislation enacted by Indiana includes:

- ◊ Requiring grain dealers to provide a proof of registry with the CFTC, to demonstrate the passage of the Series Three Examination administered by the National Association of Security Dealers, and to attend approved continuing education annually.
- ◊ Penalties for not complying with the grain dealer qualifications.
- ◊ A more inclusive definition of grain marketing advisors than that used by the CFTC.
- ◊ Requiring grain marketing advisors to register with the Indiana Commodity Warehouse Licensing Agency (ICWLA) and to provide ICWLA with proof of registry with the CFTC.
- ◊ Penalties for not complying with the grain marketing advisor qualifications.
- ◊ Required written notice in each contract for the purchase of grain from producers except in a flat price contract.

Mr. Reno stated that there is little legislative action taking place in other states in response to the HTA contract issue. Some states do not have a major problem with HTA contracts, some states are taking a wait-and-see approach, and Indiana is the only state to enact legislation.

(4) *Views of Elevators.* Elevator representatives Mr. David Milbrandt, Mr. Joe Goche, and Mr. Dan Beenken all discussed use of HTA contracts at their elevators. Mr. Milbrandt stated that not all of the HTA contract customers

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defaulted on their contracts at his elevator. Mr. Milbrandt noted that the defaults of the HTA contract customers at his elevator amount to approximately \$4,500,000. Mr. Goche noted that HTA contract defaults had not been a problem until 1996, when grain prices became very high. Mr. Beenken stated the defaults on HTA contracts at his elevator amount to about \$4,000,000, which equals about 70 percent of the equity in the cooperative. He stated that these defaults will have a direct negative impact on the local economy. Mr. Beenken suggested that the Legislature could create either a fund to allow producers to borrow money to repay the elevators or a fund to allow the elevators to apply for low-interest loans to relieve the financial burdens defaults of HTA contracts cause. Mr. Ray Smith, producer, stated that, although he lost money, he complied with his contractual obligation under an HTA contract in 1996. Mr. Smith stated HTA contracts can be a valuable tool and there should not be a prohibition against the use of these contracts.

(5) Audience Discussion. Mr. Ed Kordick, Iowa Farm Bureau Federation, discussed the ongoing educational efforts being made by the Iowa Farm Bureau Federation regarding HTA contract issues. Mr. Scott Buchanan, an attorney representing producers involved in litigation, discussed issues involved in the HTA contract problem and possible remedial measures including:

- ◊ The development of an emergency loan or assistance fund.
- ◊ Defining jurisdictional issues.
- ◊ The positive aspects of the Indiana HTA contract legislation.

Ms. Donna Gwinn, Bureau Chief, Grain Warehouse Bureau, Department of Agriculture and Land Stewardship, reviewed a letter she submitted to the Committee regarding the debt-to-asset ratio of grain dealer licensees. She stated a survey of licensees who have been using HTA contracts shows five licensees have a debt-to-asset ratio of above 75 percent.

c. **Third Meeting.** The third meeting of the Study Committee was held on February 3, 1997, in Room 22 of the State Capitol. The Committee discussed a number of issues relating to HTA contracts, including regulation by state agencies; the use of standardized contracts; oversight of contracts; disclosure required between the contract parties; the payment of margin calls by producers; provisions of the Indiana law requiring registration and notices to producers entering into marketing contracts; and increasing the level of education.

3. Recommendations.

The Study Committee adopted the following recommendations:

- ◆ That legislation be enacted requiring that hedge to arrive contracts include a standardized notice to sellers disclosing the risks associated with the use of the contracts.



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◆ That legislation be enacted prohibiting a grain merchandiser from entering into a contract which establishes a price for undelivered grain for more than one marketing years plus two reference months.

◆ That the Farm Division of the Attorney General's Office, along with the Iowa Institute of Cooperatives, the Iowa Agribusiness Association, and Iowa State University Extension Service, develop an industry standard contract for use by grain purchasers and producers entering into HTA or credit-sale-type contracts. The suggested contract should address a compendium of components which are deemed necessary to protect both sellers and purchasers and provide for the obligations of both parties required for performance of the contracts.

◆ That the Farm Division of the Attorney General's Office, along with the Iowa Institute of Cooperatives and the Iowa Agribusiness Association, in concert with Iowa State University Extension Service with the cooperation of concerned farm organizations and commodity groups, implement a series of educational programs regarding marketing contracts, contract production, and associated responsibilities. It is recommended that the Iowa General Assembly appropriate and the Governor approve funding in the amount of \$100,000 for these educational programs.

4. Materials Submitted to the Hedge to Arrive Study Committee on File in the Legislative Service Bureau.

- a. Adopted Committee rules.
- b. CFTC news release.
- c. Written testimony of Mr. David Reiff.
- d. Written testimony of Mr. C. Richard Stark.
- e. Written testimony of Mr. C. Richard Stark before United States Senate Agriculture Committee.
- f. Written testimony of Mr. John L. Peterson.
- g. Written testimony of Mr. Rueben Skow.
- h. Informational material provided by the Iowa Attorney General's Office.
- i. Written testimony of Mr. Harold Richard.
- j. Written testimony of Ms. Karen Davids.
- k. Written testimony of Mr. Ron Amundson.
- l. Informational material provided by Mr. Scott Buchanan.
- m. Minutes from the November 19, 1996, meeting of the Hedge to Arrive Contracts Study Committee.
- n. Written testimony of Mr. Paul Architzel.
- o. Complaint and notice in the case of *In re Wright*.

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- p. Complaint and notice in the case of *In re Southern Thumb Co-op, Inc.*
- q. Complaint and notice in the case of *Grain Land Cooperative*.
- r. CFTC news release.
- s. Written testimony of Dr. Neil Harl.
- t. Materials prepared by the Iowa Attorney General's Office.
- u. Provisions of Indiana law regulating grain sales and grain buyers.
- v. Memorandum written by Mr. Craig A. Goettsch.
- w. Written testimony of Mr. David Milbrandt.
- x. Written testimony of Mr. Joe Goche.
- y. Written testimony of Mr. Dan Beenken.
- z. Hedge to Arrive contract.
- aa. Letter written by Ms. Donna Gwinn.
- bb. Iowa Farm Bureau pamphlet titled "Commonly Used Grain Contracts."
- cc. Memorandum to the Committee from Mr. Doug Adkisson, summarizing recommendations by presenters.

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