



## CBOT® Agricultural Futures &amp; Options

# EXCHANGE FOR RISK (EFR) TRANSACTIONS

**T**he Chicago Board of Trade (CBOT) now allows Exchange for Risk (EFR) transactions in all CBOT agricultural futures contracts including Corn, Soybeans, Soybean Meal, Soybean Oil, Wheat, Rice, and Oats futures effective July 1, 2003. This is in keeping with one of the primary objectives of the CBOT: to provide better risk management tools for its customers.

An EFR is a futures market transaction that provides market participants a way to unwind existing over-the-counter (OTC) positions or to initiate new OTC positions. EFRs can be transacted at any time from the inception through the expiration of the OTC position. EFR transactions are acceptable for OTC derivatives that have a reasonable price correlation to CBOT agricultural futures contracts.

Conceptually, an EFR is similar to an Exchange for Physical (EFP) transaction, except that it involves an exchange of a futures position for an OTC position, rather than an exchange for the physical commodity.

This paper highlights the primary customer benefits of using CBOT agricultural EFR transactions. Although an EFR transaction can be used with a variety of OTC agricultural positions, a basic example is used to illustrate the mechanics and flexibility of these transactions. The paper concludes with a Question & Answer section.

## Primary Benefits

*Provides quick and efficient execution of futures transaction.*

Since the parties to an EFR transaction have to be the same parties to the OTC transaction, the timing and price are agreed upon without moving the market or being affected by intraday market volatility.

*Facilitates varying size futures transactions at a single price.*

An EFR can be transacted in any volume that is equivalent to the parties' OTC risk exposure at one price. However, all parties to an EFR transaction are subject to exchange position limits unless they have hedge exemptions.

*Improves effectiveness of non-traditional hedging programs.*

Some commodity by-product or long-dated transactions, which were previously limited to the OTC market, may now be able to benefit from reduced market exposure and slippage. Additionally, OTC positions associated with deferred months may be hedged more effectively.

*Enhances financial integrity of OTC hedging programs.* Since the futures side of an EFR transaction is a Chicago Board of Trade agricultural futures contract, it has the backing of the CBOT clearing services provider.

In summary, these customer benefits highlight the **flexibility** that an EFR transaction brings to your hedging and trading positions.

## Example of an EFR Transaction

In January, a miller wants to establish a price level for a late second quarter delivery of 500,000 bushels of wheat. A financial entity offers the miller an OTC contract to lock in \$3.50/bu for an agreed upon fee. The OTC contract is based on the July CBOT Wheat futures contract and is designed so that if July futures are above 3.50, the financial entity will pay the difference to the miller and if July futures are below 3.50, the miller will pay the difference to the financial entity. To protect the risk exposure from writing the OTC contract as well as its profit margin, the financial entity can go long (buy) 100 July CBOT Wheat futures contracts.

In mid-June, July Wheat futures are trading between \$3.97 and 4.03/bushel. The miller and financial entity decide to unwind the OTC product through an EFR transaction at the Chicago Board of Trade. The financial entity's 100 long July CBOT Wheat futures are transferred to the miller at an agreed upon price of \$4.00/bushel and the OTC position is transferred from the miller back to the financial entity.

As a result of the OTC contract and the offsetting EFR transaction:

**The Miller** (*buyer of the OTC contract*)

- Agreed to a \$4.00/bu futures price level
- Assumed a long 100 CBOT Wheat futures at \$4.00/bu that eliminated slippage
- Satisfied OTC contract requirements and received a \$0.50 credit from the financial entity
- Net Result: Locked in a net \$3.50 buying price level

**The Financial Entity** (*writer of the OTC contract*)

- Agreed to a \$4.00/bu futures price level
- Assumed a short 100 CBOT Wheat futures position at 4.00/bu which offsets the initial long futures position
- Realized a \$0.50 futures gain and eliminated slippage
- Satisfied OTC contract requirements by paying a \$0.50 credit to the miller
- Net Result: Earned original OTC fee

**The Chicago Board of Trade** (*facilitator of EFR transactions*)

- Provided risk management alternatives to the OTC market participants
- Enhances market liquidity

## Summary

There are numerous OTC products ranging from the most simplistic forward pricing agreement, as illustrated in our example, to the complex multi-phased OTC option pricing strategies. Regardless of their nature, the EFR transactions facilitate an easy, efficient entry or exit from the OTC position.

The following Q&A covers some of the more common EFR issues:

**Q** Are Chicago Board of Trade EFR transactions limited to certain futures contracts?

**A** An EFR transaction is available for all CBOT agricultural futures contracts, effective July 1, 2003.

**Q** Is the OTC transaction limited to corn, wheat, soybeans, soybean meal, soybean oil, rice, and oats?

**A** *No.* An EFR transaction could also be used to initiate or offset OTC transactions in by-products or derivatives that have a relatively good price correlation with the respective futures contract.

**Q** Can any futures contract month be used as part of an EFR?

**A** *Yes.* Any futures contract month can be used as part of an EFR, but the futures month used must be close to the expiration month of the OTC contract.

**Q** Who establishes the contract specifications and fees involved with an EFR?

**A** The Chicago Board of Trade determines the EFR regulations, exchange fees, and contract specifications for the futures component of the EFR. The two OTC parties agree on the contract specifications and contract fee for the OTC component of the EFR.

**Q** Do EFR transactions include options on futures contracts?

**A** Only futures contracts are allowed to initiate or offset the OTC contract.

**Q** Does it matter who is involved with the EFR transaction?

**A** The parties to the EFR transaction must be the same parties that are involved in the related OTC contract. The buyer and seller of the futures transaction must have, respectively, the short and long market exposure associated with the OTC contract.

**Q** Are EFR transactions limited to commercial entities?

**A** Both commercials and non-commercial entities may be participants in EFR transactions. An OTC option component of an EFR is limited to entities that are described in the Commodity Futures Trading Commission (CFTC) Ag Trade Option Regulation 32.13(g) and who enter into the option transaction in accordance with CFTC Regulations.

**Q** Are there size limits to EFR transactions?

**A** Firms involved with EFR transactions are bound by the same CBOT position limits as any other futures trader, except for those with hedge exemptions. Also, the size of the futures transaction must be approximately equivalent to the size of the OTC transaction.

**Q** Is the futures component of an EFR transaction executed in the pit?

**A** *No.* An EFR is an ex-pit form of transaction, similar to an EFP.

**Q** Is an Exchange For Physical (EFP) transaction a part of an EFR transaction?

**A** *No.* An EFR transaction is an exchange of a futures position for an OTC position.

However, an open futures position that results from an EFR transaction may eventually be unwound through an EFP.

**Q** Is an EFR transaction a substitution for a futures hedge or OTC hedge?

**A** *No.* It is a supplementary futures transaction that brings the benefits of the futures market to an OTC transaction.

**Q** Where can I find more information about EFR transactions?

**A** The Rules and Regulations of Chicago Board of Trade should be consulted as the authoritative source of information. The Rules and Regulations can be found on [www.cbot.com](http://www.cbot.com) under the Knowledge Center. Specific regulations for CBOT EFR transactions are contained in Regulations 444.01, 444.01B, 444.02 and 444.06.



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