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THE LEGALITY OF TRADING IN FUTURES.

By an Order-in-Council dated the 10th day of April, 1931, a commission, under the chairmanship of Sir Josiah Stamp, was appointed to inquire into and report upon what effect, if any, the dealing in grain futures has upon the price received by the producer. The commission held public sessions at Winnipeg, Regina and Calgary, where they heard the evidence of persons interested in the grain business in all its commercial aspects; either as farmers, officers of the Winnipeg Exchange or the Clearing House, operators of country elevators, exporters, millers, grain merchants, commission brokers or speculators. They also had informal conversations with persons in Chicago and Minneapolis who they thought might help them in the solution of the problem. After carefully considering all the information gathered by them, they unanimously found that hedging "is of distinct benefit to the producer in the price which he receives." The finding of the commission is not surprising, for this and kindred questions have been the subject of numerous public and private investigations, and the investigators, as a general rule, have arrived at the same conclusion.

The present article attempts to investigate the legality of trading in "futures." To do this, it is necessary to examine into the economic utility of hedging by way of futures. Discussion will be confined largely to the grain trade, since the Stamp Report and a valuable article by Professor Edwin W. Patterson of the Columbia Law School, entitled "Hedging and Wagering on Produce Exchanges."[1] renders available a large amount of impartially collected data. Professor Patterson's article also exhaustively discusses the statute and case law in the United States, differentiating hedging from gaming contracts in civil actions there.

[1] 40 *Yale Law Journal*, 843.

In considering transactions in futures, certain terms should be clearly understood.

Definition of Terms.

Hedging in grain-trade practice may be defined as a combination of transactions in cash grain and in futures such that a purchase of the former is accompanied by the sale of the latter in corresponding quantity, and *vice versa.* Hedging ordinarily involves fourfold transactions—an initial purchase and an initial sale, one of the cash grain, and the other of the futures, and the opposite closing transactions in each. By means of hedging, a loss on the cash grain will presumably be offset by a gain on the futures and *vice versa.*[2]

Hedging is a device by which the holder of wheat, say, seeks to protect himself against the risk of loss from an actual sale or purchase, through fluctuations in price, by balancing against it an equivalent purchase or sale for future delivery.[3]

That *hedging* by way of grain futures in undoubtedly a form of insurance, was recognized on all sides. Even though the protection it affords is not always complete it is undoubtedly cheap and effective.[4]

Cash grain does not refer to the time of payment, but to specific grain actually in the seller's possession, or in store in a terminal elevator in Fort William or "to arrive" in the near future.[5]

Futures is a term applied to a contract for the sale of grain or other commodities for delivery at a certain time in the future for a certain price. The seller does not have or expect to have the products he purports to sell; the buyer does not expect to receive the products or to pay the price. Instead of that a portion of the price[6] or "*Margin*" is paid which is increased or diminished as the market price goes up or down. Final settlement is usually made by payment of the difference in price between the original sale price and the market price of the product at the date of settlement. But if settlement is not made in this way before the date for delivery arrives the seller is bound to deliver and the buyer is bound to receive the grain on that date.

In the grain trade the very great proportion of these hedges, 90 to 95 per cent. of them, are "bought back" or closed out by purchase of an equal amount of grain. In only a few cases is delivery made.[7]

[2] Report of the United States Federal Commission on the Grain Trade, 1920-1926.

[3] Stamp Report, p. 17.

[4] *Ibid.*, p. 40.

[5] *Ibid.*, p. 41.

[6] Usually ten cents a bushel in the case of wheat.

[7] *Ibid.*, p. 34.

A sale of futures is a contract to sell grain or other products to be delivered on any day during a designated month the seller may choose. Although futures may be sold and deliveries made in any month, active trading in wheat futures is limited to deliveries in the months of July, October, November, December and May; July represents the beginning of the new winter wheat movement; October and November, the new spring wheat movement; December the closing of lake navigation and May the opening of navigation on the Great Lakes. It is the practice of the country elevators to hedge in the different future markets, with rare exceptions in Winnipeg. As the Winnipeg price is based on Fort William, the sale of wheat has to be for the grain in storage at that place. Therefore the dealer buys his futures for delivery in the month which he thinks will match the delivery of his wheat in Fort William.[8]

Characteristics of Hedging Transactions.

By means of hedging farmers, elevator companies and dealers who make contracts in advance to sell or buy grain secure themselves against the fluctuations of the market by counter contracts to buy or sell as the case may be an equal quantity of grain.

After a person has hedged his grain, fluctuations are of no interest to him. Should the price advance he will gain nothing by it; nor will he lose should the price decline.

The elevator companies do not desire to speculate. They are interested only in making a profit from the storing and handling of grain. They invariably hedge their purchases from day to day by selling futures against the amount of grain purchased.[9]

Let us illustrate some characteristic hedging transactions.

Illustration 1. In the Spring of the year 1930 farmer A. considered the price of wheat high. He estimated that he would harvest and have 10,000 bushels for sale in the Fall. He accordingly went to his broker and sold on the Winnipeg Grain Exchange 10,000 bushels of wheat for delivery in October at the going price for October wheat on the day of sale.[10] He paid his broker a margin of ten cents a bushel or $1,000.00 on the 10,000 bushels. Farmer A's crop was harvested and delivered to the local elevator. He sold the specific grain delivered to the elevator company. He then went to his broker and bought back the 10,000 bushels which he sold in

[8] *Ibid.*, p. 35.
[9] *Ibid.*, p. 34.
[10] The difference in price between cash wheat and futures is called "carrying charge." It is the charge made by the elevator company for carrying the wheat.

the Spring to be delivered in October. It will be noted that farmer A entered into three separate transactions in selling his crop, firstly, a sale of "futures"; secondly, a sale of his "cash" wheat; and thirdly, he closed out his first transaction by buying back the "futures" which he sold in the Spring. Hedging in this way enabled him to sell his wheat before it was harvested at the going price before the harvest.

Dealers now handle the farmer's grain on a cent a bushel profit. They could not do it at this price without hedging as there is always a possibility of grain advancing in price and the persons from whom they buy refusing to make delivery. Before the Winnipeg Grain Exchange commenced to function, 10 to 15 cents a bushel was not considered an unreasonable profit according to evidence adduced before the Stamp Commission.

Illustration 2. Farmer B. did nothing in the way of disposing of his wheat until he had it threshed and in the local elevator in September, 1930. He had to deliver it to the local elevator as he had no granaries on his land in which to store it; he had to sell much of it to pay harvesting and other expenses. Consequently he sold his entire crop of 10,000 bushels for cash. He then went to his broker and through him bought 10,000 bushels of May wheat, paying a margin of ten cents a bushel on it. He entered into this futures contract so that he could obtain May prices for his wheat. In May he sold the wheat which he had contracted to buy in the previous September and in this way received May prices for his wheat delivered in September. He was enabled to do this by hedging.

The Stamp Report points out that the selling of futures in this way also tends to spread the supply over a long period, and thus to check the tremendous fall in price which would inevitably take place in the autumn when the grain is harvested and disposed of if hedging were not practised.

Illustration 3. C. is the proprietor of a country grain elevator. In September 1930 he bought 10,000 bushels of wheat and stored it in his elevator. He then sold 10,000 bushels of "November wheat" at the going price on the day of sale. C.'s reason for doing this was that it would probably be November before he could make delivery and dispose of the wheat as "cash" wheat at Fort William. By that time the price might have fallen considerably. He could not afford to take the risk of a loss on his "cash" wheat by reason of a decline in price. Before November his 10,000 bushels of wheat arrived at Fort William and he sold his "cash" wheat. C. then went to his broker and closed out his sale of "futures" by buying back the 10,000 bushels of November wheat which he sold in September. By hedging in this way a loss on the "cash" wheat is offset by a gain on the "futures" and *vice versa.*

The Stamp Report points out that the country elevator operator who hedges in this way and thus eliminates risks can arrange with the Banks to finance him to the extent of 85% to 90% on hedged wheat, whereas the Banks would not likely finance beyond 60% on unhedged wheat. Consequently, without hedging, a very great amount of capital would be required and this would make it almost impossible for the small business to survive. Hence the grain trade would be confined to a few powerful companies and the salutary effect of competition would be minimized.[11]

Illustration 4. D. is a miller. He buys wheat with no forward sales of flour, but in the anticipation and hope of such sales. He could not possibly assume the risk of a market decline on the large quantities of wheat he mills. He therefore protects himself against fluctuations in the market by buying "futures" in order to hedge the "cash" wheat which he has on hand to manufacture into flour. Orders for flour are very uneven and spasmodic, but as sales are effected the hedges are lifted.[12]

Illustration 5. E. is a speculator in grain. He is generally available to buy or sell wheat or "futures." If the daily offers to buy and to sell in the futures market would balance, without the speculator, there would be no need for him. As a matter of fact they would vary a great deal, particularly in different seasons of the year. The balance is maintained by the speculator. Without him, hedging could not always be done, for the markets would be too narrow—the demand would be too limited. He hopes to profit by his superior power of forecasting prices. He buys in anticipation of a fall. He really acts in the belief that his own estimate of the future is more reliable than that of the other party to the contract.

He takes the risk of that just as every business man takes other risks in stocking goods which the public may suddenly decide not to want, or to buy elsewhere, or in making things which others may make and sell for less money. The ordinary process of business is to take chances, other than those of price fluctuation. He does not deal in the unknown, for "risks assumed in pure speculation are already existing risks which must be borne by someone" and he learns to measure as precisely as possible by sight what is not yet accurately measurable by touch. The speculator who buys wheat in the reasoned expectation of selling later at a profit, voluntarily undertakes an already existing risk of an adverse price movement, and what one speculator gains another loses or misses. "But the gain of one does not *cause* the other's loss. Indeed, the success of the first tends to lessen the loss of the second, for the more accurately the speculator forecasts the trend of the

[11] *Ibid.*, p. 37.
[12] *Ibid.*, p. 36.

market, the more will his action tend to lessen price fluctuations." To make a demand on a falling market is to lessen to some extent the loss to the seller, and to part freely in a rising market is to lessen the rise in price and thus to benefit the buyer.

The expert and knowledgeable speculator performs a *socially useful service,* fully legitimate in its economic basis. He adds to the economic *utility* of the commodity dealt in. Having, by careful study of the situation, formed a reasonable estimate of the probable future trend in the price of the commodity, he buys or sells according to his expectation of the rise or fall in price. Take the case of the "bull" or speculator for the rise. Buying when the thing is abundant and cheap (i.e. of little marginal utility) he holds to sell when it is scarce and dear (or of high marginal utility). To repeat: he adds *time* utility to the thing. Similarly buying in one market to sell in another on the same day, he gives *place utility* to the thing.[13]

Illustration 6. F. is a gambler. He creates an unnecessary risk; he does not deal merely with those that exist. The risks he speculates in are artificially created; his speculations have no economic virtue. He buys in the hope of reaping a profit in the event of the price rising; he sells short thinking that he can buy back for less money and thus make a profit. He does not deal in grain "futures" by way of hedging or insuring against loss because he has not and does not intend to have the grain. He has no interest in the price of wheat other than the interest created by his agreement to buy or sell specific "futures." In most cases the gambler is a "bull" speculating for the rise and he is almost invariably a buyer in a rising market, thus aggravating the rise. If he is a "bear" he is generally selling in a falling market thus aggravating the fall. He thus performs a social *disservice* and is in fact a social parasite who seeks to reap where he has not sown.[14]

Obviously hedging is highly beneficial to the wheat grower, the shipper and the miller. There does not seem to be any way of stopping the gambler without doing away with futures trading altogether, and thus destroying its usefulness as a means of vitally assisting in the marketing of the producers' grain, and securing for him a price which otherwise he would not likely receive.[15]

It is clear therefore that from the economic point of view hedging is a real benefit to the producer, the elevator company and the miller. Now let us consider its legality.

Legality of Future Sales.

Although the common law countenanced "idle wagers" the courts enforced them with considerable reluctance.

[13] *Ibid.*, p. 19.
[14] *Ibid.*, p. 23.
[15] *Ibid.*, p. 51.

The English Gaming Act 1845 renders all contracts by way of gaming and wagering null and void.[15a]

The common law as varied by The English Gaming Act is concisely stated by Schwabe and Branson on *The Law of the Stock Exchange, second edition,* at page 245, in these words:—

A very large number of dealings on the Stock Exchange are of a speculative nature; persons buy and sell shares for a future date, with the hope of making a profit by the rise or fall in price, and often without the least intention, or even ability, either to pay for the securities, or to deliver them, but meaning to resell or repurchase before the time for delivery arrives. This method of doing business is by no means confined to stocks and shares, but is of every-day occurrence in almost all commodities; and as far as the distinction between speculation and gaming is concerned it makes but little difference whether the commodities are actually paid for, and held with a view of selling again at a profit, or whether the matter is arranged by a resale before the time for delivery. Such dealings are perfectly legitimate. Gaming and wagering contracts, on the other hand, are not real dealings at all; they may take the form of purchases and sales, but they are, in fact, mere bets on the market price of commodities at a future date. *For a contract to be a gaming and wagering contract, there must not only be no intention on the part of either party to deliver, or take delivery of the commodities, but also no obligation on either to do so; there must be an agreement or understanding that all the buyer has to do is to receive from, or pay to, the seller the difference between the price of the bargain and the price at some future date.* Further, the essence of gaming and wagering is that one party is to win and the other to lose upon a future event, which at the time of the contract is of an uncertain nature.[16]

Are hedging contracts prohibited in Canada? The Criminal Code, sec. 231, abbreviated is as follows:

231. Every one is guilty of an indictable offence . . . who, with the intent to make gain or profit by the rise or fall in price of any stock . . . . goods, wares or merchandise,

(a) without the *bona fide* intention, of acquiring any such shares, goods, wares or merchandise, or of selling the same, as the case may be, makes . . . any contract . . . purporting to be for the sale or purchase of any shares of stock, goods, wares or merchandise; or

(b) makes . . . any contract . . . purporting to be for the sale or purchase of any such shares of stock, goods, wares or merchandise in respect of which no delivery of the thing sold or purchased is made or received, and without the *bona fide* intention to make or receive such delivery.[16a]

2. It is not an offence under this section if the broker of the purchaser receives delivery, on his behalf, of the articles sold, notwithstanding that such

[15a] This act or similar legislation is in force in each of the Provinces.

[16] See also *The Universal Stock Exchange* v. *Strachan,* [1896] A.C. 166.

[16a] "Bona fide *intention* to make or receive such delivery" as the test of the legality of a sale of futures in hedging grain is unfortunate since delivery is rarely made and the seller does not *expect* to make, or the buyer to receive, delivery, but *intends* to do so, if necessary.

broker retains or pledges the same as security for the advance of the purchase money or any part thereof.

The farmer, the proprietor of a country elevator, the miller and the speculator who wish to deal in wheat futures usually employ a broker who occupies a seat, or will transact business through someone who does occupy a seat on the Winnipeg Grain Exchange.[17] The rules of the Winnipeg Grain Exchange binds everyone buying or selling thereon to make or receive delivery of all the grain bought or sold by him as the case may be. And "when one employs a broker to do business on a Stock Exchange he should, in the absence of anything to shew the contrary, be taken to have employed the broker on the terms of the Stock Exchange."[18] In the absence of evidence to the contrary the court presumes that every man intends to carry out his obligations, and that the broker *intends* to make or accept delivery, if necessary.

Let us review some of the leading cases.

In *Forget* v. *Ostigny*[19] a broker on the Montreal Stock Exchange bought shares from time to time on margin for his customer, pursuant to his directions. This action was brought by the broker against his customer for a balance alleged to be due on such contracts. The customer defended on the ground that the transactions which gave rise to it were gambling transactions which were forbidden by the civil code of Quebec which denied a right of action on a gaming transaction or a bet, and were also forbidden by sec. 231 of the Criminal Code. The customer was known to the broker to be a bank clerk with a small salary and without the means to pay for the shares he was buying. The customer never asked for nor received delivery of any of the shares bought by him. But in every case delivery of the shares was obtained by the broker and the shares were duly paid for. The money necessary for this purpose beyond the margins paid by the customer were raised by the broker hypothecating to a bank shares and other securities bought by his several customers and obtaining the advance of a lump sum. The broker charged a commission on all transactions entered into by him for his customer.

The concurrent finding of the two lower courts was that the customer had never intended to take delivery and that the transactions

[17] According to the rules and usages of the Exchange its members deal with one another as principals, whether they act as brokers or on their own account; and customers who employ members, as brokers are not recognized as parties to any transactions between members.

[18] *Forget* v. *Baxter*, [1900] A.C. 467, at p. 479. *Cartwright & Crickmore* v. *MacInnes*, [1931] S.C.R. 425, at p. 429.

[19] [1895] A.C. 318.

were nothing else but bets upon the rise in the price of the shares in question, the broker undertaking to pay to the customer the difference of prices if they rose, and the customer undertaking to pay the broker the difference of prices if they fell. However the Privy Council reversed this finding and held that the purchases were legitimate transactions in furtherance of a speculation. The reasons for the Privy Council's judgment read in part as follows:

> The words of the English statute relating to gambling contracts do not differ substantially from those found in the Code, (p. 325).
>
> It is a legitimate commercial transaction to buy a commodity in the expectation that it will rise in value and with the intention of realizing a profit by its resale. Such dealings are of every-day occurrence in commerce. The legal aspect of the case is the same whatever be the nature of the commodity, whether it be a cargo of wheat or the shares of a joint-stock company. Nor, again, do such purchases and sales become gaming contracts because the person purchasing is not possessed of the money required to pay for his purchases, but obtains the requisite funds in a large measure by means of advances on the security of the stocks or goods he has purchased. This, also, is an everyday commercial transaction (p. 323).
>
> In the present case, the respondent might at any time on tendering the balance due in respect of any of the shares purchased have required the appellant to deliver them to him (p. 324).

Cotton, L.J. in *Thacker* v. *Hardy*[20] said:

> The essence of gaming and wagering is that one party is to win and the other to lose upon a future event, which at the time of the contract is of an uncertain nature—that is to say, if the event turns out one way A will lose, but if it turns out the other way he will win. But that is not the state of facts here. The plaintiff was to derive no gain from the transaction; his gain consisted in the commission which he was to receive, whatever might be the result of the transaction to the defendant. Therefore the whole element of gaming and wagering was absent from the contract entered into between the parties.

Maloof v. *Bickell & Co.*[21] was an action by a customer who was a large speculator in corn, against his broker for a balance of $2,000.00, which had been standing in his favor on the broker's books and had been used by the latter at the customer's request in buying futures on margin on the Chicago Board of Trade. The transactions between them were very numerous and very extensive. The customer was not hedging corn in which he was interested. He was speculating on corn futures. It was contended that the transactions in question were within the prohibitions of sec. 231 of the Criminal Code; but the court held that as they were bona fide transactions, and that as, in the words of Davies, C.J.

[20] 4 Q.B.D. 685, at p. 695.
[21] 59 S.C.R. 429 at p. 430.

there was no evidence of any express, implied or tacit understanding, that the contracts so made were not enforceable or that any loss or gain in reference to the price of the commodities contracted for should be paid by a settlement of differences

they were not illegal transactions within the provisions of sec. 231 of the Criminal Code.[22]

Woodward & Co. v. *Koefoed*[23] was an action on a promissory note given to protect margins on trading in wheat futures. The defendant was a farmer. At the time he opened an account with his broker he had 7,000 or 8,000 bushels of wheat on his farm which he was unable to market owing to a shortage of railway cars. He believed wheat was going to come down and in order to protect himself against a fall in the price he sold for future delivery. A few days later he bought 10,000 bushels more for future delivery. This was followed by further transactions, all purely speculative. He met with losses. The note sued on represented a balance due in respect of such losses. The defendant disputed liability on the ground that the consideration for the note was illegal by reason of sec. 231 of the Criminal Code. But the court held that the transactions in question were actually executed by the broker on the Winnipeg Grain Exchange. They were real transactions put through in the ordinary way in the exchange. They went through the clearing house and were then dealt with as actual contracts. The broker had to make good the contract. He was entitled to look to his customer to reimburse him.[24]

In *Pearson* v. *Carpenter & Son* [25] the note sued on was given by Pearson to Carpenter & Son, his brokers, to cover margins on 30,000 bushels of May wheat bought by the brokers through brokers in Buffalo. Pearson having suspected that his broker's principals, Camp & Co., were running a bucket shop and that the transaction was fictitious repudiated liability. Hence this action. The court held:

Camp & Co. were carrying on in Buffalo what is popularly known as a bucket shop, pure and simple, that is to say, there was an absolute unreality as to any transactions. They never placed nor intended to place any order which was telegraphed to them but simply entered same upon the sheets and bet against it. . . . It is to be noted that when they telegraphed similarly to Ladenburg, Thalman & Company, or Bartlett & Fraser that the transactions were in fact placed, and while as in *Universal Stock Exchange* v. *Stevens,* 40 W.R. 494, there never was any expectation that the stocks would actually be asked for, yet, if they were asked for at any time, evidence was forthcoming

[22] See also *Rex* v. *Harkness,* 10 O.L.R. 555.
[23] 31 Man. 286.
[24] See also *Stark* v. *Somerville,* 40 O.L.R. 374. *Bernstein* v. *Shapiro,* 26 D.L.R. 406. *Tull & Ardern* v. *Shouldice* (1932), 1 W.W.R. 144.
[25] 35 S.C.R. 380 at p. 382 ff.

that the transactions had been originally placed and were carried, and, therefore the customer was bound, on the one hand, to pay any losses that might occur in selling the stocks out or, on the other, he could, if he desired, pay up the balance over and above the margins and get his stocks. I have no doubt whatever that Pearson was perfectly aware of the difference between the two styles of broker's offices, and it was for this reason that he made the inquiry that he did . . . . until inquiry was made it was impossible for him to tell whether the transaction was a mere bet or was, as in the case of the two brokers' offices I have mentioned, a real transaction. He was not liable to pay if it was a mere bet . . . on the other hand, if the transaction was one they could show had been placed he knew that he would be liable to pay.

In *Topper Grain Co.* v. *Mantz*[26] the court "without expressing any independent opinion" felt bound by *Beamish* v. *Richardson*[27] as interpreted in *Medicine Hat Wheat Co.* v. *Norris Commission Co.*[28] to hold that a broker could not recover on a purely speculative contract even in the absence of an understanding, express or implied, that deliveries or acceptance could not be demanded. As neither the *Topper Grain Co.* case nor the *Medicine Hat Wheat Co.* case appear to be in harmony with the weight of judicial opinion they need not be further considered.

It will be noted that in all of the cases reviewed except the *Pearson* case (*supra*) the transactions were carried out on a reputable exchange, the contracts of sale and purchase all dealt with actual commodities, and the broker was bound in all cases to make or accept actual delivery if the contract was not terminated before the time fixed for delivery.

The following conclusions may fairly be drawn from the authorities:

1. The effect of sec. 231 of the Code[29] is not to stifle hedging but merely to suppress gambling.[30]

2. Transactions entered into on a reputable exchange, where there is no understanding, express or implied, that the contracts entered into are not to be enforceable by delivery or acceptance of the commodity contracted for, are presumptively valid.

[26] [1926] 2 D.L.R. 712.

[27] 49 S.C.R. 595.

[28] 14 Alta. 235.

[29] Apparently sec. 231 of the Code does not render null and void any contracts which would not be null and void as gambling transactions should sec. 231 be repealed. Yet from a perusal of the many conflicting decisions reported, it apparently causes the judges considerable embarrassment.

[30] The courts will readily assume that a statute was enacted to facilitate the reasonable transaction of business and not to impede it. *Osborn* v. *Boulter & Son*, [1930] 2 K.B. 226.

3. Hedging agreements made with no expectation that the delivery of the commodity shall actually occur, but with "the bona fide intention to make or receive such delivery" if the contract is not terminated before the date fixed for delivery, are prima facie valid and enforceable.

4. Transactions which are not real bargains to sell and buy an actual commodity but are purely fictitious and intended to end in the payment of differences are gaming transactions and are null and void.

5. Agreements entered into on the understanding, express or implied, that delivery will not be called for or made are invalid as contravening sec. 231 of The Criminal Code.

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