The CISG and Commodity Sales

Carlos Eduardo Fujita

eleven

Published, sold and distributed by Eleven
P.O. Box 85576
2508 CG The Hague
The Netherlands
Tel.: +31 70 33 070 33
Fax: +31 70 33 070 30
e-mail: sales@elevenpub.nl
www.elevenpub.com

Sold and distributed in USA and Canada
Independent Publishers Group
814 N. Franklin Street
Chicago, IL 60610
USA
Order Placement: (800) 888-4741
Fax: (312) 337-5985
orders@ipgbook.com
www.ipgbook.com

Eleven is an imprint of Boom uitgevers Den Haag.

ISBN 978-94-6236-316-8
ISBN 978-94-0011-167-7 (E-book)

© 2022 Carlos Eduardo Fujita | Eleven

This publication is protected by international copyright law.
All rights reserved. No part of this publication may be reproduced, stored in a retrieval system, or transmitted in any form or by any means, electronic, mechanical, photocopying, recording or otherwise, without the prior permission of the publisher.

especially those run by ICE and, secondarily, to crude oil, petroleum products and grain markets, with a particular bias towards markets run by the CME Group. The bias is mainly due to the author's personal experience, but at times it is also a by-product of the availability of case law and literature. I strive to make it clear whenever I believe that any remark refers only to a specific commodity or to a particular subset of the commodities markets. Caution is advised, in any case, because the main traits of these markets may not reflect those of other commodities, or even of the same commodities when traded in other venues.

Finally, practically no references are made to the trade of electricity, because although it is treated as a good in some jurisdictions, it is expressly excluded from the scope of application of the CISG (Article 2(f)) (see Section 2.5.1).

1.5 Contractual Typology of the Commodity Trade

1.5.1 Cash Contracts and Futures Contracts

Commodities are sold pursuant to several different contractual arrangements. A traditional categorization divides a typical market for any commodity into a cash market and a futures market.

The cash market is negatively defined as the whole market for a commodity except for the futures market.[29] The cash market is subdivided into the spot market and the forward market.[30] Contracts for the sale of commodities could, therefore, be divided into three corresponding categories: spot contracts, forward contracts and futures contracts,[31] hierarchized as follows:

29 Holbrook Working, "Futures Trading and Hedging," *The American Economic Review* 43, no. 3 (1953): 317.

30 Anastasios G. Malliaris, *Futures Markets*, vol. 1 (Cheltenham: Edward Elgar, 1996), xi–xii.

31 This categorization is widely adopted by legal scholars. See, for instance, Benjamin K. Leisinger, *Fundamental Breach Considering Non-Conformity of the Goods* (München: Sellier, 2007), 116-17.

Figure 1 The main forms of commodity contracts

Spot contracts are those made for the 'immediate delivery of and payment for the product'.[32] They are 'ordinary' sales contracts[33] in the sense that they provide for a simple exchange of goods[34] for money.

Forward contracts are sales of goods for delivery and payment at a future time.[35] The essential difference between spot and forward contracts is, therefore, one of time.

Futures contracts are often described as legal agreements to buy or sell goods on a specific date in the future.[36] Besides being imprecise, this definition offers nothing to set them apart from forward contracts. The distinctive trait of futures contracts is that they are necessarily negotiated in organized markets – exchanges[37] – a circumstance that is at the root of many fundamental differences between these two classes of contracts, as will be seen in the following subsection.

The cash market forms the bulk of commodity trading. Futures markets are a product of the necessity of more sophisticated instruments to allow for price discovery, hedging and other features that the cash markets would not be able to provide by themselves.[38]

---

32 U.S. Commodity Futures Trading Commission, "Glossary," CFTC Education Center, accessed 29 January 2022, www.cftc.gov/ConsumerProtection/EducationCenter/CFTCGlossary/index.htm; Malliaris, *Futures Markets*, 1:xi.

33 Fernando Eguidazu, "Las Bolsas de Mercancías y La Contratación de Futuros," in *Mercados de Futuros (Commodities)*, ed. Fernando Eguidazu (Madrid: ICE, 1978), 15-56.

34 For a discussion as to the concept of "goods" under the CISG, see Section 2.1.

35 U.S. Commodity Futures Trading Commission, "Glossary"; John Hull, *Options, Futures, and Other Derivatives*, 11th ed. (Harlow: Pearson, 2021), 28; Malliaris, *Futures Markets*, 1:xi.

36 CME Group, "A Trader's Guide to Futures: Thought Leadership with a Global Perspective," 4, accessed 29 January 2022, www.cmegroup.com/education/files/a-traders-guide-to-futures.pdf.

37 Richard J. Teweles and Frank J. Jones, *The Futures Game*, 3rd ed. (New York: McGraw-Hill, 1999), 28; Simon Fisher and Michael Hains, "Futures Market Law and Practice and the Vienna Sales Convention," *Lloyd's Maritime and Commercial Law Quarterly*, no. 4 (1993): 534.

38 Henry H. Bakken, *Futures Trading in Livestock: Origins and Concepts* (Madison: Mimir, 1970), 64-68.

Long-term contracts for the supply of goods are also addressed (see Section 1.5.5). These contracts could be categorized as cash contracts in the sense that they are not contracts entered into in the context of a futures market. However, they often raise concerns that do not commonly occur in 'ordinary' cash contracts. For this reason, in this work they are treated as a separate category.

1.5.2 Futures Contracts

This section summarizes the distinctive traits of futures contracts. The description provided herein is focused on the elements relevant to the subject matter of this book and is, for this reason, partial and oversimplified. The reader interested in understanding the futures market should therefore seek specific literature, some of which is referenced along the text.

Futures contracts differ from forward (cash) contracts in at least three fundamental ways: (1) they focus on the financial aspects of the transactions; (2) they are negotiated in organized markets (exchanges) and (3) they are subject to clearing. Each of these traits has important ramifications, which are briefly addressed later.[39]

1.5.2.1 Futures Contracts as Financial Instruments

Futures contracts are derivative contracts: their existence is ancillary to the existence of an underlying item,[40] which may be a good (including commodity-type goods) or something else. There are futures contracts that are derivatives referring to physical commodities, but there are derivatives for currency exchange rates, interest rates, stock market indices,[41] weather conditions[42] and many other items.

When two parties enter into a futures contract, they take opposite positions regarding the variation of the price[43] of the underlying item. If the price of such an item increases, one of the parties (the party that is 'long' in relation to the price) earns money, while the other (the party that is 'short') loses money. If the price of the same item decreases, the 'long' party loses money, whereas the 'short' party earns money. Money earned or lost as a result of the variation of the price of the underlying item is paid or collected daily from each person's account (a practice known as 'daily settlement'[44]).

Therefore, even though it is customary to refer to parties 'buying' and 'selling' goods, currencies, contracts or positions in the market, the essence of futures contracts is that

---

39 See Hull, *Options, Futures, and Other Derivatives*, 64-65, for a more detailed comparison.
40 Malliaris, *Futures Markets*, 1:xiii; Working, "Futures Trading and Hedging," 316-17.
41 Hull, *Options, Futures, and Other Derivatives*, 70.
42 For an explanation regarding weather derivatives, see ibid., sec. 35.5.
43 Strictly speaking, it need not be the price; for the sake of simplicity, we refer only to derivatives referring to the price of an underlying item.
44 Hull, *Options, Futures, and Other Derivatives*, 51.

parties irrevocably[45] take positions that cause money to change hands daily, at a predetermined ratio, each time the price of the underlying item changes.

When a future is bought, the buyer does not receive anything, nor does it pay a price to the seller. Likewise, when a future is sold, the seller does not have to deliver anything, nor does it have a right to receive a price. Apart from providing cash, if the market moves against its interests (owing to the daily settlement), the only other immediate obligations of each party are to provide margin[46] and to observe certain rules of the exchange regarding their risk exposure. Moreover, until the expiration of the contract, each party has the prerogative to liquidate its position by entering into the opposite transaction with anyone willing to serve as a counterparty.[47] If a 'long' sells a contract for the same delivery period, the original 'long' position ceases to exist, and so do the corresponding rights and obligations. The result is purely financial.[48]

For cash-settled futures, this is all that is there. On liquidation or expiration, daily settlement occurs one last time, with cash being paid or received according to the variation of the price of the underlying item. As the obligations are met, margin is returned. The only result is cash changing hands.

The exchange of goods for money, therefore, is not of the essence of futures contracts.[49] Any futures contract – including futures in relation to which the underlying item is a commodity-type good – could theoretically be cash settled. Commodity futures are said to be physically settled only because this is necessary to tie the futures prices to the price of the underlying commodity.[50] The vast majority of

45 In exceptional cases, such as a market malfunction, trades can be cancelled by the intervention of the exchange. See, *e.g.*, Michael J. Panzner, *The New Laws of the Stock Market Jungle: An Insider's Guide to Successful Investing in a Changing World* (London: Pearson Education, 2004), 33-34. The relevant contract was, however, for an index.

46 Margins are funds that serve as collateral to secure the performance of the contract or at least equitable indemnification in case of default. See Robert R. Bliss and Robert S. Steigerwald, "Derivatives Clearing and Settlement: A Comparison of Central Counterparties and Alternative Structures," *Economic Perspectives* 30, no. 4 (4th Quarter 2006): 25.

47 Early liquidation is not an exceptional or abnormal way to terminate a contract; it satisfies the contract. See U.S. Commodity Futures Trading Commission, "Glossary", "futures".

48 Hull, *Options, Futures, and Other Derivatives*, 48.

49 Luiz Gastão Paes de Barros Leães, "A Estrutura Jurídica Dos Mercados de Futuros," in *Pareceres*, 1st ed., vol. 1 (São Paulo: Singular, 2004), 21, states that the delivery of the physical goods is not "the essential objective" of the futures market.

50 Hull, *Options, Futures, and Other Derivatives*, 48; Technical Committee of the IOSCO, "Principles for the Regulation and Supervision of Commodity Derivatives Markets – Final Report" (IOSCO, 2011), 23-24, www.iosco.org/library/pubdocs/pdf/IOSCOPD358.pdf; Chris McMahon, "Financial Settlement vs. Physical Delivery," *Futures Magazine*, 25 July 2006, www.futuresmag.com/2006/07/24/financial-settlement-vs-physical-delivery; Henry H. Bakken, *Futures Trading: Origin, Development and Present Economic Status* (Madison: Mimir, 1966), 11, mentions that this has been observed in practice in the early days of the Japanese Dojima rice market. The futures contracts negotiated there initially did not provide for the delivery of physical goods, resulting in the failure of the market in reflecting spot prices of the goods.

futures contracts, however, including commodity futures contracts, are liquidated in cash and never result in a physical delivery.[51]

For several factors, futures markets are indeed considered an inadequate medium in which to trade physical products:[52] the available delivery periods[53] and places[54] may be inadequate to fulfil the needs of buyers and sellers; the quality grade of futures contracts may not suit the needs of the parties;[55] the parties may be unwilling or unable to undertake the financial obligations that come with operating in the futures market; futures contracts may be subject to limited trading hours, something that can be important in moments of acute stress;[56] cash contracts may be subject to more favorable tax regimes under certain circumstances.[57] Customarily, therefore, market participants with an interest in the physical commodities use futures as a pricing and/ or risk-management instrument and the cash market to deliver or take the physical product.[58]

In futures that are physically settled (*i.e.* futures contracts that can potentially be performed through the delivery of a physical good), the financial effect of a futures contract – cash changing hands – occurs in the same way as it would if the contract were cash settled. The difference is that if the contract is not liquidated for cash before it expires, the exchange will pair the parties that have 'open positions' (*i.e.* have not exercised their prerogative to liquidate their contracts, thus receiving or paying cash only) and manifest (explicitly or implicitly) the intention to transition to deal with the physical goods. At this moment, 'longs' become 'receivers' and 'shorts' become 'deliverers'. In other words, only on the expiration of the futures contract does an obligation to deliver goods and the corresponding obligation to pay the price come into

51 Hull, *Options, Futures, and Other Derivatives*, 48. Earlier literature suggested that around 98 to 99.6% of all futures contracts were liquidated prior to expiration. See Teweles and Jones, *The Futures Game*, 29; and Thomas A. Hieronymus, *Economics of Futures Trading*, 2nd ed. (New York: Commodity Research Bureau, 1977), 4. Currently, with the advent of automated trading, the actual number is likely even higher, with only an infinitesimally small percentage of contracts resulting in physical delivery. As stated in *Cargill, Inc. v. Hardin*, at 1156 n. 2, 1157, 'virtually all futures contracts' are closed out and do not resolve in delivery of any physical good.

52 Glenn Willett Clark, "Genealogy and Genetics of 'Contract of Sale of a Commodity for Future Delivery' in the Commodity Exchange Act," *Emory Law Journal* 27 (1978): 1213; Neil C. Schofield, *Commodity Derivatives: Markets and Applications* (Chichester: Wiley, 2008), chap. 5.7.3.

53 Clark, "Genealogy and Genetics of 'Contract of Sale of a Commodity for Future Delivery' in the Commodity Exchange Act," 1213; Graham L. Rees, *Britain's Commodity Markets* (London: Elek, 1972), 438.

54 Schofield, *Commodity Derivatives*, sec. 5.8.1.

55 Clark, "Genealogy and Genetics of 'Contract of Sale of a Commodity for Future Delivery' in the Commodity Exchange Act," 1214.

56 David Long, *Oil Trading Manual: A Comprehensive Guide to the Oil Markets* (Amsterdam: Elsevier, 2003), chap. 7.1:1, cites as an example the need to hedge oil prices on the eve of the Gulf War.

57 Ibid.

58 See illustrations of such combined use in Teweles and Jones, *The Futures Game*, 38-40. A more economic-oriented description of a similar use can be found in Leland L. Johnson, "The Theory of Hedging and Speculation in Commodity Futures," *The Review of Economic Studies* 27, no. 3 (1960): 139-41.

existence. Moreover, only then will the counterparties (the deliverer and the receiver) know each other's identities, and only then will the price of the goods be determined.[59]

Futures contracts, when observed in isolation (*i.e.* not taking into account what occurs after their expiration), therefore, do not constitute sales contracts in the meaning of the CISG. They do not provide for the exchange of goods for money. They are contracts that shift the economic effect of the variation of the price of an underlying item between the parties, during a period of time (which may even be indefinite, in the case of perpetual futures).[60] Only upon expiration futures that are physically settled originate contracts that are sales contracts within the meaning implicitly defined by the CISG.[61]

1.5.2.2 Standardized Contracts

Futures contracts, as we have seen, are negotiated within commodity exchanges. Currently, the most important commodity exchanges are organized in the form of electronic platforms maintained and offered by for-profit companies, where users can find prospective counterparties and make contracts.[62]

In commodity exchanges, contracts are standardized.[63] The usual obligations of the parties, such as acceptable quality grades, procedures for measurement and delivery, etc., are identical in all contracts entered into in the market. Even the quantity of product is fixed, meaning that the only way of transacting different quantities is to enter into more than one contract at a time. The delivery dates are open to the choice of the parties but only within time frames predetermined by the exchange. The price is the only parameter of the contract that is not standardized – and for some commodities, the contract provides for standardized adjustments according to predetermined quality grades.[64]

---

59 The sale price of the physical commodity is the spot price on the expiration of the futures contract; the difference between such spot price and the price each party agreed on when they first made their respective futures contracts will already have been paid to/received by each party as a result of the daily settlement mechanism.

60 Clark, "Genealogy and Genetics of 'Contract of Sale of a Commodity for Future Delivery' in the Commodity Exchange Act," 1218; Hieronymus, *Economics of Futures Trading*, 70. Working, "Futures Trading and Hedging," 315, stated that '[f]utures trading in commodities may be defined as trading conducted under special regulations and conventions, more restrictive than those applied to any other class of commodity transactions, which serve primarily to facilitate hedging and speculation by promoting exceptional convenience and economy of transactions'. To Francisco Satiro, "Derivativos de Bolsa," in *Temas Essenciais de Direito Empresarial – Estudos Em Homenagem a Modesto Carvalhosa*, ed. Luiz Fernando Martins Kuyven (São Paulo: Saraiva, 2012), 599-600; and Fernando Albino de Oliveira, "Contratos Futuros," *Revista de Direito Público* 87 (1988): 81, whereas the economic purpose of the sales contract is the exchange of goods for money, the purpose of the futures contracts, as well as other derivatives, is exchanging risks.

61 Stating that a sales contract exists since the formation of a futures contract amounts to saying that a sales contract may exist before the parties are defined and while such parties are still not obliged to deliver goods or to pay the corresponding price.

62 Hull, *Options, Futures, and Other Derivatives*, 24-25.

63 Teweles and Jones, *The Futures Game*, 28; Fisher and Hains, "Futures Market Law and Practice and the Vienna Sales Convention," 534.

64 Hull, *Options, Futures, and Other Derivatives*, 48.

Uniformity among all contracts traded within an exchange allows them to be traded as fungible items.

1.5.2.3 Clearing

Contracts made within futures exchanges are subject to clearing. A clearing house associated with the exchange interposes itself between the two parties who agreed a trade, either at the moment when the contract is formed or immediately thereafter. As a result, there are no bilateral contracts in futures markets.[65] The clearing house becomes the counterparty to every contract.

This role of the clearing house is important for several reasons.

It greatly reduces the costs of assessing the counterparty risk, since every trader is only exposed to the credit risk of the clearing house. In practice, the clearing house acts as a guarantor for every contract.[66]

Clearing, coupled with the marketplace nature of exchanges, also makes it much easier for each party to liquidate their futures positions before the contract expires. In a bilateral contract, each party willing to proceed to such liquidation would have to seek agreement with the respective counterparty. If the other party does not agree, liquidation does not occur. A contractual prerogative to liquidate at any time could, of course, be negotiated, but it would probably not be feasible for both parties to have this prerogative, since it would render the financial results of the contract essentially uncontrollable and unpredictable for each of the parties considered individually.

Clearing ensures that the subsequent actions of the original contractual parties are no longer relevant to each other.[67] A party who wants to liquidate a contract only needs to find another market participant willing to enter into a contract for the opposite transaction.[68] All market participants, therefore, can enjoy the increased possibility of liquidating their contract in cash, without having to forgo their own ability to receive or deliver the physical goods if they so prefer.[69] Such flexibility could never be achieved by using only cash contracts.[70]

Finally, in order to ensure the financial solidity of the clearing house, only previously approved parties are allowed to submit trades for clearing; this means that only such

---

65 Where they technically exist, their existence lasts only until the contract is cleared, a period that, with the adoption of electronic trading systems by futures exchanges, is infinitesimally short.

66 Hieronymus, *Economics of Futures Trading*, 43; Jerry W. Markham and Daniel J. Harty, "For Whom the Bell Tolls: The Demise of Exchange Trading Floors and the Growth of ECNs," *Journal of Corporation Law* 33, no. 4 (2008): 871; Paes de Barros Leães, "A Estrutura Jurídica Dos Mercados de Futuros," 20; Luiz Gastão Paes de Barros Leães, "Mercado de Futuros e Liquidação Compulsória," in *Pareceres*, 1st ed., vol. 1 (São Paulo: Singular, 2004), 194.

67 Eguidazu, "Las Bolsas de Mercancías."

68 Franklin R. Edwards, "The Clearing Association in Futures Markets: Guarantor and Regulator," *The Journal of Futures Markets* 3, no. 4 (1983): 370.

69 Bliss and Steigerwald, "Derivatives Clearing and Settlement," 26.

70 Edwards, "The Clearing Association in Futures Markets," 369.

approved parties will act as direct contractual counterparties to the clearing house. These parties are known as clearing members. Clearing membership is granted only to entities that meet strict requirements regarding capitalization and risk management experience, among other usual criteria.[71] All clearing members must, moreover, contractually adhere to a set of rules and regulations enacted by the exchange and the clearing organization.

In order to trade, the clearing members must also provide security by depositing cash and other liquid assets with the clearing house. Such security is constantly monitored and must be reinforced if their exposure to risk increases as a result of the transactions in which they engage and of the market prices of the assets and/or positions they carry. These practices, collectively known as the margining system,[72] are designed to ensure that the security provided will be sufficient to cover the obligations of a party most of the time, even if it faces sudden material losses. As a last resort, the clearing house can call its members for financial aid, thus 'socializing' any losses that cannot be offset by the appropriation of security.[73]

This structure means that most persons interested in trading within a futures exchange are unwilling to become clearing members. For most prospective traders, it makes more sense to act through an intermediary who already holds clearing membership.[74] This leads to another important trait of futures trading, which is the relationship formed between the clearing member and the parties that trade through such a clearing member.

1.5.2.4 FCMs as Agents Acting for Undisclosed Principals

Whoever intends to trade in futures without requesting clearing membership can access futures markets through entities known in the US as futures commission merchants (FCMs).[75] FCMs are entities that 'solicit or accepts orders to buy or sell futures contracts, options on futures (…) and accept money or other assets from customers to

---

71 Intercontinental Exchange, Inc., "How Clearing Works," ICE Website, accessed 29 January 2022, www.theice.com/publicdocs/How_Clearing_Works.pdf.

72 Bliss and Steigerwald, "Derivatives Clearing and Settlement," 25.

73 Craig Pirrong, *The Economics of Central Clearing: Theory and Practice* (New York: ISDA, 2011), 21, www2.isda.org/attachment/MzE0NA==/ISDAdiscussion_CCP_Pirrong.pdf; Intercontinental Exchange, Inc., "How Clearing Works," 2; Carmen Alonso Ledesma and Ana Felícitas Muñoz Pérez, "Organización y gobierno de las cámaras de contrapartida central," in *Estudios jurídicos sobre derivados financieros*, ed. Carmen Alonso Ledesma et al. (Madrid: Civitas, 2013), 160.

74 Jon Gregory, *Central Counterparties: Mandatory Clearing and Bilateral Margin Requirements for OTC Derivatives* (Chichester: Wiley, 2014), 207. The alternative would be becoming a member of a clearing organization, something that is quite burdensome from financial and compliance standpoints, making it possible only for a few considerably large traders.

75 U.S. Commodity Futures Trading Commission, "Understanding Contractual Obligations," accessed 29 January 2022, www.cftc.gov/ConsumerProtection/EducationCenter/understandcontractobligations; Gregory, *Central Counterparties*, 207.

support such orders'.[76] FCMs are also known as commission houses[77] or brokers,[78] although this term does not precisely describe the role that FCMs play in commodity exchanges.[79] Not all FCMs hold clearing membership in every exchange. It is possible for a nonmember FCM to trade through a member FCM.[80]

Traders may also opt to deal through another intermediary, known as an introducing broker, who will receive the clients' trading orders and place them through their FCM of choice.[81]

In such a situation, the contractual relationships needed so that an individual or a legal entity may trade in an exchange could easily be as complex as the one illustrated by the following chart:

Figure 2 Exemplificative flow chart of a client order within a commodity exchange

Each of the parties forming the 'chain' of relationships illustrated in Figure 2 must have entered into at least one contract with another party.[82] The client will normally have entered into service contracts with both the introducing broker and the FCM;[83] the FCM carrying the client's account will in turn have a contract in place with the clearing FCM, which will be the entity actually placing trades in the exchange. In order to simplify the analysis, the illustrative examples we will devise throughout this book shall assume a simpler chain of parties, where a client has a contractual relationship directly with an FCM with clearing privileges. This chain can be represented by the following chart:

76 "Futures Commission Merchant (FCM) Registration," National Futures Association Website, accessed 29 January 2022, www.nfa.futures.org/registration-membership/who-has-to-register/fcm.html.

77 Hieronymus, *Economics of Futures Trading*, 54.

78 Teweles and Jones, *The Futures Game*, 28-29.

79 Hieronymus, *Economics of Futures Trading*, 54.

80 John W. McPartland, "Clearing and Settlement of Exchange Traded Derivatives," *Chicago Fed Letter*, no. 267 (2009): 4; U.S. Commodity Futures Trading Commission, "Glossary"; See "Omnibus Account"; Teweles and Jones, *The Futures Game*, 29.

81 U.S. Commodity Futures Trading Commission, "Understanding Contractual Obligations."

82 In some cases, the relationship will take the form of a 'membership' of an organization. This membership is often of associative nature rather than purely contractual.

83 U.S. Commodity Futures Trading Commission, "Understanding Contractual Obligations."

Figure 3 Simplified exemplificative flow chart of a client order within a commodity exchange

The client-FCM relationship is treated differently across different exchanges and clearing organizations. There are two generally recognized clearing models: the agency model and the principal (or principal-to-principal) model.[84] As one might guess, in the agency model, the FCM that carries a client position is deemed to act as an agent of the client. The client, therefore, would be the legal counterparty of the clearing organization in any given contract. In the principal model, the FCM is deemed as the legal counterparty of the clearing organization. The agency model is said to be predominant in the United States, while the principal model is said to be the most common in Europe.[85]

In the principal model, it is quite evident that the FCM acts in its own name even when trading on behalf of a client. It is recognized from the outset that the FCM itself is the party of the futures (or other derivative) contract formed with the clearing organization. As an illustration, the LCH[86] standard agreement with clearing members textually states that when entering into contracts with the clearing organization, FCMs shall act as principals and not as agents.[87]

Conversely, in the agency model, although the FCM is said to act as an agent of the client, this circumstance is not always conspicuous. In fact, even though in the US this relationship is quite clearly referred to in statute as an agency relationship,[88] the rules

84 Gregory, *Central Counterparties*, 208.

85 Stan Renas, Noah Melnick, and Chris Davis, "OTC Derivatives Clearing: How the Agency and Principal Models Compare," *International Financial Law Review*, March 2012; Pauline Ashall et al., "Client Clearing of Derivatives in Europe – A Client's Perspective" (Linklaters LLP, 2 September 2015), 3.

86 LCH (formerly, LCH.Clearnet) is a clearing organization controlled by a holding company incorporated in the UK, with operating entities acting in the UK, Luxembourg, France and the US. See: www.lch.com/about-us.

87 See Clause 2.12: "The Firm [*i.e.*, the clearing member] agrees that in respect of any Contract for which central counterparty services are to be provided to the Firm by the Clearing House (…) the Firm shall contract as principal and not as agent." Full text: www.lch.com/index.php/system/files?file=media_root/CLEARING%20MEMBERSHIP%20AGREEMENT.pdf. The quoted clause belongs to a standard agreement to be entered into with the operating entity of LCH in the UK.

88 17 CFR Rule 39.12(b)(6)(i) and (ii): "A derivatives clearing organization that clears swaps shall have rules providing that, upon acceptance of a swap by the derivatives clearing organization for clearing: (i) The original swap is extinguished; (ii) The original swap is replaced by an equal and opposite swap between the derivatives clearing organization and each clearing member acting as principal for a house trade or *acting as agent for a customer trade*; (…)" (emphasis added).

governing the relationship between the clearing organization and an FCM representing a client often seem to indicate that the FCM acts as a principal. Rule 401 (Acceptance for Clearance) of the ICE Clear US rule book, for instance, reads as follows:

> (a) The [clearinghouse], by accepting a Contract offered to it for clearance by or on behalf of a Clearing Member, shall assume, in the place of each Clearing Member that is a party to such Contract, all liabilities and obligations imposed thereby to the Clearing Member that is the other party thereto, to the extent provided in Rule 401(b), and shall succeed to and become vested with all rights and benefits accruing therefrom. Such assumption by the Corporation shall terminate all liabilities and obligations of the Clearing Member whose Contract is so accepted to the other Clearing Member which was a party to such Contract.
> (b) The liabilities and obligations of the Corporation arising pursuant to Rule 401(a) shall be subject to the following limitations:
> (i) Such liabilities and obligations shall extend only to Clearing Members. Without limiting the generality of the foregoing, the Corporation shall not have any liability or obligation arising out of or with respect to any contract to any customer of a Clearing Member or any Exchange member which acted as a broker for a customer or a Clearing Member.

The first aspect of the wording that deserves attention is that all references to the contracting parties are to 'Clearing Members', who, in accordance with the ICE Clear US by-laws, are those who are entitled to clear contracts directly with the clearing organization.[89] As we have pointed out, clients seek FCMs mostly because they either cannot or do not want to bear the obligations that come with membership.[90] It seems sensible to conclude that, by operation of the cited rule, FCMs become bound to the clearing house even if acting as agents to their clients. This is corroborated by the explicit exclusion contained in Rule 401(b)(i), according to which the liabilities and obligations of the clearing organization 'shall extend only to Clearing Members', and also shall not extend 'to any customer of a Clearing Member'. The client, therefore, does not become personally obligated to the clearing house, which makes sense, considering the concept of clearing membership.

Similar rules seem to have been around for a long time: it is reported that as early as 1924, the rules of the Board of Trade of the City of Chicago required that all brokers contracted on the floor as principals.[91]

---

89 In accordance with Arts. 1 and 5 of the ICE Clear US by-laws.
90 Gregory, *Central Counterparties*, 210.
91 Telford Taylor, "Trading in Commodity Futures – A New Standard of Legality," *Yale Law Journal* 43 (1933): 68.

On the other hand, rules imposed, for instance, by the CME Group clearing houses are drafted in a way that makes it unclear whether the clearing member enters into a contract as a principal or as an agent.

The wording of some contracts between FCMs and clients also implies that FCMs act as principals. For instance, the standard terms of the customer agreement drafted by FC Stone, an FCM located in Chicago, contains a clause with the following wording:

> Customer agrees to deliver to FCM, at least two business days prior to the delivery date, any commodity or property, or documents representing ownership of same (including but not limited to warehouse receipts), previously sold by FCM on Customer's behalf, which FCM in its sole and absolute discretion deems necessary to effect a good delivery pursuant to the rules and delivery procedures of the contract market on which the delivery is contemplated. If at any time Customer shall be unable to deliver to FCM any commodity or other property previously sold by FCM on Customer's behalf, Customer authorizes FCM, in FCM's sole discretion, to borrow or buy and deliver the same, and Customer shall immediately pay and indemnify FCM for any Losses which FCM may sustain from its inability to borrow or buy any such security, commodity or other property.[92]

If the FCM did not consider itself to be a principal, it should not be so concerned about fulfilling the delivery obligation, to the point of borrowing or buying substitute commodities in order to do it.

Other elements in favor of the 'FCM as principal' position derive from the mechanics of the established relationship between FCM, client and clearing organization.

One of these is the way the margining system works. As we have seen, margin is collateral that is provided by clearing members to secure their performance of the cleared contracts. All clearing house regulations analyzed place the burden of providing margin on their clearing members. Again, this makes sense because clearing members are the only entities allowed to be direct counterparties in contracts with the clearing house.

Margin requirements are calculated on the basis of the aggregate position of the party subject to risk exposure. Since at any given moment an FCM may carry a combination of proprietary positions (trades entered into by the FCM on its own behalf) and positions undertaken on behalf of several clients, margins called against a FCM will result from the combined risk of positions ultimately belonging to different entities. This may result in a situation where the FCM may be under no obligation to contribute margin but nonetheless may want to request margin from a client, if such client's net position

92 Clause 12 of the Futures & Exchange-Traded Options Customer Agreement. Full text: accountforms.intlfcstone.com.s3.amazonaws.com/FCM-AgreementandDisclosures-20160311.pdf. The law governing the agreement, in accordance with Clause 28, is that of the State of Illinois, US.

represents a risk to the FCM.[93] Normally, FCMs' terms of service will contain a reservation of rights to discretionally call for margin regardless of any determination by the clearing organization,[94] and this is precisely because it is of the essence of the relationship between FCM, client and clearing organization that the FCM bears the credit risk of the client.

Case law in the US has long considered that FCMs trade on their own name only. In a case argued in 1905, Justice Holmes described trading on futures as sales and purchases where the members traded 'always as principals between themselves, and being bound practically at least, as principals to those who employ them when they are not acting on their own behalf'.[95]

On the other hand, there were, also, sound arguments in favor of the characterization of the client-FCM relationship as an agency agreement.

Perhaps the strongest among these arguments concerns the intentions of the parties involved. The FCM, when acting on the client's orders, are always on the same side of the trading as their clients: when the client undertakes a short position, the FCM will also take a short position; when the client takes a long position, so does the FCM. The client and the FCM are not counterparties in a futures (or a sales) contract; it is clear for the client that he is trading with other market participants through the exchange. It is even possible that a client operating through a FCM can make a contract within an exchange with another client operating through the same FCM.

Also, there is no spread between the client's position and the FCM's position. In other words, the FCM usually does not get to profit from the commercial aspect of the trade; the FCM acts for the benefit of the client, and the compensation it receives comes in the form of the commission the client agrees to pay. This aspect of their relationship is said to be essentially inconsistent with the notion that FCMs act as principal.[96]

Moreover, in view of concerns on transparency and financial soundness of market participants, FCMs subject to the jurisdiction of the CFTC must account client funds separately from the FCM's own assets.[97] Client funds so segregated have preferential treatment in case the FCM becomes insolvent.[98] This is also inconsistent with the notion of FCMs being purely principals. In Europe, the European Market Infrastructure

93 M. Markovic, "The Futures Broker and Client Relationship in Australia," *Corporate & Business Law Journal* 2 (1989): 93.

94 For a concrete case where this was acknowledged, see Mr. Justice Kerr, *E. Bayley & Co. Ltd. v. Balholm Securities Ltd.*, 2 Lloyd's Law Reports 404 (Queen's Bench Division (Commercial Court) 1973).

95 Mr. Justice Holmes, *Board of Trade v. Christie Grain & Stock Co.*, 198 United States Reports 236 (United States Supreme Court 1905).

96 Markovic, "The Futures Broker and Client Relationship in Australia," 92.

97 Although not necessarily separated from the other clients of the same FCM. See: Gregory, *Central Counterparties*, 221.

98 U.S. Commodity Futures Trading Commission, "FCMs & IBs," Generic, CFTC Website, accessed 29 January 2022, www.cftc.gov/IndustryOversight/Intermediaries/FCMs/fcmsegregationfunds.

Regulation (EMIR)[99] requires that FCMs and clearing houses keep a record of client assets and positions in a way that makes it possible to clearly identify which of these assets and positions ultimately belong to the client.

The legal category within the common law framework that best reconciles the elements of the client-FCM relationship is that of the agency agreement with an undisclosed principal.[100] This subtype of agency is characterized by the circumstance that the agent 'makes the contract [with a third party] in his own name, without disclosing the fact that he is acting on behalf of another'.[101] The third party, therefore, acts on the belief that it is contracting with a principal, not an agent.[102]

The client-FCM relationship differs from a traditional agent-principal relationship in certain respects.

In common law, an undisclosed principal and the contractual counterparty have mutual rights to directly sue each other.[103] Rules usually applicable in futures markets, as seen previously, and market usages, do not recognize such rights.

Likewise, client agreements drafted by FCMs also usually contain rules that vary traditional fiduciary duties that the law imposes on agents.[104] Virtually all agreements between clients and FCMs, for instance, contain clauses empowering the FCM to trade for the account of the client whenever the client fails to comply with the contract or with the rules of an exchange where it trades (*e.g.* to liquidate contracts if the client undertakes excessive risk), regardless of his acquiescence or knowledge, and even if such trades are detrimental to the client's interests.[105]

Thus far, we have covered the client-FCM relationship from the standpoint of the common law. Since, however, the regulation of agency, as we shall see in more detail in Section 4.4, falls outside of the scope of the CISG, it could be useful to briefly analyze the treatment reserved for such a relationship by legal systems affiliated to the continental legal tradition.

99 EMIR, Art. 39(3) and (5).

100 This conclusion borrows heavily from Markovic, "The Futures Broker and Client Relationship in Australia," 92.

101 Hugh Beale, *Chitty on Contracts*, 32nd ed., vol. 2 (London: Sweet & Maxwell, 2017), paras. 31-088.

102 Martin Schiff, "The Undisclosed Principal: An Anomaly in the Laws of Agency and Contract," *Commercial Law Journal* 88 (1983): 237; Eric Bennett Rasmusen, *Agency Law and Contract Formation* (Cambridge: Harvard Law School, 2001), 29.

103 Schiff, "The Undisclosed Principal," 237; Markovic, "The Futures Broker and Client Relationship in Australia," 95; Beale, *Chitty on Contracts*, 2017, vol. 2, paras. 31-064, 31-065 and 31-066.

104 Markovic, "The Futures Broker and Client Relationship in Australia," 92.

105 For a case debating the legitimacy of trades executed on the order of an exchange, see: Mr. Justice David Steel, *ED&F Man Commodity Advisers Ltd. & Anor v. Fluxo-Cane Overseas Ltd & Anor*, 212 British and Irish Legal Information Institute Website (High Court of Justice of England and Wales (Commercial) 2010).

In the continental tradition, the contract that better adjusts to the relationship under discussion is the commission contract[106] (in Spanish: *contrato de comisión*; in French: *contrat de commission*; in German: *Kommissionsgeschäft*; in Italian: *contratto di commissione*; in Portuguese: *contrato de comissão*).[107]

The precise definition and legal traits of the commission contract vary in each jurisdiction. However, it can be generally described as an agreement that enables one party (the client) to direct another (the FCM) to enter into one or more contracts with third parties. The agreement thus generates a relationship that can be described as one of principal-agent.[108]

In many jurisdictions it is possible that the agent enters into the agreement with a third party on his (*i.e.* the agent's) own name, albeit in accordance with the instructions of the principal. The French Commercial Code, for instance, defines the *commissionnaire* (the agent) as 'someone who acts on his own name or under a social name for the account of a *commettant* [a principal]'.[109] The Spanish Commercial Code contains an express provision allowing the *comisionista* (the agent) to contract in his own name or in the name of the *comitente* (the principal).[110] If the parties to the commission agreement agree that the agent will act in his own name, only the agent will be bound to the transaction entered into with the third party pursuant to the commission contract.[111]

In Brazil, the Civil Code states that the *contrato de comissão* is a contract that provides for the acquisition or sale of a good by the *comissário* (the agent) in his own name, for the account of the *comitente* (the principal).[112] The Code also states that the *comissário* is directly bound to the third party (*i.e.* the person with whom he contracts under the commission contract) and that such third party shall have no action against the *comitente*, nor vice versa, unless the *comissário* assigns his rights under the sales contract to any of the parties.[113]

In this respect, the commission contract of the continental tradition is different from the agency under the common law.[114] Arguably, this trait renders the commission contract closer to the structure of the client-FCM relationship, as described previously, than the common law agency.

---

106 The resemblance between the position of the FCM and that of the agent under a *commission contract* is noted, for instance, by Vera Helena Mello Franco, *Contratos* (São Paulo: Thomson Reuters, 2012), 257; and Luis Muñoz, *Derecho Comercial*, vol. 2 (Buenos Aires: TEA, 1960), 116-19.

107 Francisco Cavalcanti Pontes de Miranda, *Tratado de Direito Privado*, 1st ed., vol. 43 (São Paulo: RT, 2012), 535-52.

108 Mello Franco, *Contratos*, 257.

109 French Commercial Code, Art. L132-1.

110 Spanish Commercial Code, Art. 245.

111 Elena Leiñena, *El Régimen Jurídico Unificado de La Comisión Mercantil y El Mandato En El Derecho de Obligaciones y Contratos* (Madrid: Dykinson, 2007), 41-42.

112 Brazilian Civil Code, Art. 693.

113 Ibid., Art. 694.

114 Muñoz, *Derecho Comercial*, 2:118.

Finally, it is also interesting to briefly analyze the international instruments regarding the relationship between principal and agent. Article 13 CAISG,[115] for instance, which refers to the legal effects of acts carried out by the agent, is worded as follows:

> (1) Where the agent acts on behalf of a principal within the scope of his authority, his acts shall bind only the agent and the third party if:
> (a) the third party neither knew nor ought to have known that the agent was acting as an agent, or
> (b) it follows from the circumstances of the case, for example by a reference to a contract of commission, that the agent undertakes to bind himself only.

The cited article reveals two interesting elements: first, it recognizes the relationship between the agency agreement and 'a contract of commission'. Second, it establishes that where the principal is not disclosed, or where it can be established that the agent undertakes to bind himself only, the agent is, in principle,[116] the sole party bound to the resulting obligations.

Similar provisions can be found in Articles 2.2.3 and 2.2.4 PICC. The former concerns the agency where the principal is disclosed, in which case 'no legal relation is created between the agent and the third party' with whom the agent makes the contract, unless the agent, 'with the consent of the principal undertakes to become the party to the contract'. The latter refers to the situation of an undisclosed principal, in which case 'the acts of the agent shall affect only the relations between the agent and the third party', meaning that, as a rule, the principal will not be directly bound to the third party. As per paragraph (2), however, where the agent declares that it owns the 'business' he purports to represent, 'the third party, upon discovery of the real owner of the business, may exercise also against the latter the rights it has against the agent'. It establishes, therefore, a regime that is very similar to that of the CAISG (which is not a coincidence, since the CAISG was an important source of inspiration for the PICC when it incorporated provisions related to agency contracts,[117] and considering that both have been drafted under the auspices of Unidroit): where the principal is undisclosed, only the

115 This convention is not in force (see Unidroit, "Status of the Convention on Agency in the International Sale of Goods," Unidroit Website, 10 June 2021, www.unidroit.org/instruments/agency/status/), and its Art. 3 expressly excludes from its scope 'the agency of a dealer on a stock, commodity or other exchange'. It is therefore only of indirect interest, as an example of how agency agreements are intended to be governed in the international setting. It is also said to have inspired national legislators. See Danny Busch, Laura Macgregor, and Peter Watts, *Agency Law in Commercial Practice* (Oxford: Oxford University Press, 2016), 88.

116 'In principle', because, as noted by Busch, Macgregor, and Watts, *Agency Law in Commercial Practice*, 88, Art. 13(2) allows the undisclosed principal to 'sue and be sued' if the agent fails to perform his obligations.

117 Stefan Vogenauer, *Commentary on the Unidroit Principles of International Commercial Contracts (PICC)*, 2nd ed. (Oxford: Oxford University Press, 2015), Art. 2.2, sec. II.

agent becomes bound by his acts. However, the principal may become bound if it reveals itself.[118]

The rules governing commission contracts are, therefore, reasonably uniform in both domestic and uniform laws. When the principal is undisclosed, in principle, only the agent becomes bound to the third party.[119] The position of the agent before such third party is practically the same as if it were a principal acting on its own behalf.

It is also reasonable to assert that the client-FCM relationship conforms well to the concept of commission contract. Domestic laws adopt terminology consistent with the notion that the client and the FCM are bound by a commission contract.[120] The use of the expression 'commission house' to designate FCMs[121] and of the term 'commission' to refer to the fees due by the client to the FCM for services rendered under such contract[122] also suggests a degree of relatedness even in jurisdictions where the law is affiliated to the English common law.[123]

It falls outside of the scope of this book to conclusively determine what the nature of such relationship is. However, throughout this book, I assume that the relationship between an FCM and its client is one of principal-agent, where the FCM is the agent and the client is the principal.

I also consider that the FCM, when acting on a client's orders, contracts in its own name, even on those exchanges said to function in accordance with the agency clearing model. Indeed, considering the way futures exchanges work, when contracts are made, it is not possible to know for sure whether an FCM is trading on its own behalf or on behalf of a client (and, if so, on behalf of which client).[124] Therefore, from the standpoint of its counterparty (another FCM or a clearing house), the FCM appears as a principal, even though it may be acting for the account of a client. As such, the FCM will be the sole person legally bound to the contract – which is consistent with the common law

118 As a counterexample, see ICC, "ICC Model Commercial Agency Contract" (ICC, 2015), 49. The notes accompanying the model contract explain that the model is aimed at a relationship involving a principal and a professional self-employed commercial agent, where, unless otherwise indicated, the agent does not have the power to bind the principal.

119 Beale, *Chitty on Contracts*, 2017, vol. 2, paras. 31-065; 31-072, also mention that this civil law category is akin to the common law notion of agency to an undisclosed principal.

120 For instance: the Brazilian CVM Normative Instruction No. 387, on Art. 2, item VII, uses 'client' and '*comitente*' as synonyms; the Spanish Securities Market Law (Royal Legislative Decree No. 4/2015), Art. 71.3, refers to the liabilities of the members of the securities market to their '*comitentes*'; the Peruvian Legislative Decree No. 861/1996, Art. 171 refers to duties owed by the intermediary agents to their '*comitentes*'.

121 Hieronymus, *Economics of Futures Trading*, 54.

122 U.S. Commodity Futures Trading Commission, "Glossary." See "Commission".

123 Fritz Enderlein and Dietrich Maskow, *International Sales Law: UN Convention on Contracts for the International Sale of Goods – Convention on the Limitation Period in the International Sale of Goods: Commentary* (New York: Oceana, 1992), 31.

124 Markovic, "The Futures Broker and Client Relationship in Australia," 95.

treatment of agencies with undisclosed principals (at least in England[125]), with the civil law notion of commission contract and also with related uniform law.

1.5.3 Options

Options are also a common occurrence in the context of the trade of commodity-type goods.

In the context of cash contracts, an option can be contractually established so that the buyer or the seller can discretionarily adjust the amount of goods being purchased or sold, adjusting the price proportionally. In such a situation, the contract will usually provide for a fixed quantity of goods that is not subject to the option, plus a range within which the beneficiary of the option will be able to adjust the total quantity. In this context, the option is a term of a broader contract.

It would also be possible to envision – although, at least, in the experience of the author, it is not a common occurrence in practice – a pure option contract, where one party would be entitled to an option to buy or sell a commodity.

Finally, options are also widely traded in commodity exchanges, as a derivative of futures contracts. Such options represent the right to buy (call options) or to sell (put options) an underlying good or right, for a certain predetermined price, in a predetermined time frame.[126] They differ from futures contracts insofar as they grant the holder the right, but not the obligation, to buy or to sell.[127] Because of this asymmetrical essence, options only impose financial obligations on the issuer (who must provide margin and bear losses if the market moves against it and the option is exercised). In futures markets, options grant the holder the right to acquire or dispose of a short or long futures position or, in other words, the right to enter into or to terminate a futures contract.[128]

Futures options are often used in conjunction with futures in order to build strategic positions,[129] meaning that, in practice, they serve the same purposes of futures contracts.[130]

Finally, there are option contracts that are 'traded' on unregulated over-the-counter (OTC) financial markets. These over-the-counter options often take the form of sophisticated contracts intertwining aspects of the financial and, sometimes, also the physical markets. These contracts may contain mark-to-market provisions that impose

---

125 Beale, *Chitty on Contracts*, 2017, vol. 2, paras. 31-088.
126 Long, *Oil Trading Manual*, sec. 9.2.
127 Hull, *Options, Futures, and Other Derivatives*, 31. This understanding has long been adopted by US case law. See 468 F. Supp. at 1555, *CFTC v. United States Metals Depository Co.*
128 Ibid., 401.
129 Long, *Oil Trading Manual*, sec. 9.1.
130 Hull, *Options, Futures, and Other Derivatives*, 404.

on the parties financial obligations similar to the daily adjustments required on the futures markets.[131]

The exercise of an option contract that refers to the sale or purchase of goods results in the formation of sales contracts; the exercise of an option contract that refers to a futures position results in the formation of a futures contract, which, in turn, may result in the formation of sales contracts. In this sense, option contracts may be seen as instruments for the formation of sales contracts.

1.5.4 Commodity Swaps

Swap contracts are OTC contracts pursuant to which two parties agree to exchange ('swap') cash flows in the future.[132] Commodity swaps are swaps where at least one of the cash flows is bound to the price of a commodity.[133]

Cash flows are payments due on future dates. A contract for the provision of crude oil for 10 years in exchange of periodic price payments generates a cash flow. If the contract provides for a floating price (*e.g.* a price at least partially indexed to the spot prices at the moment of each payment), the seller can swap (exchange) such cash flow for a fixed price cash flow, thus shifting away the uncertainty regarding price variation.[134] Like futures, therefore, swap contracts are instruments to transfer risks.

Swap contracts are usually performed by means of periodic payments of the net difference between the payments constituting each cash flow. In the illustration cited previously, if on a given month the price of the commodity is higher than the monthly payment due by the bank, the bank pays the difference to the buyer of the commodity; if the price of the commodity is lower than the monthly payment due by the bank, the buyer pays the difference to the bank.[135]

Although it might, in principle, be possible,[136] commodity swaps do not usually involve the delivery of physical commodities[137] (note, however, that at least one author firmly asserts that swaps are 'always (…) cash settled'[138]).

Commodity swaps are often described as 'a series of forward contracts',[139] but are not to be conflated with the cash forward contracts mentioned before. Swap contracts that do

131 Long, *Oil Trading Manual*, sec. 9.2.
132 Hull, *Options, Futures, and Other Derivatives*, 172.
133 Ibid., 831.
134 Reportedly, such agreements occur frequently. See ibid., 787.
135 Niti Nandini Chatnani, *Commodity Markets: Operations, Instruments, and Applications* (New Delhi: Tata McGraw Hill Education, 2010), 40.
136 Since swap contracts do not have to be standardized, the parties may agree on the delivery of the physical commodity. However, swap contracts are usually used for hedging.
137 Chatnani, *Commodity Markets*, 40.
138 Schofield, *Commodity Derivatives*, chap. 5.7.1.
139 Hull, *Options, Futures, and Other Derivatives*, 195.

not provide for future delivery are akin to forward contracts only insofar as they refer to payments to be made in the future.

Likewise, market jargon sometimes refer to swaps being 'sold' or 'bought', but this usually does not mean that a purchase and sale contract is being made between the parties: to sell a swap means to enter into an agreement to receive a fixed cash flow against payment of a cash flow indexed to a variable reference, while to buy a swap means agreeing to receive a fixed cash flow in exchange for paying a cash flow indexed to a variable reference.[140]

1.5.5 Long-Term Contracts

The reasons why buyers and sellers would prefer to enter into a longer term agreement instead of engaging in several spot or forward transactions are usually a combination of the following: (1) a market with low liquidity; (2) dependence on a steady supply of the commodity during a long period of time; (3) the need for a very specific subtype of the commodity, which can be provided by only one or a few sellers;[141] (4) the need for foreseeable cash flows in order to secure financing arrangements,[142] which is more difficult to establish without long-term contracts.[143]

These factors are often interrelated: the dependence on a continuous supply of a commodity would not require long-term contractual commitments if there were abundance of suppliers operating in the cash market and an associated futures and/or OTC market to satisfy risk management needs. The need for a specific subtype of commodity is in itself a limitation of liquidity. Finally, the association between financing arrangements and sales is typical of commodities that require heavy capital expenditures in order to explore or produce the goods – this is also sometimes associated with the lower liquidity of the market, as discussed in subsection 1.6. In order to secure repayment of the loans taken to support such expenditures, the expected cash flows are pledged in advance.[144] It is therefore important that those cash

140 Schofield, *Commodity Derivatives*, sec. 5.8.1.

141 This occurs with some petroleum derivates. See Luís Manuel Teles de Menezes Leitão, "Os Contratos No Direito Do Petróleo e Do Gás," in *Direito Dos Petróleos: Uma Perspectiva Lusófona*, ed. Dário Moura Vicente and António Menezes Cordeiro (Coimbra: Almedina, 2013), 259.

142 Izabella Kaminska, "The Decline of the Oil Spot Market?," *Financial Times Alphaville*, 24 April 2013, ftalphaville.ft.com/2013/04/24/1469422/the-decline-of-the-oil-spot-market/; Teles de Menezes Leitão, "Os Contratos No Direito Do Petróleo e Do Gás," 260; specifically regarding natural gas, see Carol Mulcahy, "The Changing Face of Disputes in the Liquefied Natural Gas Market," *Journal of Energy & Natural Resources Law* 33, no. 3 (3 July 2015): 272-73.

143 David Long, Geoff Moore, and Gay Wenban-Smith, *Gas Trading Manual*, 2nd ed. (Cambridge: Woodhead, 2003), sec. 1.3.2; Mulcahy, "The Changing Face of Disputes in the Liquefied Natural Gas Market," 279.

144 Sophia Rüster, "Financing LNG Projects and the Role of Long-Term Sales-and-Purchase Agreements," *DIW Discussion Papers* 1441 (January 2015): 3.

flows be contractually established at the outset, often before the extraction facility is built.[145] Such arrangements are known as 'offtake contracts', some of which are entered into for terms between 15 and 25 years.[146] The contracts between producers and consumers of cobalt – for instance – are, reportedly, predominantly long term.[147]

Although long-term contracts can be classified as cash contracts, as noted in Section 1.5.1, the circumstance that they are designed to last for long periods, during which many shipments will take place, creates concerns that would not exist in the case of usual forward contracts. One of the most obvious is that facts that could be generally classified under the titles of 'change of circumstances', 'force majeure' or, in common law jurisdictions, 'frustration', will have an amplified effect on the ability of the parties to perform the contract or to take purchased goods.[148] Indeed, the longer the term of the contract, the more likely it becomes that such facts take place before the obligations of the parties are fully performed.

It is also known that political instability, purposeful interference of monopolistic or monopsonic companies[149] and/or governments in the production, either to control prices or to obtain other advantages, or even natural events that affect only one or a few suppliers or regions, may cause serious disruptions on the offer side and, therefore, produce wild price variations in short periods.

Moreover, states, either directly or through companies that they own or control, have quite often used in recent history their *de facto* power to unilaterally modify contractual provisions, in ways that would not have been possible in a normal business relationship between two privately owned companies (not to mention cases of outright expropriation of assets).[150] This is relevant in markets such as those for oil and gas, where state-controlled companies hold a substantial share.

These particularities must be accounted for when interpreting contracts inserted into such contexts. This will be reflected throughout Chapters 2-8.

---

145 Ibid., 1.

146 Ibid.

147 David R. Wilburn, "Cobalt Mineral Exploration and Supply from 1995 Through 2013" (U.S. Geological Survey, 2012), 7, pubs.usgs.gov/sir/2011/5084/pdf/SIR2011-5084_final_012612.pdf; Marcelo Azevedo et al., "Lithium and Cobalt: A Tale of Two Commodities" (McKinsey & Co., June 2018), 13, www.mckinsey.com/~/media/mckinsey/industries/metals%20and%20mining/our%20insights/lithium%20and%20cobalt%20a%20tale%20of%20two%20commodities/lithium-and-cobalt-a-tale-of-two-commodities.ashx; Henry Sanderson, "Glencore Signs Five-Year Cobalt Supply Deal with China's GEM Co," *Financial Times*, 7 October 2019, www.ft.com/content/511a1610-e8ea-11e9-85f4-d00e5018f061; Heidi Vella, "Inside China's Move to Monopolise Cobalt," *Mining Technology*, 4 June 2018, www.mining-technology.com/features/inside-chinas-move-monopolise-cobalt/.

148 Paul Dillon, Luca Salerno, and Joanne Lewis, "When Russian Gas Is Turned Off – Do You Have Any Recourse?," *Reed Smith Client Alert* 09-005 (January 2009): 1-3.

149 Brian C. Black, *Crude Reality: Petroleum in World History* (Lanham: Rowman & Littlefield, 2012), 231.

150 Carole Nakhle, "Lower Oil Prices: An Opportunity for Oil and Gas Companies," Natural Resource Governance Institute Blog, 11 June 2015, resourcegovernance.org/blog/lower-oil-prices-opportunity-oil-and-gas-companies.

1.5.6 Contract Farming Arrangements

Another contract type usually associated with agricultural commodities is referred to under the designation of 'contract farming'.[151]

The definition of this contractual type is contentious, and it appears to encompass a broad range of contractual arrangements.[152] Some of these arrangements are close to sales contracts, insofar as they may provide for an exchange of goods for money. As the expression 'contract farming' suggests, however, these contracts often take the form of services agreements whereby the farmer is hired by a sponsor as a contractor,[153] rendering them closer to labor contracts than to sales contracts. In fact, in some jurisdictions, the imbalance in the contract is seen as an essential trait of contract farming arrangements.[154] This prompted states to enact legislation with the aim of protecting farmers from the integrator,[155] often imposing external surveillance by an entity such as a government organ or a cooperative of farmers in order to guarantee that contracts are performed without abuse.[156] Because of this protective purpose, rules governing these relationships are more likely to be considered more specific than the CISG for cases falling under their ambit, meaning that the former will likely prevail in case of conflict. The many possible implications of the interplay between domestic law and the Convention in such a context are contingent on the tenor of the applicable domestic legislation and, as such, would be more suitably studied in a country-specific analysis.[157]

151 Kassia Watanabe and Decio Zylbersztajn, "Contract Farming in the Brazilian Agri-Business System: Private Institutions and State Intervention," *Uniform Law Review* 19 (2014): 472-73; Peter D. Little and Michael J. Watts, *Living Under Contract: Contract Farming and Agrarian Transformation in Sub-Saharan Africa* (Madison: University of Wisconsin Press, 1994), 22-23.

152 Ewell Paul Roy, *Contract Farming, U.S.A.* (Danville: Interstate, 1963), 1.

153 Little and Watts, *Living Under Contract*, 33; Nunziata Stefania Valenza Paiva, "O Problema Da Qualificação Jurídica Dos Contratos de Integração Vertical Agroindustriais No Direito Brasileiro," *Revista Da Faculdade de Direito Da UFG* 33, no. 2 (December 2009): 187; Lisa Gröger, "The Effect of Farm Policy on Production Strategies among French Family Farmers," *Human Ecology* 14, no. 3 (1986): 349.

154 Watanabe and Zylbersztajn, "Contract Farming in the Brazilian Agri-Business System: Private Institutions and State Intervention," 476.

155 Ibid., 474; Brazilian Law No. 13.288, enacted on 16 May 2016, is one such example. It was explicitly enacted to increase protection of rural producers, recognized as the 'weaker party' under those contracts. See Ana Amélia, "Senate Law Project No. 330/2011" (2011), www25.senado.leg.br/web/atividade/materias/-/materia/100728. India has also regulated this contractual arrangement. See "India: Union Agriculture Minister Releases Model Agriculture Produce and Livestock Contract Farming and Services (Promotion & Facilitation) Act, 2018," *MENA Report*, 23 May 2018.

156 Nunziata Stefania Valenza Paiva, "Contornos Jurídicos e Matizes Econômicas Dos Contratos de Integração Vertical Agroindustriais No Brasil," *Latin American and Caribbean Law and Economics Association (ALACDE) Annual Papers*, 1 May 2007, 8-9, escholarship.org/uc/item/7049p03n.

157 Although there also exists a claim in the sense that harmonization might play an important role in this area. See Anna Veneziano, "Beyond the CISG: Agricultural Production under Contract," in *35 Years CISG and Beyond*, ed. Ingeborg Schwenzer, International Commerce and Arbitration, volume 19 (35 Years CISG and Beyond (Conference), The Hague: Eleven, 2016), 348-50.

Contract farming arrangements, moreover, are usually purely domestic, and as such are typically not part of the international trade of commodities.[158] Hence, these contracts will not be studied in this book.

1.6 The Economics of Commodities

Although this book deals primarily with the legal aspects of commodity sales, there are some economic considerations that play a relevant role in the interpretation and application of contract and legal provisions. This section is dedicated to a brief discussion of two aspects of the commodity markets that fit this description: liquidity and price volatility.

1.6.1 Liquidity

Commodity markets are often described as near-perfect, very liquid markets, where buyers and sellers may freely and easily transact and where a spot market price is always readily available.[159] However, not all commodities are traded in markets like that.

A global consultancy firm[160] grouped commodities, according to their liquidity, into roughly four classes: (1) illiquid (not traded); (2) semi-liquid; (3) liquid; and (4) near-perfect markets. The first category encompasses goods such as met coal and concentrates (the latter are on the 'border' between categories one and two); the second includes commodities such as iron ore and liquified natural gas (with the remark that the latter is on its way to becoming more liquid); the third includes thermal coal, oil products and soft commodities other than grains; and the fourth contains natural gas, grains, crude oil and other energy commodities, finished and precious metals. The categorization is, of course, not exhaustive but illustrates that the markets for distinct commodities can be very different.

Commodities classified as illiquid are associated with a necessity for heavier asset investments, whereas semi-liquid were said to be 'attractive for traders who are able to secure structural longs and build network'. Liquid commodities are better suited to independent traders because trading volumes are high, and so are profit margins. Nearly perfect markets are those with the highest degree of liquidity; volumes are the

---

158 Unidroit, ed., *Legal Guide on Contract Farming* (Rome: Unidroit, 2015), 17.

159 See, for instance, Nicholas Gregory Mankiw, *Principles of Economics*, 9th ed. (Boston: Cengage Learning, 2021), 62.

160 Alexander Franke et al., "The Dawn of a New Era in Commodity Trading – Act III – Five Megatrends That Will Alter the Industry and Commodity Markets," *Risk Journal* 4 (2014): 105.