Glossary

Abandon: The act of an option holder in electing not to exercise or offset an option.

Approved Delivery Facility: Any bank, stockyard, mill, storehouse, plant, elevator, or other depository that is authorized by an exchange for the delivery of commodities tendered on futures contracts.

Arbitrage: Simultaneous purchase of cash commodities or futures in one market against the sale of cash commodities or future in the same or a different market to profit from a discrepancy in prices. Also includes some aspects of hedging. See *Spread, Switch.*

Asian Option: An option whose payoff depends on the average price of the underlying asset during some portion of the life of the option.

At-the-Money: When an option's exercise price is the same as the current trading price of the underlying commodity, the option is at-the-money.

Backwardation: Market situation in which futures prices are progressively lower in the distant delivery months. For instance, if the gold quotation for the February is $160.00 per ounce and that for June is $155.00 per ounce, the backwardation for four months against January is $5.00 per ounce. (Backwardation is the opposite of *contango*.) See *Inverted Market*.

Basis: The difference between the spot or cash price of a commodity and the price of the nearest futures contract for the same or a related commodity. Basis is usually computed in relation to the futures contract next to expire and may reflect different time periods, product forms, qualities, or locations.

Basis Risk: The risk associated with an unexpected widening or narrowing of basis between the time a hedge position is established and the time it is lifted.

Bear: One who expects a decline in prices. The opposite of a *bull*. A news item is considered bearish if it is expected to result in lower prices.

Bear Market: A market in which prices are declining.

Bear Spread: The simultaneous purchase and sale of two futures contracts in the same or related commodities with the intention of profiting from a decline in prices but at the same time limiting the potential loss if this expectation does not materialize. In agricultural products, this is accomplished by selling a nearby delivery and buying a deferred delivery.

Bid: An offer to buy a specific quantity of a commodity at a stated price.

Broker: A person paid a fee or commission for executing buy or sell orders for a customer. In commodity futures trading, the term may refer to: (1) Floor Broker—a person who actually executes orders on the trading floor of an exchange. (2) Account Executive, Associated Person, registered Commodity Representative or Customer's Man—the person who deals with customers in the offices of futures commission merchants. (3) The futures Commission Merchant.

Bucketing: Directly or indirectly taking the opposite side of a customer's order into a broker's own account or into an account in which a broker has an interest, without open and competitive execution of the order on an exchange.

Bucket Shop: A brokerage enterprise which "books" (i.e., takes the opposite side of) a customer's order without actually having it executed on an exchange.

Bull: One who expects a rise in prices. The opposite of *bear*. A news item is considered bullish if it portends higher prices.

Bull Market: A market in which prices are rising.

Buyer: A market participant who takes a long futures position or buys an option. An option buyer is also called a *taker*, *holder*, or *owner*.

Buying Hedge (or Long Hedge): Hedging transaction in which futures contracts are brought to protect against possible increases in the cost of commodities. See *Hedging*.

Call: (1) A period at the opening and the close of some futures markets in which the price for each futures contract is established by auction. (2) *Buyer's Call*, also called *Call Sale*, generally applies to cotton. A purchase of a specified quantity or grade of a commodity at a fixed number of points above or below a specified delivery month futures price with the buyer allowed a period of time to fix the price either by purchasing a future for the account of the seller or telling the seller when he wishes to fix the price. (3) *Seller's Call*, also called *Call Purchase*, is the same as the buyer's call except that the obligation is to purchase the commodity or to enter into a long futures position. (4) The requirement that a financial instrument be returned to the issuer prior to maturity, with principal and accrued interest paid off upon return.

Called: Another term for "exercised" when the option is a call. The writer of a call must deliver the indicated underlying commodity when the option is exercised or called.

Call Option: A contract that entitles the buyer/taker to buy a fixed quantity of commodity at a stipulated basis or striking price at any time up to the expiration of the option. The buyer pays a premium to the seller.

Cash Commodity: The physical or actual commodity as distinguished from the futures contract. Sometimes called *Spot Commodity* or *Actuals*.

Cash Forward Sale: See *Forward Contracting*.

Cash Market: The market for the cash commodity (as contrasted to a futures contract), taking the form of: (1) an organized, self-regulated central market (e.g., a commodity exchange); (2) a decentralized over-the-counter market; or (3) a local organization, such as a grain elevator or meat processor, which provides a market for a small region.

Cash Price: The price in the marketplace for actual cash or spot commodities to be delivered via customary market channels.

Cash Settlement: A method of settling certain futures or option contracts whereby the seller (or short) pays the buyer (or long) the cash value of the commodity traded according to a procedure specified in the contract.

Circuit Breakers: A system of trading halts and price limits on equities and derivative markets designed to provide a cooling-off period during large, intraday market movements. The first known use of the term circuit breaker in this context was in the Report of the Presidential Task Force on Market Mechanisms (January 1988), which recommended that circuit breakers be adopted following the market break of October 1987.

Clearing: The procedures through which the clearinghouse or association becomes the buyer to each seller of a futures contract, and the seller to each buyer, and assumes responsibility for protecting buyers and sellers from financial loss by assuring performance on each contract.

Clearinghouse: An adjunct to, or division of, a commodity exchange through which transactions executed on the floor of the exchange are settled. Also charged with assuring the proper conduct of the exchange's delivery procedures and the adequate financing of the trading.

Clearing Member: A member of the Clearinghouse or Association. All trades of a non-clearing member must be registered and eventually settled through a clearing member.

Close: The period at the end of the trading session, officially designated by the exchange, during which all transactions are considered made "at the close." See also *Call*.

Closing-Out: Liquidating an existing long or short futures or option position with an equal and opposite transaction. Also known as *Offset*.

Closing Price (or Range): The price (or price range) recorded during trading that takes place in the final moments of day's activity that is officially designated as the *close*.

Commodity Futures Trading Commission (CFTC): The Federal regulatory agency established by the CFTC Act of 1974 to administer the Commodity Exchange Act.

Congestion: (1) A market situation in which shorts attempting to cover their positions are unable to find an adequate supply of contacts provided by longs willing to liquidate or by new sellers willing to enter the market, except at sharply higher prices. (2) In technical analysis, a period of time characterized by repetitious and limited price fluctuations.

Contango: Market situation in which prices in succeeding delivery months are progressively higher than in the nearest delivery month; the opposite of *backwardation*.

Convergence: The tendency for prices of physicals and futures to approach one another, usually during the delivery month. Also called a *narrowing of the basis*.

Corner: (1) Securing such relative control of a commodity or security that its price can be manipulated. (2) In the extreme situation, obtaining contracts requiring the delivery of more commodities or securities than are available for delivery.

Cover: (1) Purchasing futures to offset a short position. Same as *Short Covering*. See *Offset, Liquidation*. (2) To have in hand the physical commodity when a short futures or leverage sale is made, or to acquire the commodity that might be deliverable on a short sale.

Covered Option: A short call or put option position that is covered by the sale or purchase of the underlying futures contract or physical commodity. For example, in the case of options on futures contracts, a covered call is a short call position combined with a long futures position. A covered put is a short put position combined with a short future position.

Crack: In energy futures, the simultaneous purchase of crude oil futures and the sale of petroleum product futures to establish a refining margin. See *Gross Processing Margin*.

Cross-Hedge: Hedging a cash market position in a futures contract for a different but price-related commodity.

Default: Failure to perform on a futures contract as required by exchange rules, such as failure to meet a margin call, or to make or take delivery.

Delivery: The tender and receipt of the actual commodity, the cash value of the commodity, or of a delivery instrument covering the commodity (e.g., warehouse receipts or shipping certificates), used to settle a futures contract. See *Notice of Delivery*.

Delivery Price: The price fixed by the clearinghouse at which deliveries on futures are invoiced—generally the price at which the futures contract is settled when deliveries are made.

Deposit: The initial outlay required by a broker of a client to open a futures position, returnable upon liquidation of that position.

Derivative: A financial instrument, traded on or off an exchange, the price of which is directly dependent upon (i.e., "derived from") the value of one or more underlying securities, equity indexes, debt instruments, commodities, other derivative instrument, or any agreed upon pricing index or arrangement (e.g., the movement over time of the Consumer Price Index or freight rates). Derivatives involve the trading of rights or obligations based on the underlying product but do not directly transfer property. They are used to hedge risk or to exchange a floating rate of return for a fixed rate of return.

Distant or Deferred Delivery: Usually, one of the more distant months in which futures trading is taking place.

Efficient Market: A market in which new information is immediately available to all investors and potential investors. A market in which all information is instantaneously assimilated and therefore has no distortions.

EFP: Exchange for Physical.

Exchange Rate: The price of one currency stated in terms of another currency.

Exercise: To elect to buy or sell, taking advantage of the right (but not the obligation) conferred by an option contract.

Exercise (Strike) Price: The price specified in the option contract at which the buyer of a call can purchase the commodity during the life of the option, and the price specified in the option contract at which the buyer of a put can sell the commodity during the life of the option.

Exotic Options: Any of a wide variety of options with non-standard payout structures, including Asian options and Lookback options. Exotic options are mostly traded in the over-the-counter market.

Expiration Date: The date on which an option contract automatically expires; the last day an option can be exercised.

Fictitious Trading: Wash trading, bucketing, cross trading, or other schemes which give the appearance of trading when, actually, no *bona fide* competitive trade has occurred.

Financial Instrument: As used by the CFTC, this term generally refers to any futures or option contract that is based on an agricultural commodity or a natural resource. It includes currencies, securities, mortgages, commercial paper, and indexes of various kinds.

Forced Liquidation: The situation in which a customer's account is liquidated (open positions are offset) by the brokerage firm holding the account, usually after notification that the account is undercapitalized (margin calls).

***Force Majeure*:** A clause in a supply contract which permits either party not to fulfill the contractual commitments due to events beyond their control. These events may range from strikes to exports delays in producing countries.

Foreign Exchange: Foreign currency. On the foreign exchange market, foreign currency is bought and sold for immediate or future delivery.

Forward: In the future.

Forward Contracting: A cash transaction common in many industries, including commodity merchandising, in which a commercial buyer and seller agree upon delivery of a specified quality and quantity of goods at a specified future date. A price may be agreed upon in advance, or there may be agreement that the price will be determined at the time of delivery.

Forward Market: Refers to informal (non-exchange) trading of commodities to be delivered at a future date. Contracts for forward delivery are "personalized" (i.e., delivery time and amount are as determined between seller and customer).

Fungibility: The characteristic of interchangeability. Futures contracts for the same commodity and delivery month are fungible due to their standardized specifications for quality, quantity, delivery dates, and delivery locations.

Futures Commission Merchant (FCM): Individuals, associations, partnerships, corporations, and trusts that solicit or accept orders for the purchase or sale of any commodity for future delivery on or subject to the rules of any contract market and that accept payment from or extend credit to those whose orders are accepted.

Futures Contract: An agreement to purchase or sell a commodity for delivery in the future: (1) at a price that is determined at initiation of the contract; (2) which obligates each party to the contract to fulfill the contract at the specified price; (3) which is used to assume or shift price risk; and (4) which may be satisfied by delivery or offset.

Futures Price: (1) Commonly held to mean the price of a commodity for future delivery that is traded on a futures exchange. (2) The price of any futures contract.

Grantor: The maker, writer, or issuer of an option contract who, in return for the premium paid for the option, stands ready to purchase the underlying commodity (or futures contract) in the case of a put option or to sell the underlying commodity (or futures contract) in the case of a call option.

Haircut: (1) In determining whether assets meet capital requirements, a percentage reduction in the stated value of assets. (2) In computing the worth of assets deposited as collateral or margin, a reduction from market value.

Hedge Ratio: Ratio of the value of futures contracts purchased or sold to the value of the cash commodity being hedged, a computation necessary to minimize basis risk.

Hedging: Taking a position in a futures market opposite to a position held in the cash market to minimize the risk of financial loss from an adverse price change; a purchase or sale of futures as a temporary substitute for a cash transaction that will occur later.

Initial Margin: Customers' funds put up as security for a guarantee of contract fulfillment at the time a futures market position is established.

In-the-Money: A term used to describe an option contract that has a positive value if exercised. A call at $400 on gold trading at $10 is in-the-money 10 dollars.

Intrinsic Value: A measure of the value of an option or a warrant if immediately exercised. The amount by which the current price for the underlying commodity or futures contract is above the strike price of a call option or below the strike price of a put option for the commodity or futures contract.

Introducing Broker (IB): Any person (other than a person registered as an "associated person" of a futures commission merchant) who is engaged in soliciting or in accepting orders for the purchase or sale of any commodity for future delivery on an exchange and who does not accept any money, securities, or property to margin, guarantee, or secure any trades or contracts that result therefrom.

Inverted Market: A futures market in which the nearer months are selling at prices higher than the more distant months; a market displaying "inverse carrying charges," characteristic of markets with supply shortages. See *Backwardation*.

Invisible Supply: Uncounted stocks of a commodity in the hands of wholesalers, manufacturers, and producers that cannot be identified accurately; stocks outside commercial channels but theoretically available to the market.

Licensed Warehouse: A warehouse approved by an exchange from which a commodity may be delivered on a futures contract.

Limit (Up or Down): The maximum price advance or decline from the previous day's settlement price permitted during one trading session, as fixed by the rules of an exchange. See *Daily Price Limits*.

Limit Order: An order in which the customer specifies a price limit or other condition, such as time of an order; as contrasted with a market order, which implies that the order should be filled as soon as possible.

Liquidation: The closing out of a long position. The term is sometimes used to denote closing out a short position, but this is more often referred to as covering.

Liquid Market: A market in which selling and buying can be accomplished with minimal price change.

Long: (1) One who has bought a futures contract to establish a market position. (2) A market position which obligates the holder to take delivery. (3) One who owns an inventory of commodities. See also *Short*.

Long Hedge: Purchase of futures against the fixed-price forward sale of a cash commodity.

Margin: The amount of money or collateral deposited by a customer with his broker, by a broker with a clearing member, or by a clearing member with the clearinghouse, for the purpose of insuring the broker or clearinghouse against loss on open futures contracts. The margin is not partial payment on a purchase. (1) Initial margin is the total amount of margin per contract required by the broker when a futures position is opened. (2) Maintenance margin is a sum which must be maintained on deposit at all times. If the equity in a customer's account drops to, or under, the required level because of adverse price movement, the broker must issue a margin call to restore the customer's equity.

Margin Call: (1) A request from a brokerage firm to a customer to bring margin deposits up to initial levels. (2) A request by the clearinghouse to a clearing member to make a deposit of original margin, or a daily or intra-day variation payment, because of adverse price movement, based on positions carried by the clearing member.

Mark to Market: Daily cash flow system used by U.S. futures exchanges to maintain minimum level of margin equity for a given futures or option contract position by calculating the gain or loss in each contract position resulting from changes in the futures or option contracts at the end of each trading day.

Maturity: Period within which a futures contract can be settled by delivery of the actual commodity.

Naked Option: The sale of a call or put option without holding an offsetting position in the underlying commodity.

Nearby Delivery Month: The month of the futures contract closest to maturity.

Nominal Price (or Nominal Quotation): Computed price quotation on futures for a period in which no actual trading took place, usually an average of bid and asked prices.

Notional Amount: The amount (in an interest rate swap, forward rate agreement, or other derivative instrument) or each of the amounts (in a currency swap) to which interest rates are applied (whether or not expressed as a rate or stated on a coupon basis) in order to calculate periodic payment obligations. Also called the *notional principal amount*, the *reference amount*, and the *currency amount*.

Offer: An indication of willingness to sell at a given price; opposite of *bid*.

Offset: Liquidating a purchase of futures contracts through the sale of an equal number of contracts of the same delivery month, or liquidating a short sale of futures through the purchase of an equal number contracts of the same delivery month.

Open Interest: The total number of futures contracts long or short in a delivery month or market that has been entered into and not yet liquidated by an offsetting transaction or fulfilled by delivery. Also called *Open Contracts* or *Open Commitments*.

Option: (1) A commodity option is a unilateral contract that gives the buyer the right to buy or sell a specified quantity of a commodity at a specific price within a specified period of time, regardless of the market price of that commodity. See also *Put*, *Call*. (2) A term sometimes erroneously applied to a futures contract. It may refer to a specific delivery month, such as the "July Option."

Out-of-the-Money: A term used to describe an option that has no intrinsic value. For example, a call at $400 on gold trading at $390 is out-of-the-money 10 dollars.

Out Trade: A trade that cannot be cleared by a clearinghouse because the trade data submitted by the two clearing members involved in the trade differ in some respect (e.g., price and/or quantity). In such cases, the two members or brokers involved must reconcile the discrepancy, if possible, and resubmit the trade for clearing. If an agreement cannot be reached by the two clearing members or brokers involved, the dispute is settled by an appropriate exchange committee.

Paper Profit or Loss: The profit or loss that would be realized if open contracts were liquidated as of a certain time or a certain price.

Pit: A specially constructed arena on the trading floor of some exchanges where trading in a futures contract is conducted. On other exchanges the term "ring" designates the trading area for a commodity.

Point: A measure of price change equal to 1/100 of one cent in most futures in decimal units. For grains, such as wheat or corn, a point is one cent. For Treasury bonds, a point is one percent of par. See *Tick*.

Pork Bellies: One of the major cuts of the hog carcass that, when cured, becomes bacon.

Position: An interest in the market, either long or short, in the form of one or more open contracts. Also, *in position* refers to a commodity located where it can readily be moved to another point or delivered on a futures contract. Commodities not so situated are *out of position*. Soybeans in Mississippi are out of position for delivery in Chicago but in position for export shipment from the Gulf.

Position Limit: the maximum position, either net long or short, in one commodity future (or option) or in all futures (or options) of one commodity combined which may be held or controlled by one person as prescribed by an exchange and/or by the CFTC.

Position Trader: A commodity trader who either buys or sells contracts and hold them for an extended period of time, as distinguished from the day trader, who will normally initiate and offset a futures position within a single trading session.

Price Discovery: The process of determining the price level for a commodity based on supply and demand factors.

Price Manipulation: Any planned operation, transactions, or practice calculated to cause or maintain an artificial price.

Primary Market: (1) For producers, their major purchaser of commodities. (2) In commercial marketing cannels, an important center at which spot commodities are concentrated for shipment to terminal markets. (3) To processors, the market that is the major supplier of their commodity needs.

Puts: Option contracts which give the holder the right but not the obligation to sell a specified quantity of a particular commodity or other interest at a given price (the *strike price*) prior to or on a future date. Also called *put options*, they will have a higher (lower) value when the current market value of the underlying article is lower (higher) than the strike price.

Put Option: An option to sell a specified amount of a commodity at an agreed price and time at any time until the expiration of the option. A put option is purchased to protect against a fall in price. The buyer pays a premium to the seller / grantor of this option. The buyer has the right to sell the commodity or enter into a short position in the futures market if the option is exercised. See also *Call Option*.

Pyramiding: The use of profits on existing positions as margin to increase the size of the position, normally in successively smaller increments.

Range: The difference between the high and low price of a commodity during a given period.

Ratio Hedge: the number of options compared to the number of futures contracts bought or sold in order to establish a hedge that is risk neutral.

Ratio Spread: This strategy, which applies to both puts and calls, involves buying or selling options at one strike price in greater numbers than those bought or sold at another strike price.

Replicating Portfolio: A portfolio of assets for which changes in value match those of a target asset. For example, a portfolio replicating a standard option can be constructed with certain amounts of the asset underlying the option and bonds. Sometimes referred to as a *Synthetic Asset*.

Reporting Level: Sizes of positions set by the exchange and / or the CFTC at or above which commodity traders or brokers who carry these accounts must make daily reports about the size of the position by commodity, by delivery month, and whether the position is controlled by a commercial or noncommercial trader.

Risk/Reward Ratio: The relationship between the probability of loss and profit. The ratio is often used as a basis for trade selection or comparison.

Short: (1) The selling side of an open futures contract. (2) A trader whose net position in the futures market shows an excess of open sales over open purchases. See also *Long*.

Short Selling: Selling a futures contract with the idea of delivering on it or offsetting it at a later date.

Short the Basis: The purchase of futures as a hedge against a commitment to sell in the cash or spot markets.

Special Purpose Entity (SPE): A subsidiary established by a company for a particular project or activity. The company establishing the SPE may treat the SPE as if it were an independent, outside entity for accounting purposes if two conditions are met: (1) an owner independent of the company must make a substantive equity investment of at least 3 percent of the SPE's assets, and that 3 percent must remain at risk throughout the transaction; and (2) the independent owner must exercise control of the SPE. In those circumstances, the company may record gains and losses on transactions with the SPE, and the assets and liabilities of the SPE are not included in the company's balance sheet, even though the company and the SPE are closely related.

Speculative Bubble: A rapid, but usually short-lived, run-up in prices caused by excessive buying unrelated to any of the basic, underlying factors affecting the supply or demand for the commodity. Speculative bubbles usually are associated with a "bandwagon" effect in which speculators rush to buy the commodity (in the case of futures, "to take positions") before the price trend ends, and an even greater rush to sell the commodity (unwind positions) when prices reverse.

Speculator: In commodity futures, an individual who does not hedge, but who trades with the objective of achieving profits through the successful anticipation of price movements.

Spot: Market of immediate delivery of the product and immediate payment. Also refers to a maturing delivery month of a futures contract.

Spot Commodity: (1) The actual commodity as distinguished from a futures contract. (2) Sometimes used to refer to cash commodities available for immediate delivery. See also *Actuals*, *Cash Commodity*.

Spot Cash Price: The price at which a physical commodity for immediate delivery is selling at a given time and place.

Squeeze: A market situation in which the lack of supplies tends to force shorts to cover their positions by offset at higher prices.

Striking Price (Exercise or Contract Price): The price, specified in an option contract, at which the underlying futures contract or commodity will move from seller to buyer.

Swap: In general, the exchange of one asset or liability for a similar asset or liability for the purpose of lengthening or shortening maturities, or raising or lowering coupon rates, to maximize revenue or minimize financing costs. In securities, this may entail selling one issue and buying another in foreign currency, or it may entail buying a currency on the spot market and simultaneously selling it forward. Swaps may also involve exchanging income flows; for example, exchanging the fixed rate coupon stream of a bond for a variable rate payment stream, or vice versa, while not swapping the principal component of the bond.

Swaption: An option to enter into swap—i.e., the right, but not the obligation, to enter into a specified type of swap at a specified future date.

Tick: Refers to a minimum change in price up or down. See *Point*.

Time Spread: The selling of a nearby option and buying of a more deferred option with the same strike price.

Time Value: That portion of an option's premium that exceeds the intrinsic value. The time value of an option reflects the probability that the option will move into-the-money. Therefore, the longer the time remaining until expiration of the option, the greater its time value. Also called *Extrinsic Value.*

Trade Option: A commodity option transaction in which the taker is reasonably believed by the writer to be engaged in business involving use of that commodity or related commodity.

Trader: (1) A merchant involved in cash commodities. (2) A professional speculator who trades for his own account.

Transaction: The entry or liquidation of a trade.

Underlying Commodity: The commodity or futures contract on which a commodity option is based, and which must be accepted or delivered if the option is exercised. Also, the cash commodity underlying a futures contract.

Wash Sale: Transactions that give the appearance of purchases and sales but which are initiated without the intent to make a *bona fide* transaction and which generally do not result in any actual change in ownership. Such sales are prohibited by the Commodity Exchange Act.

Wash Trading: Entering into, or purporting to enter into, transactions to give the appearance that purchases and sales have been made, without resulting in a change in the trader's market position.

Writer: The issuer, grantor, or maker of an option contract.

Yield Curve: A graphic representation of market yield for a fixed income security plotted against the maturity of the security.