Section I

Introduction to Futures and Options Markets

Chapter 6: Standardized terms of the futures contract

Learning objectives

- Deliverable grades and delivery points
- Daily price limits
- Delivery months

Key terms

Futures contract: A contract to deliver or take delivery of a commodity in some future month at a price determined by auction.

Convergence: The process by which the price of a futures contract moves toward the price of the underlying cash commodity.

Nearby contract: The nearest active trading month of a futures contract. The nearby month rolls forward to the next month on or about the first day of a delivery month. Sometimes called the lead or front month.

Deferred contracts: Futures contracts traded further from expiration than the nearby contract. Sometimes called the back months.

The Futures Contract

A futures contract is a contract to deliver or take delivery of a commodity in some future month at a price determined by auction. Only a small percentage of futures contracts are satisfied by actual delivery of the commodity. But the delivery mechanism is very important. The possibility of delivery forces cash and futures prices to converge at the time of delivery. This convergence links cash and futures prices together. This link means that futures contracts can be used as a temporary and reliable substitute for a later transaction in the cash market.

All terms of a futures contract, except the price, are standardized by the exchange. Using the example of the Chicago Board of Trade corn contract, we can examine some common terms of a futures contract.

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Delivery months: March, May, July, September, and December. Delivery months were established to coincide with important times in the production and marketing year, i.e. planting and harvest, and the opening and closing of waterways. The industry uses ticker symbols for each month, and for individual commodities. These ticker symbols are shown in the third and fourth columns in the table below.

Commodity	Exchange	Ticker Symbol	Electronic Ticker Symbol
Corn	CBOT	C	ZC
Soybeans	CBOT	S	ZS
Sugar #11	ICE U.S.	--	SB
Wheat	CBOT	W	ZW
Soybean Oil	CBOT	BO	ZL
Soybean Meal	CBOT	SM	ZM
Live Cattle	CME	LC	LE
Lean Hogs	CME	LH	HE
Wheat	KCBOT	KW	KE
Cotton	ICE U.S.	--	CT
Coffee	ICE U.S.	--	KC
Cocoa	ICE U.S.	--	CC
Canola	ICE Canada	--	RS
Wheat	MGEX	--	MW
Feeder Cattle	CME	FC	GF
Orange Juice	ICE U.S.	--	OJ
Class III Milk	CME	DA	DC
Oats	CBOT	O	ZO

The grain trade has its own language when referring to different delivery months. For example, the "nearby" refers to the nearest active trading month of a futures contract. The delivery month considered the "nearby" month rolls forward on or about the first day of a delivery month. For example,

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in the month of June, the nearby contract is the July contract. On or about July 1, the market rolls forward and the September contract becomes the nearby contract. On or about September 1, the December contract will become the nearby contract. The nearby contract is sometimes called the lead or front month.

"Deferred" contracts are futures contracts traded further from expiration than the nearby contract. In the month of June, the July contract is the "nearby" while the September, December, March etc. are deferred contracts. Deferred contracts are sometimes called the back months.

New crop contracts are the delivery months that represent the price of the new crop. In corn, December is the new crop contract. In soybeans, the November contract is new crop. In hard red winter wheat (HRW traded at the Kansas City Board of Trade) and soft red winter wheat (SRW), the July contract is new crop. In the hard red spring wheat market (HRS traded at the Minneapolis Grain Exchange), the September contract is new crop.

Delivery Month	Code
January	F
February	G
March	H
April	J
May	K
June	M
July	N
August	Q
September	U
October	V
November	X
December	Z

Occasionally you may hear a reference to the "red" contract – the contract one year out. For example, if the Jul'15 contract is the nearby contract, then the "red July" refers to the Jul'16 contract.

Contract quantity: 5,000 bushels

Minimum price fluctuations (tick): ¼ cent in grains, or $12.50 per contract.

Maximum daily price move from the previous day's close ("limit move"): 40 cents per bushel in corn (60 cents in wheat and 70 cents in soybeans). Limits are established by the exchanges and can be changed. There is no limit in the spot month. The logic behind setting limits is to, (1) reduce the risk of default and, (2) force a pause in trading to allow traders more time to assess information that is creating volatility.

Contract deliverable grade: No. 2 Yellow Corn at contract price. No. 1 Yellow Corn can be delivered for a 1.5 cent per bushel premium, or No. 3 Yellow Corn at a 1.5 cent per bushel discount.

Time of delivery: Delivery occurs at the seller's choice in the delivery month. They select the time of delivery, the contract grade and the place of delivery.

Method of delivery: Shipping certificates are used for corn. Warehouse receipts are another method of delivery. Many new contracts in non-agricultural commodities specify cash settlement.

Place of delivery: Several shipping districts in and around the Chicago area. Grain futures contracts generally have a par delivery point with alternative points deliverable at a discount or premium.

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Further reading

Self-Study Guide to Hedging with Grain and Oilseed Futures and Options (handbook), CME Group, April 2012 http://www.cmegroup.com/trading/agricultural/self-study-guide-to-hedging-with-grain-and-oilseed-futures-and-options.html

Exercise #6

Go play the game!

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