

CFTC Adopts Final Rule to Treat Commodity Options as Swaps; Provides Exemption for Physical Options

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On April 18, 2012, the Commodity Futures Trading Commission (CFTC or the Commission) adopted a final rule that will generally regulate commodity options as swaps (the Final Rule) under the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act). As part of the [Final Rule](#), the CFTC adopted an interim final rule that, subject to certain conditions, will exempt physically settled commodity options (Physical Options) from several key Dodd-Frank Act requirements.¹

Although the Final Rule (including the interim final rule) will become effective on June 26, 2012, compliance will not be required until 60 days after the final definition of “swap” is published in the Federal Register. The “swap” definition will likely be issued by the CFTC and the Securities and Exchange Commission (SEC) in the coming months. Market participants will not be required to comply with any applicable condition referencing a swap rule, regulation or order, with respect to commodity options, until such time as the rule, regulation or order is applicable to other swaps. The Final Rule also contains a grandfather provision, which provides that commodity options transacted pursuant to current CFTC regulations prior to June 26 will not be affected by the Final Rule (*i.e.*, compliance with the new Dodd-Frank Act requirements for swaps will not be required).

Current Treatment of Commodity Options

Existing part 32 of the CFTC’s regulations generally bans commodity option transactions but permits them under certain conditions. Existing CFTC Rule 32.4, which is commonly known as the “trade option exemption,” permits commodity option transactions, other than on certain enumerated agricultural commodities,² that are offered to a producer, processor or commercial user of, or a merchant handling, the commodity, so long as such person enters into the commodity option solely for purposes related to its business. There is no net worth requirement to qualify for the existing trade option exemption.

Commodity options on enumerated agricultural commodities are subject to more stringent requirements: they are only permissible if they (a) are sold by a registered “agricultural trade option merchant,”³ or (b) are entered into in accordance with the agricultural trade option exemption found in CFTC Rule 32.13(g), the terms of which are essentially the same as those of existing CFTC Rule 32.4 with one significant difference – the agricultural trade option exemption contains a \$10 million net worth requirement for both parties to the option.

¹ Comments in response to the interim final rule must be received by the Commission no later than June 26, 2012. The scope of the exemption and the conditions for the exemption are discussed below.

² “Enumerated agricultural commodities” typically refers to the list of commodities enumerated in the Commodity Exchange Act (CEA) definition of “commodity” at, § 1a(9).

³ The agricultural trade option merchant (ATOM) regime has been rendered obsolete by lack of participation. Since its adoption in 1999, only one entity has registered as an ATOM, and this registration was subsequently withdrawn.

The Final Rule

The Final Rule repeals and replaces Part 32 of the CFTC's rules in light of the Dodd-Frank Act's definition of "swap," which includes "option[s] of any kind that [are] for the purchase or sale, or based on the value, of 1 or more ... commodities." (Options on futures which, when settled, result in a futures position, are excluded from the statutory "swap" definition.) Pursuant to the Final Rule, commodity options will be subject to the same laws, rules and orders applicable to other swaps.⁴ Also, the distinction between commodity options generally and commodity options on the enumerated agricultural commodities that exists in current CFTC regulations will be eliminated.

Trade Option Exemption

As part of the Final Rule, the CFTC adopted an interim final rule that will exempt Physical Options from many Dodd-Frank Act requirements that would otherwise apply to them as swaps including, among others, inclusion in swap dealer and major swap participant determinations,⁵ mandatory clearing and real-time reporting. Pursuant to the interim final rule, Physical Options will qualify for this revised trade option exemption so long as:

- The offeror of the option is an eligible contract participant or a producer, processor or commercial user of, or a merchant handling, the commodity which is the subject of the commodity option, or the byproducts thereof, and is offering or entering into the transaction solely for purposes related to its business as such;
- The offeree is a producer, processor or commercial user of, or a merchant handling the commodity which is the subject of the commodity option, or the products or by-products thereof, and is entering into the transaction solely for purposes related to its business as such; and
- Both parties intend that the commodity option be physically settled so that, if exercised, the option would result in the sale of an exempt or agricultural (*i.e.*, non-financial) commodity for immediate (spot) or deferred (forward) shipment or delivery.

The interim final rule, which was adopted in response to public comments, is intended to ensure that hedging opportunities for commercial entities, for physically delivered transactions used for purposes related to their business as such, remain available regardless of the size or sophistication of the commercial entity.

Conditions for Exemption

The interim final rule's relief is predicated on compliance with certain Dodd-Frank Act requirements that are intended to preserve a level of market visibility for the Commission while reducing the regulatory compliance burden for market participants:

⁴ The Final Rule does not address whether a transaction with optionality is subject to the swap definition in the first instance. Instead, the CFTC expressly put off this question until the further definition of "swap" is finalized.

⁵ The CFTC and SEC recently finalized joint final rules to further define these terms, among others. For more information, see Sutherland's April 19, 2012 Legal Alert, [CFTC and SEC Define "Swap Dealer" and "Major Swap Participant."](#)

- **Recordkeeping requirements.** All market participants availing themselves of the revised trade option exemption must comply with the CFTC's final recordkeeping requirements with respect to the exempted transactions.⁶
- **Reporting requirements.** If any Physical Option for which the revised trade option exemption is invoked involves at least one counterparty that (a) has become obligated to comply with the CFTC's final Regulatory Reporting Rule,⁷ (b) as a reporting party, (c) during the 12 month period preceding the date on which the Physical Option is entered into, (d) in connection with any non-trade option swap trading activity, then such trade option must also be reported pursuant to the CFTC's final reporting rules.

If neither counterparty to a Physical Option is already complying with the CFTC's final reporting rules, then a Physical Option qualifying for the revised trade option exemption need not be reported pursuant to the CFTC's final reporting rules. Rather, any counterparty to an otherwise unreported commodity option will be required to electronically submit the new "Form TO" to the CFTC annually for the purpose of providing notice that it has entered into one or more unreported commodity options in the calendar year. Form TO will require an unreported Physical Option counterparty to: (a) provide its name and contact information; (b) identify the categories of commodities underlying one or more unreported commodity options which it entered into during the prior year; and (c) for each commodity category, identify the approximate aggregate value of the underlying physical commodities that it either delivered or received in connection with the exercise of the unreported commodity options during the prior calendar year.

The first compliance date for the Form TO requirement will be for the calendar year beginning January 1, 2013 – counterparties to unreported commodity options will be required to submit Form TO on or before March 1, 2014. There is no Form TO filing requirement for unreported commodity options entered into between the effective date of the Final Rule and December 31, 2012.

- **Large trader reporting and position limits.** The CFTC's final rules pertaining to: (a) large trader reporting for physical commodity swaps;⁸ and (b) position limits for futures and swaps,⁹ will also apply to Physical Options that qualify for the revised trade option exemption.
- **Swap dealer and major swap participant requirements.** Swap dealers and major swap participants that are parties to Physical Options transacted in accordance with the revised trade option exemption will remain subject to the recently finalized internal business conduct standards¹⁰ and capital and margin requirements (when finalized),¹¹ to the same extent that they are applicable to other types of swap transactions.

⁶ *Swap Data Recordkeeping and Reporting Requirements*, 76 Fed. Reg. 2,136 (Jan. 13, 2012) (to be codified at 17 C.F.R. pt. 45) (Regulatory Reporting Rule).

⁷ *Id.*

⁸ *Large Trader Reporting for Physical Commodity Swaps*, 76 Fed. Reg. 43,851 (July 22, 2011) (to be codified at 17 C.F.R. pts. 15 and 20).

⁹ *Position Limits for Futures and Swaps*, 76 Fed. Reg. 71,626 (Nov. 18, 2011) (to be codified at 17 C.F.R. pts. 1, 150 and 151).

¹⁰ *Swap Dealer and Major Swap Participant Recordkeeping, Reporting, and Duties Rules; Futures Commission Merchant and Introducing Broker Conflicts of Interest Rules; and Chief Compliance Officer Rules for Swap Dealers, Major Swap Participants, and Futures Commission Merchants*, 77 Fed. Reg. 20,128 (Apr. 3, 2012) (to be codified at 17 C.F.R. pts. 1, 3 and 23).

- Enforcement provisions. The interim final rule stipulates that Physical Options transacted pursuant to the revised trade option exemption will remain subject to anti-fraud and anti-manipulation provisions contained in the CEA and CFTC rules.

The adopting release for the Final Rule expressly requests public comments on several aspects of the revised trade option exemption. Any comments received by the Commission will be considered if and when the Commission determines to amend the interim final rule. As noted above, comments must be received by the Commission no later than June 26, 2012.



If you have any questions about this Legal Alert, please feel free to contact any of the attorneys listed below or the Sutherland attorney with whom you regularly work.

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¹¹ Final capital and margin rules have yet to be finalized. See the proposed rules: Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 76 Fed. Reg. 23,732 (Apr. 28, 2011) (to be codified at 17 C.F.R. pt. 23); Capital Requirements for Swap Dealers and Major Swap Participants, 76 Fed. Reg. 27,802 (May 12, 2011) (to be codified at 17 C.F.R. pts. 1, 23, and 140); and Margin and Capital Requirements for Covered Swap Entities, 76 Fed. Reg. 27,564 (May 11, 2012) (to be codified at 12 C.F.R. pts. 45, 237, 324, 624 and 1221).