COMMODITY FUTURES TRADING COMMISSION

17 CFR Parts 3, 32, 33, and 35

Commodity Options and Agricultural Swaps

AGENCY: Commodity Futures Trading Commission.

ACTION: Notice of proposed rulemaking

SUMMARY: The Commodity Futures Trading Commission ("Commission" or "CFTC") is charged with proposing rules to implement new statutory provisions enacted by Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"). Section 723(c)(3) of the Dodd-Frank Act provides that swaps in an agricultural commodity (as defined by the Commission) are prohibited unless entered into pursuant to a rule, regulation or order of the Commission adopted pursuant to Commodity Exchange Act ("CEA" or "Act") section 4(c). Section 721 of the Dodd-Frank Act includes options (other than an option on a futures contract) in its definition of swaps. Broadly speaking, the rules proposed herein would implement regulations whereby (1) swaps in agricultural commodities and (2) all commodity options (including options on both agricultural and non-agricultural commodities), other than options on futures, may transact subject to the same rules as all other swaps. The proposed rules for swaps in an agricultural commodity would repeal and replace part 35 of the Commission's regulations, "Exemption of Swap Agreements." Because the Dodd-Frank Act defines commodity options (other than options on futures) as swaps, the proposed rules for options would substantially amend part 32 of the Commission's regulations, "Regulation of Commodity Option Transactions." Also, current part 33 of the Commission's regulations, "Regulation of Domestic Exchange-Traded Commodity

Option Transactions," applies not only to exchange-traded options on futures (which are excluded from the Dodd-Frank definition of a swap), but also to exchange-traded options on physical commodities (which are within the Dodd-Frank swap definition). Therefore, to conform part 33 to the Dodd-Frank Act, the proposed rules would delete references to options on physical commodities from part 33.

DATES: Written comments must be received on or before **[INSERT DATE 60 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER]**.

ADDRESSES: You may submit comments, identified by RIN number 3038-AD21, by any of the following methods:

- Agency web site, via its Comments Online process: http://comments.cftc.gov. Follow the instructions for submitting comments through the web site.
- Mail: David A. Stawick, Secretary of the Commission, Commodity Futures Trading Commission, Three Lafayette Centre, 1155 21st Street NW, Washington, DC 20581.
- Hand Delivery/Courier: Same as mail above.
- Federal eRulemaking Portal: http://www.regulations.gov. Follow the instructions for submitting comments.

Please submit your comments using only one method.

All comments must be submitted in English, or if not, accompanied by an English translation. Comments will be posted as received to www.cftc.gov. You should submit only information that you wish to make available publicly. If you wish the Commission to consider information that you believe is exempt from disclosure under the Freedom of Information Act, a petition for confidential treatment of the exempt information may be

submitted according to the procedures established in § 145.9 of the Commission's Regulations.[1]

The Commission reserves the right, but shall have no obligation, to review, pre-screen, filter, redact, refuse or remove any or all of your submission from www.cftc.gov that it may deem to be inappropriate for publication, such as obscene language. All submissions that have been redacted or removed that contain comments on the merits of the rulemaking will be retained in the public comment file and will be considered as required under the Administrative Procedure Act and other applicable laws, and may be accessible under the Freedom of Information Act.

FOR FURTHER INFORMATION CONTACT: Donald Heitman, Senior Special Counsel, (202) 418-5041, dheitman@cftc.gov, or Ryne Miller, Attorney Advisor, (202) 418-5921, rmiller@cftc.gov, Division of Market Oversight, Commodity Futures Trading Commission, Three Lafayette Centre, 1155 21st Street, NW, Washington, DC 20581.

SUPPLEMENTARY INFORMATION:

I Introduction

On July 21, 2010, President Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act.[2] Title VII of the Dodd-Frank Act[3] amended the CEA[4] to establish a comprehensive new regulatory framework for swaps and security-based

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[1] 17 CFR 145.9. Unless otherwise indicated, the rules and regulations referenced in this notice are found in chapter 1 of title 17 of the Code of Federal Regulations; 17 CFR Chapter 1 et seq.

[2] See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, 124 Stat. 1376 (2010). The text of the Dodd-Frank Act may be accessed at http://www.cftc.gov./LawRegulation/OTCDERIVATIVES/index.htm.

[3] Pursuant to section 701 of the Dodd-Frank Act, Title VII may be cited as the "Wall Street Transparency and Accountability Act of 2010."

[4] 7 U.S.C. 1 et seq.

swaps. The legislation was enacted to reduce risk, increase transparency, and promote market integrity within the financial system by, among other things: (1) providing for the registration and comprehensive regulation of swap dealers and major swap participants; (2) imposing clearing and trade execution requirements on standardized derivative products; (3) creating robust recordkeeping and real-time reporting regimes; and (4) enhancing the Commission's rulemaking and enforcement authorities with respect to, among others, all registered entities and intermediaries subject to the Commission's oversight.

Section 723(c)(3) of the Dodd-Frank Act provides that swaps in an agricultural commodity (as defined by the Commission)[5] are prohibited unless entered into pursuant to a rule, regulation or order of the Commission adopted pursuant to CEA section 4(c). Further, section 733 of the Dodd-Frank Act, new CEA section 5h(b)(2), provides that a swap execution facility ("SEF") may not list for trading or confirm the execution of any swap in an agricultural commodity (as defined by the Commission) except pursuant to a rule or regulation of the Commission allowing the swap under such terms and conditions as the Commission shall prescribe.

In addition to the provisions on swaps in an agricultural commodity, the Dodd-Frank Act definition of "swap" includes options (other than options on futures). Section 721 of the Dodd-Frank Act adds new section 1a(47) to the CEA, defining "swap" to include not only "any agreement, contract, or transaction commonly known as," among other things, "an agricultural swap" or "a commodity swap," but also "[an] option of any

[5] As discussed below, in accordance with the mandate of the Dodd-Frank Act, the Commission has recently proposed a definition of the term "agricultural commodity." See 75 FR 65586, Oct. 26, 2010.

kind that is for the purchase or sale, or based on the value, of . . . commodities . . . ."[6] As a result of the Dodd-Frank changes, the Commission is issuing this notice proposing: (1) to withdraw and replace current part 35;[7] (2) to substantially amend current part 32;[8] (3) to withdraw rule 3.13, which will be rendered moot by the withdrawal of rule 32.13; and (4) to amend part 33[9] to remove references to options on physical commodities. As proposed, new part 35 and revised parts 32 and 33 will provide the regulatory authority under which market participants may enter into, respectively, swaps in an agricultural commodity ("agricultural swaps")[10] and commodity options.[11]

To that end, this notice includes a background discussion of the statutory and regulatory framework governing agricultural swaps and commodity options. The notice also provides an overview and summary of the comments received on the Commission's Advanced Notice of Proposed Rulemaking regarding the agricultural swaps provisions in

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[6] See new CEA section 1a(47), as added by section 721 of the Dodd-Frank Act. The Dodd-Frank swap definition excludes exchange-traded options on futures, but not exchange-traded options on physical commodities (see new CEA section 1a(47)(B)(i)). Accordingly, the Commission is amending part 33 of its regulations, "Regulation of Domestic Exchange-Traded Commodity Option Transactions," to the extent that Part 33 applies to exchange-traded options on physical commodities, which are swaps under the Dodd-Frank definition. The rules proposed herein would remove any reference in part 33 to "options on physicals," and such transactions would become subject to the regulations in revised part 32, discussed below. Other options excluded from the definition of swap are options on any security, certificate of deposit, or group or index of securities, including any interest therein or based on the value thereof, that is subject to the Securities Act of 1933 and the Securities Exchange Act of 1934 (see new CEA section 1a(47)(B)(iii)) and foreign currency options entered into on a national securities exchange registered pursuant to section 6(a) of the Securities Exchange Act of 1934 (see new CEA section 1a(47)(B)(iv)).

[7] 17 CFR Part 35.

[8] 17 CFR Part 32.

[9] 17 CFR Part 33.

[10] When this notice refers to "agricultural swaps," it is referring to swaps in an agricultural commodity, as identified in section 723(c)(3) of the Dodd-Frank Act.

[11] "Commodity option" and "commodity option transaction" are defined in 17 CFR 1.3(hh). When this notice refers generally to "commodity options" or "options," the terms will refer to all commodity options transactions other than those options on futures that are excluded from the Dodd-Frank definition of swap (see footnote 6, above).

the Dodd-Frank Act.[12] Finally, the notice includes an explanation of the rulemakings proposed herein, a discussion of CEA section 4(c) as the authority for the agricultural swaps aspect of this rulemaking, a request for comment on the proposed rulemaking, and a section addressing related matters.

II. Background

A. Agricultural Swaps

i. Pre Dodd-Frank

Since 2000, bilateral swaps[13] between certain sophisticated counterparties have been generally exempted from the Commission's jurisdiction pursuant to current CEA section 2(g),[14] which was added to the CEA by the Commodity Futures Modernization Act of 2000 ("CFMA").[15] However, current section 2(g) specifically excludes an "agreement, contract, or transaction" in an "agricultural commodity" from the CFMA swaps exemption.[16]

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[12] See Agricultural Swaps, 75 FR 59666, Sept. 28, 2010.

[13] Prior to the Dodd-Frank Act, the Commission had defined a "swap" as follows: "A swap is a privately negotiated exchange of one asset or cash flow for another asset or cash flow. In a commodity swap [including an agricultural swap], at least one of the assets or cash flows is related to the price of one or more commodities." (See 72 FR 66099, note 7, Nov. 27, 2007). As discussed above, see new CEA section 1a(47) for the statutory definition of a "swap," as added to the CEA by section 721 of the Dodd-Frank Act.

[14] Current section 2(g) provides:
No provision of this Act (other than section 5a (to the extent provided in section 5a(g)), 5b, 5d, or 12(e)(2)) shall apply to or govern any agreement, contract, or transaction in a commodity other than an agricultural commodity if the agreement, contract, or transaction is—

(1) entered into only between persons that are eligible contract participants at the time they enter into the agreement, contract, or transaction;

(2) subject to individual negotiation by the parties; and

(3) not executed or traded on a trading facility.

CEA section 2(g).

[15] Current CEA section 2(g) was added to the CEA as section 105(b) of the CFMA, enacted as Appendix E to Pub. L. 106-554.

[16] Notably, current CEA section 2(g) is not the only statutory provision added by the CFMA that excludes or exempts bilateral swaps between eligible contract participants from the Commission's jurisdiction.

While the term "agricultural commodity" is not specifically defined in the Act,[17] it is used in the Act in conjunction with the definition of the term "exempt commodity," which is defined as neither an "agricultural commodity" nor an "excluded commodity."[18] The effect of current CEA section 2(g) was that swaps involving exempt and excluded commodities were allowed to transact largely outside of the Commission's jurisdiction or oversight. And while the Dodd-Frank Act largely rewrites the world of law and regulation applicable to swaps in non-agricultural commodities,[19] swaps involving agricultural commodities,[20] including both the enumerated agricultural commodities and other non-enumerated agricultural commodities,[21] remain subject to the Commission's pre-CFMA swaps regulations as set forth in part 35.[22]

Current CEA section 2(d)(1) excludes any such bilateral "agreement, contract, or transaction" in excluded commodities from Commission jurisdiction, while CEA section 2(h)(1) creates a similar exemption for a "contract, agreement or transaction" in exempt commodities.

[17] Note that the Commission has proposed for comment a formal definition of agricultural commodity. See Agricultural Commodity Definition, 75 FR 65586, Oct. 26, 2010.

[18] "The term 'exempt commodity' means a commodity that is not an excluded commodity or an agricultural commodity." Current CEA section 1a(14). An "excluded commodity" is defined in current CEA section 1a(13) to include financial commodities such as interest rates, currencies, economic indexes, and other similar items.

[19] See Dodd-Frank non-agricultural swaps discussion, below.

[20] See 75 FR 59666, at 59667, Sept. 28, 2010, for an explanation of the legislative history discussing "agricultural commodity" as used in CEA section 2(g).

[21] "Enumerated agricultural commodities" typically refers to the list of commodities specifically enumerated in the CEA definition of "commodity" at current CEA Section 1a(4) (renumbered as section 1a(9) under Dodd-Frank): wheat, cotton, rice, corn, oats, barley, rye, flaxseed, grain sorghums, mill feeds, butter, eggs, Solanum tuberosum (Irish potatoes), wool, wool tops, fats and oils (including lard, tallow, cottonseed oil, peanut oil, soybean oil, and all other fats and oils), cottonseed meal, cottonseed, peanuts, soybeans, soybean meal, livestock, livestock products, and frozen concentrated orange juice (but not onions).

[22] 17 CFR Part 35 remains in effect for agricultural swaps because it was originally adopted under the Commission's CEA section 4(c) exemptive authority, and section 723(c)(3)(B) of the Dodd-Frank Act grandfathers existing 4(c) exemptions in the context of agricultural swaps.

Part 35 provides a broad exemption for certain swap agreements. As noted, part 35 originally applied to swaps in all commodities.[23] After the CFMA amendments to the CEA, which statutorily exempted swaps on "exempt" and "excluded" commodities from virtually all of the Commission's jurisdiction, part 35 remained relevant only for agricultural swaps. With the exception of three outstanding exemptive orders related to cleared agricultural basis and calendar swaps[24] (which exempt certain swaps transactions from part 35's non-fungibility and counterparty creditworthiness requirements), part 35 is the sole existing authority under which market participants may transact agricultural swaps that are not options.[25]

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[23] Part 35 provides eligible swap participants (as defined in § 35.1(b)(2)) with a general exemption from the CEA for a swap that is not part of a fungible class of agreements that are standardized as to their material economic terms, where the creditworthiness of each counterparty is a material consideration in entering into or determining the terms of the swap, and the swap is not entered into and traded on or through a multilateral transaction execution facility. See § 35.2.

[24] Part 35, at § 35.2(d), also provides that "any person may apply to the Commission for exemption from any of the provisions of the Act (except 2(a)(1)(B) [liability of principal for act of agent]) for other arrangements or facilities, on such terms and conditions as the Commission deems appropriate, including but not limited to, the applicability of other regulatory regimes." See 17 C.F.R. § 35.2(d). The Commission has granted three such exemptions, which have in each instance been styled as exemptive orders pursuant to CEA section 4(c). See

Order (1) Pursuant to Section 4(c) of the Commodity Exchange Act (a) Permitting Eligible Swap Participants To Submit for Clearing and ICE Clear U.S., Inc. and Futures Commission Merchants To Clear Certain Over-The- Counter Agricultural Swaps and (b) Determining Certain Floor Brokers and Traders To Be Eligible Swap Participants; and (2) Pursuant to Section 4d of the Commodity Exchange Act, Permitting Certain Customer Positions in the Foregoing Swaps and Associated Property To Be Commingled With Other Property Held in Segregated Accounts, 73 FR 77015, Dec. 18, 2008;

Order (1) Pursuant to Section 4(c) of the Commodity Exchange Act, Permitting the Chicago Mercantile Exchange to Clear Certain Over-the-Counter Agricultural Swaps and (2) Pursuant to Section 4d of the Commodity Exchange Act, Permitting Customer Positions in Such Cleared-Only Contracts and Associated Funds To Be Commingled With Other Positions and Funds Held in Customer Segregated Accounts, 74 FR 12316, Mar. 24, 2009; and

Order (1) Pursuant to Section 4(c) of the Commodity Exchange Act, Permitting the Kansas City Board of Trade Clearing Corporation To Clear Over-the-Counter Wheat Calendar Swaps and (2) Pursuant to Section 4d of the Commodity Exchange Act, Permitting Customer Positions in Such Cleared-Only Swaps and Associated Funds To Be Commingled With Other Positions and Funds Held in Customer Segregated Accounts, 75 FR 34983, June 21, 2010.

[25] Options on agricultural commodities are reviewed in detail in the options discussion of this notice.

ii. Dodd-Frank swaps provisions

a. Non-agricultural swaps

Under the CEA, as amended by the Dodd-Frank Act, only eligible contract participants ("ECPs")[26] may enter into a swap, unless such swap is entered into on a designated contract market ("DCM"),[27] in which case any person may enter into the swap.[28]

New CEA section 2(h), as added by section 723(a)(3) of the Dodd-Frank Act, establishes a clearing requirement for swaps. Under that subsection, the Commission would determine, based on factors listed in the statute, whether a swap, or a group, category, type, or class of swaps, should be required to be cleared. A swap that is required to be cleared must be executed on a DCM or a SEF,[29] if a DCM or SEF makes the swap available for trading. Swaps that are not required to be cleared may be executed bilaterally. Notwithstanding the above, a swap entered into by a commercial end user[30] is not subject to the mandatory clearing requirement; however an end user may opt to submit the swap for clearing.

Section 731 of the Dodd-Frank Act adds a new section 4s to the CEA that provides for the registration and regulation of swap dealers and major swap

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[26] "Eligible contract participant" is defined in current CEA section 1a(12). Generally speaking, an eligible contract participant is considered to be a sophisticated investor.

[27] A designated contract market is a board of trade designated as a contract market under CEA section 5.

[28] See new CEA section 2(e) as added by section 723(a)(2) of the Dodd-Frank Act.

[29] The requirements for SEFs are set forth in new CEA section 5h.

[30] Generally, a commercial end user is described in new CEA section 2(h)(7) as a non-financial entity that is using swaps to hedge or mitigate commercial risk and that notifies the Commission as to how it generally meets its financial obligations associated with entering into non-cleared swaps.

participants.[31] The new requirements for swap dealers and major swap participants include, in part, capital and margin requirements, business conduct standards, and reporting, recordkeeping, and documentation requirements.

Section 737 of the Dodd-Frank Act amends current CEA section 4a regarding position limits. Under the Dodd-Frank provisions and amended CEA section 4a, the Commission is directed to adopt position limits for futures and options traded on or subject to the rules of a designated contract market, and swaps that are economically equivalent to such futures and exchange-traded options for both exempt and agricultural commodities.

b. Agricultural swaps

As noted above, under section 723(c)(3) of the Dodd-Frank Act, swaps in an "agricultural commodity" (as defined by the Commission)[32] are prohibited unless the swap is entered into pursuant to an exemption granted under CEA section 4(c). The requirements of section 4(c) are discussed in greater detail, below.[33]

Dodd-Frank section 723(c)(3)(B) includes a "grandfather" clause providing that any rule, regulation, or order regarding agricultural swaps that was issued pursuant to the Commission's exemptive authority in CEA section 4(c), and that was in effect on the date of enactment of the Dodd-Frank Act, would continue to be permitted under such

[31] "Swap dealer" is defined in new CEA section 1a(49), as added by section 721(a)(21) of the Dodd-Frank Act. "Major swap participant" is defined in new CEA section 1a(33), as added by section 721(a)(16) of the Dodd-Frank Act.

[32] See proposed definition of agricultural commodity at 75 FR 65586, Oct. 26, 2010.

[33] Generally speaking, section 4(c) provides that, in order to grant an exemption, the Commission must determine that: (1) the exemption would be consistent with the public interest and the purposes of the CEA; (2) any agreement, contract, or transaction affected by the exemption would be entered into by "appropriate persons" as defined in section 4(c); and (3) any agreement, contract, or transaction affected by the exemption would not have a material adverse effect on the ability of the Commission or any contract market to discharge its regulatory or self-regulatory duties under the CEA.

terms and conditions as the Commission may prescribe. Such rules, regulations or orders would include part 35 with respect to agricultural swaps and the agricultural basis and calendar swaps noted above, but would not include options entered into pursuant to part 32.[34]

In addition to the provisions in section 723(c)(3), section 733 of the Dodd-Frank Act, new CEA section 5h(b), provides that a SEF may not list for trading or confirm the execution of any swap in an agricultural commodity (as defined by the Commission) except pursuant to a rule or regulation of the Commission allowing the swap under such terms and conditions as the Commission shall prescribe.

B. Commodity Options

i. Commodity options are swaps

The Dodd-Frank Act defines the term "swap" to include not only the various types of swaps listed in the definition, including commodity swaps and agricultural swaps, but also options of any kind (other than options on futures).[35] Even before the Dodd-Frank Act, commodity options have been subject to the Commission's plenary authority under CEA section 4c(b).[36] Based on that general prohibition of any option

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[34] Part 32 was not issued pursuant to the Commission's section 4(c) exemptive authority and thus does not qualify for the Dodd-Frank grandfather provision for existing 4(c) exemptions. See section 723(c)(3)(B) of the Dodd-Frank Act.

[35] See new CEA section 1a(47)(B), as added to the CEA by section 721 of the Dodd-Frank Act. But see also footnote 6, above, for the list of certain options that are excluded from the swap definition.

[36] Section 4c(b) provides:
No person shall offer to enter into, enter into or confirm the execution of, any transaction involving any commodity regulated under this Act which is of the character of, or is commonly known to the trade as, an "option", "privilege", "indemnity", "bid", "offer", "put", "call", "advance guaranty", or "decline guaranty", contrary to any rule, regulation, or order of the Commission prohibiting any such transaction or allowing any such transaction under such terms and conditions as the Commission shall prescribe. Any such order, rule, or regulation may be made only after notice and opportunity for hearing, and the Commission may set different terms and conditions for different markets. CEA section 4c(b); 7 U.S.C. 6c(b).

transactions contrary to any Commission rule, regulation or order prohibiting options, or allowing them under such conditions as the Commission may prescribe, the only options currently authorized under the CEA are those specifically provided for in the Commission's regulations.

ii. Options on agricultural commodities; trade options

As noted above, the Commission maintains plenary authority over options and has used that authority to, among other things, issue part 32 of the Commission's regulations. Part 32 includes a general ban on commodity options,[37] but allows for commodity option transactions under certain conditions. Part 32 specifically allows for options on agricultural commodities in two instances.[38]

First, rule 32.13 establishes rules for trading bilateral options on the "enumerated" agricultural commodities ("agricultural trade options" or "ATOs") whereby ATOs may only be sold by an Agricultural Trade Option Merchant ("ATOM"), who must first register with the Commission as such pursuant to CFTC rule 3.13. Since its 1998 adoption and one amendment in 1999,[39] the ATOM registration scheme has attracted only one registrant, which registrant has since withdrawn its ATOM registration. Accordingly, ATOs currently may only be transacted pursuant to an exemptive provision found at § 32.13(g)(1). The exemption at § 32.13(g)(1) allows ATOs to be sold when:

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[37] See Commission regulation 32.11, 17 CFR 32.11.

[38] Note that part 32 was not issued under the Commission's section 4(c) exemptive authority. After the effective date of the Dodd-Frank Act, options on agricultural commodities will also fall under the Dodd-Frank Act's provisions governing the trading of swaps (and, specifically, agricultural swaps) since options on commodities fall within the Act's definition of a swap. Accordingly, it is important to identify which options on agricultural commodities are currently being traded pursuant to part 32 and, where appropriate, to implement rules to preserve that market (in addition to rules proposed herein that will preserve the majority of the existing non-agricultural trade option market, subject to the same laws and rules as all other swaps).

[39] 63 FR 18821, Apr. 16, 1998; and 64 FR 68011, Dec. 6, 1999, respectively.

(1) the option is offered to a commercial ("a producer, processor, or commercial user of, or a merchant handling" the underlying commodity); (2) the commercial enters the transaction solely for purposes related to its business as such; and (3) each party to the option contract has a net worth of not less than $10 million.

In either case (whether transacted pursuant to the ATOM registration scheme or accomplished via the exemption at § 32.13(g)), the phrase "agricultural trade option" refers specifically to a trade option on an agricultural commodity enumerated in § 32.2.

In addition to the ATO rules in § 32.13, part 32 includes, at § 32.4, a basic trade option exemption applicable to options on commodities other than the enumerated agricultural commodities. The terms of the § 32.4 exemption are essentially the same as those of the § 32.13(g) exemption with one significant difference – the § 32.4 trade option exemption does not include any net worth requirement. Under § 32.4, the option must be offered to a producer, processor, or commercial user of, or a merchant handling, the commodity, who enters into the commodity option transaction solely for purposes related to its business as such.

Because the term "agricultural commodity" as used in section 723(c)(3) of the Dodd-Frank Act refers to more than just the enumerated commodities, the Commission recognizes that certain options authorized under § 32.4 (e.g. options on coffee, sugar, cocoa, and other agricultural products that do not appear in the enumerated commodity list) would be considered options on an agricultural commodity. As such, and without adopting the rules proposed herein, those options would be swaps on an agricultural commodity and would thereby fall under the Dodd-Frank Act's general prohibition of agricultural swaps.

iii. Remainder of part 32

In addition to the foregoing provisions regarding § 32.13 agricultural trade options and § 32.4 general trade options, part 32 contains various other provisions that have been rendered obsolete, either by the Dodd-Frank Act, by subsequent Commission rulemaking actions, or by the passage of time. The amendments proposed herein would substantially update and revise part 32 and remove these unnecessary provisions.

iv. Part 33

As noted above, current part 33 applies to both exchange-traded options on futures and exchange-traded options on physical commodities. However, Dodd-Frank exempts only options on futures from the swaps definition. Therefore, options on physical commodities, even if traded on a DCM, are to be regulated as swaps. Accordingly, these proposed rules would remove all references to exchange-traded options on physicals from part 33.

III. The ANPRM

A. General Description of the ANPRM

On September 28, 2010 (75 FR 59666), the Commission published an advanced notice of proposed rulemaking ("ANPRM") and request for comment on the appropriate conditions, restrictions or protections to be included in any rule, regulation or order of the Commission adopted pursuant to section 4(c) of the Act governing the trading of swaps in an "agricultural commodity,"[40] as defined by the Commission.[41] The Commission

[40] The Commission also informally solicited comments on its website at http://www.cftc.gov/LawRegulation/DoddFrankAct/OTC_19_AgSwaps.html. In addition, Commission staff has met with market participants and other interested parties. A complete list of external meetings held at the Commission may be found on the Commission's website at http://www.cftc.gov/LawRegulation/DoddFrankAct/ExternalMeetings/index.htm.

requested specific input pertaining to five topics: Current Agricultural Swaps Business (overall size, the types of entities, and any unique characteristics of agricultural swaps that distinguish them from other types of physical commodity swaps); Agricultural Swaps Clearing (the extent to which existing swaps are cleared or uncleared, whether existing swaps would generally qualify for a commercial end-user exemption, and the desirability of a clearing requirement for swaps that do not qualify for such an exemption); Trading (description of any significant trading problems encountered in this market); Agricultural Swaps Purchasers (whether agricultural swaps participants need more protections than other physical commodity swaps participants, or whether special provisions are needed to make it easier for producers to participate); Designated Contract Markets (should agricultural swaps be permitted on DCMs to the same extent as other swaps); Swap Execution Facilities (should agricultural swaps be permitted on SEFs to the same extent as other swaps); and Trading Outside of DCMs and SEFs (should agricultural swaps be permitted to trade outside of a DCM or SEF to the same extent as other swaps, and generally should agricultural swaps be treated any differently than other types of physical commodity swaps).

B. Summary of Comments

Nineteen formal comment letters representing a broad range of interests, including producers, merchants, swap dealers, commodity funds, futures industry organizations, and academics/think tanks, responded to the ANPRM. In particular, comment letters were received from: the American Farm Bureau Federation, the American Soybean Association, the Commodity Markets Council, the National

[41] The Commission has published for comment a proposed regulatory definition of the term, "agricultural commodity" (See: 75 FR 65586, Oct. 26, 2010, and plans to publish a final definition in the near future.

Association of Wheat Growers, the National Cattlemen's Beef Association, and the National Corn Growers Association, who filed a joint statement (collectively, "the Ag Associations"); the National Grain and Feed Association ("NGFA"); the Commodity Markets Council ("CMC," which filed a separate letter in addition to signing onto the joint statement noted above); the National Milk Producers Federation ("NMPF"); the Dairy Farmers of America ("DFA"); the National Council of Farmer Cooperatives ("NCFC"); the Gavilon Group, LLC ("Gavilon"), a feed manufacturer; Cargill, an agricultural commodities merchant; Allenberg Cotton, a cotton merchant; the Agricultural Commodity Swaps Working Group ("Ag Swap Working Group"), comprised of financial institutions that provide risk management and investment products to agricultural end users; the International Swaps and Derivatives Association ("ISDA"); United States Commodity Funds ("USCF"); the Alternative Investment Management Association, Ltd. ("AIMA"); International Assets Holding Corporation ("IAHC"); Teucrium Trading; the Futures Industry Association ("FIA"); the CME Group, Inc. ("CME"); the Institute for Agriculture and Trade Policy ("IATP"); and Dr. Robert Pollin, a university professor.[42]

The vast majority of commenters supported the equal treatment of agricultural swaps (including trade options) under the same regulatory scheme as other categories of swaps. The following statement from the Ag Associations is representative of this sentiment:

> Ag swaps are used, to varying degrees, by our members because they provide a targeted, customized, cost-effective, and efficient risk management strategy... In a world with increasing inherent volatility, the need for risk management instruments has never been greater.

[42] In addition, two comments were received that did not directly address the ANPRM.

> We urge the Commission to treat swaps for all commodities harmoniously. We believe the comprehensive regulation of swaps should not be based on distinctions among commodity types. The generally applicable protections under the Dodd-Frank Bill – such as reporting, mandatory clearing, mandatory trading of standardized swaps, minimum capital requirements, and the CFTC's authority to impose position limits, determine which swaps are subject to clearing and trading and to exercise emergency powers – will protect ag swaps from fraud and manipulation.

Two commenters (Dr. Pollin and the IATP) were generally opposed to the trading of agricultural swaps under the same conditions as other physical commodity swaps. Both commenters expressed the belief that speculative investment in agricultural derivatives has increased price volatility, to the detriment of producers and consumers of agricultural products, and that trading in agricultural swaps could potentially exacerbate this problem.

Commenters offered the following specific information and/or individual perspectives on the five topic areas outlined above:

Current Agricultural Swaps Business. Regarding the state of the current agricultural swaps business (including trade options), commenters generally noted that agricultural swaps are used to a considerable extent, but they were unable to quantify the overall size of this market. Swap participants include commercial end users (producers, processors and merchants), hedge funds, swap dealers, and financial institutions. Generally, commenters did not believe that the characteristics of agricultural swaps were significantly different from the characteristics of other types of physical commodity swaps.

Agricultural Swaps Clearing. According to the commenters, most agricultural swap activity (including trade options) is not cleared (for example, the NCFC estimated that less than one percent of its members' swaps are cleared). Several commenters

pointed to the small amount of swaps cleared by DCOs under existing 4(c) exemptions, relative to the presumed size of the market, as evidence of how few swaps are cleared. Commenters representing agricultural producers and merchants indicated that virtually all of their swaps would qualify for the end-user exemption from the mandatory clearing requirement of the Dodd-Frank Act. Furthermore, most commenters suggested that agricultural swaps should be individually scrutinized as to their clearability, rather than subjecting all agricultural swaps to a clearing requirement. (NCFC, for example, observed that, "the low volume, small sizes and odd lots [of many agricultural swaps] would not be attractive for exchanges or clearing houses to offer those specific products." Thus, "if all entities are required to clear agricultural swaps through an exchange or standardize a non-standard transaction (both in terms of quantity and structure), costs would likely increase to a point where the use of swaps as a bona fide hedge/risk management tool would not be available to segments of the agricultural marketplace.") IATP, however, supported mandatory clearing for all agricultural swaps as a means of discouraging producers from participating directly in this market.

Trading Practices and Issues. Commenters generally were not aware of any specific problems pertaining to the existing trade in agricultural swaps and most saw no need for additional requirements for trading agricultural swaps relative to other types of swaps. Some commenters did observe that the Commission's existing regulatory requirements governing agricultural trade options in the enumerated agricultural commodities (as distinct from other types of physical commodities) have restricted the development of this market to the detriment of commercial end users (see, for example, comments by CMC, Gavilon and DFA).

Additional Protections for Agricultural Swaps Purchasers. Most commenters did not believe that agricultural swaps participants need more protection than participants in other types of commodity swaps. Most commenters also believed that the Dodd-Frank Act requirement, limiting swap purchasers to "eligible contract participants" ("ECPs"), is appropriate to apply to the purchasers of agricultural commodity swaps. However, several commenters suggested that transactions within farmer cooperatives (that is, between individual farmer members and their local elevator cooperative, and between affiliated cooperatives at the local, regional or national levels) should not be subject to the ECP requirement (for example, the NCFC states that individual members who do not meet the ECP requirement should be permitted to purchase swaps directly from their producer cooperatives, and the NMPF argues that transactions between members and their cooperatives are internal transactions and should be treated as such, rather than be subject to provisions that govern transactions between unaffiliated parties). In addition, one commenter favored making agricultural trade options (but not other types of swaps) available from registered swap dealers to non-ECPs who enter into them explicitly for commercial risk management purposes (see Cargill comment).

Trading on DCMs and SEFs. Commenters generally supported the listing and trading of agricultural swaps (including options) on DCMs and SEFs to the same extent as other physical commodity swaps, with the exception of Dr. Pollin and the IATP.

Trading off of DCMs and SEFs. Commenters generally expressed the opinion that agricultural swaps (including options) should be permitted to trade outside of DCMs and SEFs under the same conditions that apply to other types of physical commodity swaps (again, with the exception of the IATP and Dr. Pollin). Most commenters did not

believe there were any specific agricultural commodities that would require special or different protections. IATP expressed the opinion that "A higher collateral and capital requirement should be applied to any bilateral swaps a CFTC rule would allow." Dr. Pollin argued that there is no good reason for offering any exemptions from the blanket prohibition on agricultural swaps contained in the Dodd-Frank Act.

In addition to comments addressing the five specific topic areas directly related to the ANPRM, several commenters requested that the Commission provide clarity on the treatment of certain types of swap participants and transactions within the overall regulatory scheme for swaps. In this regard, several commenters requested that the Commission clarify that agricultural producer cooperatives that enter into swaps with their own members or third parties in the course of marketing their members' agricultural products should be considered to be end users for purposes of the clearing exception, and further that the Commission should clarify that producer cooperatives are excluded from the definitions of swap dealer and major swap participant (see, for example, comments from NGFA, NCFC, NMPF, and DFA). These issues are beyond the scope of this proposed rulemaking. The Commission has issued proposed rules regarding: (1) the end-user exception to mandatory clearing of swaps pursuant to § 723 of the Dodd-Frank Act;[43] and (2) further definition of certain terms regarding market participants, including the terms "swap dealer" and "major swap participant," pursuant to § 712(d) of the Dodd-Frank Act.[44] The Commission encourages all interested parties to submit comments

[43] See: End User Exception to Mandatory Clearing of Swaps, 75 FR 80747, Dec. 23, 2010 (comment period closes February 22, 2011).

[44] See: Further Definition of "Swap Dealer," "Security-Based Swap Dealer,'" "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant," 75 FR 80174, Dec. 21, 2010 (joint rulemaking with Securities and Exchange Commission ("SEC"), comment period closes February 22, 2011).

addressing these proposed rules, including responses to the requests for comment set forth therein.

Some commenters also requested that the Commission clarify that certain types of transactions (embedded options in forward contracts[45] and book-outs[46]) fall within the definition of an excluded forward contract rather than the definition of a swap. These issues, too, are beyond the scope of this proposed rulemaking. Commission staff, jointly with staff of the SEC, is also considering further definition of terms regarding certain products, including the term "swap," pursuant to § 712(d) of the Dodd-Frank Act. Any comment addressing the distinction between swaps and forward contracts will be shared with appropriate staff.

IV. Explanation of the Proposed Rules

A. Introduction

After considering the complete record in this matter, including all comments on the ANPRM, the Commission is proposing the rulemaking contained herein. Broadly speaking, the proposed rules would implement regulations whereby (1) swaps in agricultural commodities, and (2) all commodity options (including options on both agricultural and non-agricultural commodities), other than options on futures, may transact subject to the same rules as all other swaps.

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[45] See: Characteristics Distinguishing Cash and Forward Contracts and "Trade" Options, Interpretive Statement of the Commission's General Counsel, 50 FR 39656, Sept. 30, 1985, regarding the differences between forward contracts and options.

[46] A book-out is a separate, subsequent agreement whereby two commercial parties to a forward contract, who find themselves in a delivery chain or circle at the same delivery point, can agree to settle (or "book-out") their delivery obligations by exchanging a net payment. See: Statutory Interpretation Regarding Forward Transactions, 55 FR 39188, Sept. 25, 1990.

First, the proposal would withdraw existing part 35 of the Commission's regulations – thus withdrawing the provisions originally adopted in 1993 to provide legal certainty for the bilateral swaps market by largely exempting bilateral swaps transactions from CEA regulation.[47] Second, pursuant to the exemptive authority in CEA section 4(c), the proposed rules would adopt a new part 35 to provide the primary authority for transacting swaps in an agricultural commodity ("agricultural swaps") as authorized by Sections 723(c)(3) and 733 of the Dodd-Frank Act. Third, the proposed rulemaking would substantially update and revise the existing framework for off-exchange options in existing part 32. In part pursuant to the exemptive authority in CEA section 4(c) and in part pursuant to the Commission's general rulemaking authority set out at CEA section 8a(5) and the Commission's plenary authority over options, revised part 32 would affirm that all commodity options (other than options on futures) are swaps, and as such will be subject to all provisions of the CEA otherwise applicable to swaps, including any rule, regulation, or order thereunder. The proposed rulemaking would also withdraw rule 3.13, which sets out procedures for the registration of agricultural trade option merchants and their associated persons. Rule 3.13 will become moot upon the withdrawal of rule 32.13, which includes the underlying registration requirement. Finally, the proposed rules would revise part 33 to delete references to exchange-traded options on physical commodities (which will now be regulated as swaps), leaving only exchange-traded options on futures subject to part 33.

B. Withdrawal of Current Part 35

[47] "[Part 35 . . .] exempt[s] swap agreements (as defined herein) meeting specified criteria from regulation under the Commodity Exchange Act (the "Act"). This rule was proposed pursuant to authority recently granted the Commission, a purpose of which is to give the Commission a means of improving the legal certainty of the market for swaps agreements." 58 FR 5587, Jan. 22, 1993.

In enacting the Futures Trading Practices Act of 1992 (the "1992 Act"),[48] Congress added section 4(c) to the CEA and authorized the Commission, by rule, regulation, or order, to exempt any agreement, contract or transaction, or class thereof, from the exchange-trading requirement of CEA section 4(a), or (with minor exceptions not relevant here) from any other provision of the Act.[49] Pursuant to its new authority in section 4(c), the Commission proposed in 1992[50] and adopted in 1993[51] part 35 of the Commission's regulations, generally exempting certain swap agreements from the CEA. As explained above, part 35 originally applied to all commodities. However, certain amendments to the CEA made by the CFMA had the effect of making part 35 relevant only for swaps in agricultural commodities.

The Dodd-Frank Act amends, repeals, or replaces many CEA sections added by the CFMA (including the statutory exemptions for swaps in excluded and exempt commodities at current CEA sections 2(d), 2(g), and 2(h)). To avoid any uncertainty as to whether the Commission will allow bilateral swaps in non-agricultural commodities to revert to reliance on existing part 35 for exemption from the CEA and the Dodd-Frank amendments, the Commission is proposing to revoke current part 35 in its entirety. Once part 35 is revoked, the only swaps authorized under the CEA or the Commission's rules

[48] Pub. L. 102-546 (Oct. 28, 1992).

[49] While section 4(c) was amended by the Dodd-Frank Act, for the purposes of this rulemaking its function and effect have not changed. See 4(c) discussion, below.

[50] See the original proposal at 57 FR 53627, Nov. 12, 1992. See also 57 FR 58423, Dec. 28, 1992, extending the comment period for an additional fourteen days.

[51] 58 FR 5587, Jan. 22, 1993.

will be those swaps that comport with the requirements of the CEA, as amended by the Dodd-Frank Act.[52]

C. Proposed New Part 35

The provisions of proposed new part 35 would generally provide that agricultural swaps may be transacted subject to all provisions of the CEA, and any Commission rule, regulation or order thereunder, that is otherwise applicable to swaps. New part 35 would also clarify that by issuing a rule allowing agricultural swaps to transact subject to the laws and rules applicable to all other swaps, the Commission is allowing agricultural swaps to transact on DCMs, SEFs, or otherwise to the same extent that all other swaps are allowed to trade on DCMs, SEFs, or otherwise.

D. Revisions to Part 32

Because commodity options (other than options on futures) clearly fall within the Dodd-Frank Act definition of swap,[53] the Commission is proposing to substantially update and revise the now duplicative off-exchange commodity option regulations set forth in current part 32. Revised part 32, authorized by the Commission's plenary options authority, will provide legal certainty for the commodity options market by making it clear that commodity options (other than options on futures) are authorized to continue subject to all provisions of the CEA, and any rule, regulation, or order thereunder, that is otherwise applicable to swaps.

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[52] Section 723(c)(3)(B) of the Dodd-Frank Act grandfathers existing 4(c) orders that relate to agricultural swaps unless superseded by subsequent Commission order. This notice of proposed rulemaking is not taking any action to alter the continued effectiveness of the orders identified in footnote 24 above. See also, 76 FR [_____] n. 38Jan. 20, 2011.

[53] See footnote 6 above.

In order to support the revisions to part 32, including the withdrawal of several sections in their entirety, the Commission reviewed and analyzed each provision of existing part 32, including the corresponding history of the Commission's development of commodity options regulation. Based on its review, the Commission has determined that there would be little practical effect and no detrimental consequences in adopting the proposed revisions to the existing commodity options regime in part 32.

i. 1978 suspension of commodity options (§ 32.11)

From a historical perspective, the Commission adopted its first broad anti-fraud rule applicable to commodity options transactions on June 24, 1975.[54] After an unsuccessful effort to generally permit off-exchange commodity options subject to certain rules and regulations (that is, original part 32),[55] the Commission issued a general suspension of commodity options transactions in 1978.[56] The suspension was adopted by the Commission on April 17, 1978 and was added to the original part 32 as § 32.11.[57] Upon its adoption in 1978, § 32.11 suspended all commodity option transactions (except for those trade options authorized by § 32.4)[58] that had been otherwise authorized by original part 32. Aside from later amendments that authorized commodity options

[54] 40 FR 26504, June 24, 1975. Originally designated as 17 CFR 30.01, the provision was re-designated as § 32.9 and incorporated into the original part 32 regulations adopted on November 24, 1976.

[55] See discussion and review of original part 32 below.

[56] Exchange-traded options on futures were not affected since they were not available at the time and only later became available when the Commission initiated a pilot program to allow exchange-traded options on futures in 1981. See; 46 FR 54500, Nov. 3, 1981.

[57] See 43 FR 16153, Apr. 17, 1978.

[58] Dealer options, which were also being traded at the time, were also subsequently exempted from the general options ban. See: 43 FR 23704, June 1, 1978. Dealer options are discussed below in connection with the withdrawal of rule 32.12.

conducted on or subject to the rules of a contract market[59] or a foreign board of trade,[60] current § 32.11 remains in the same form as when originally adopted in 1978. Accordingly, the bulk of original part 32, as discussed below, has been obsolete and/or irrelevant since the adoption of § 32.11 in 1978. This includes the registration requirements in § 32.3, the disclosure requirements in § 32.5, the segregation requirements in § 32.6, and the books and recordkeeping requirements in § 32.7.

ii. Original part 32 (§§ 32.1 – 32.10)

Original part 32 was adopted by the Commission on November 24, 1976, and included substantially the same provisions as they exist in current §§ 32.1 – 32.10.[61]

a. 32.1

The definitions section, § 32.1, has been substantively modified only once[62] since its adoption in 1976. That revision added a scope provision as § 32.1(a). The purpose of adding the scope provision was to make clear that part 32 applied only to off-exchange bilateral options, and that it would not apply to commodity options conducted on or subject to the rules of a contract market. The § 32.1(a) scope provision was amended once in 1987 to also exclude from part 32 commodity options conducted on or subject to the rules of a foreign board of trade.[63] Beyond that, § 32.1 has not been substantively amended since its adoption 1976.

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[59] See 47 FR at 57016, Dec, 22, 1982.

[60] See 52 FR at 29003, Aug. 5, 1987.

[61] See 43 FR 51808, Nov. 24, 1976.

[62] See 47 FR at 57016, Dec. 22, 1982.

[63] See 52 FR at 29003, Aug. 5, 1987.

Because commodity options (other than options on futures) are now swaps and will be authorized to transact subject to the swaps rules, the scope provision in § 32.1 has been updated and retained in revised part 32 as appropriate. The proposal would delete the definitions in current § 32.1 as duplicative – the terms therein are already defined elsewhere, either in other Commission regulations or in the CEA, and there is no need for their repetition in part 32.

b. 32.2

As originally adopted, § 32.2(a) prohibited commodity options transactions on a list of enumerated agricultural commodities and § 32.2(b) prohibited commodity options involving any contract of sale of any commodity for future delivery traded on or subject to the rules of any contract market or involving the prices of such contracts, unless done pursuant to a subsequent Commission rulemaking. Section 32.2 was amended once in 1992 to remove § 32.2(b),[64] and § 32.2 was amended again in 1998 to reference the Commission's newly adopted Agricultural Trade Option rules in § 32.13. Because this proposal would treat agricultural swaps the same as swaps in any other commodity, and because all commodity options (other than options on futures) are now swaps, it is no longer necessary to distinguish between agricultural and non-agricultural commodities for the purposes of the Commission's options regulations, and thus the Commission is proposing to withdraw § 32.2.

c. 32.3, 32.5, 32.6, and 32.7

As adopted in 1976, § 32.3 provided that only firms registered as futures commission merchants, or registered associated persons of such firms, could offer or sell

[64] See 57 FR 27925, June 23, 1992. At that time, original § 32.2(a) was re-designated as simply § 32.2.

commodity options under part 32. Section 32.5 imposed certain disclosure requirements for options sellers, § 32.6 addressed segregation of funds, and § 32.7 set forth the books and recordkeeping requirements. Because the 1978 suspension of commodity options in § 32.11 remains in effect, the requirements in §§ 32.3, 32.5, 32.6, and 32.7 (the "abandoned sections") are of no practical effect – there are no authorized transactions subject to these abandoned sections. The commodity options that are allowed to transact outside of the § 32.11 suspension (e.g., § 32.4 trade options, § 32.12 dealer options, § 32.13 agricultural trade options, and commodity option transactions conducted on or subject to the rules of a contract market or a foreign board of trade) are each exempted from the requirements of the abandoned sections. Accordingly, the proposal would withdraw §§ 32.3, 32.5, 32.6, and 32.7.

d. 32.4

From its adoption, part 32 has included, in § 32.4, an exemption for commodity options used by commercial entities entering into the commodity option transactions solely for purposes related to their business.[65] The so-called "trade option exemption" has remained unchanged since 1976 and has provided legal certainty for that segment of the commodity options market available to commercial end users. This notice proposes revising the trade option exemption to provide that commodity options may transact subject to the same laws, rules, regulations, and orders otherwise applicable to all swaps. The rationale for the revision is that the swaps rules already allow for the equivalent of a

[65] § 32.4(a) exempts a commodity option when it is offered to "a producer, processor, or commercial user of, or a merchant handling, the commodity which is the subject of the commodity option transaction, or the products or by-products thereof, and that such producer, processor, commercial user or merchant is offered or enters into the commodity option transaction solely for purposes related to its business as such." See § 32.4(a).

trade option – the Dodd-Frank amendments permit bilateral swaps, where both parties are ECPs,[66] to remain uncleared at the election of a commercial end user. The primary substantive change to this market will be that, while current § 32.4 imposes no minimum net worth requirement on participants, both purchasers and sellers of commodity options under revised § 32.4 will have to qualify as ECPs, just as swaps (other than swaps on a DCM) may only be entered into by ECPs. The Commission is specifically requesting comment as to whether this distinction will significantly affect hedging opportunities available to currently active market participants.

e. 32.8 and 32.9

Sections 32.8 and 32.9 address unlawful representations and fraud in connection with commodity option transactions. These two consumer protection provisions are important to both the Commission and the commodity options markets. Even though commodity options are now swaps, subject to the swaps rules and any anti-fraud or other customer protection rules otherwise applicable to swaps, the Commission views §§ 32.8 and 32.9 as important protections for commodity options participants. With the exception of a minor revision expanding the unlawful representation prohibition of § 32.8(a) to all Commission registrants, §§ 32.8 and 32.9 will be retained in substantially the same form as they currently exist. The retention of §§ 32.8 and 32.9 will not affect the applicability to options of any anti-fraud or other similar rule that is applicable to a swap. That is, §§ 32.8 and 32.9 are being retained in addition to any other protections provided by the general swaps rules.

f. 32.10

[66] See footnote 26, above.

Section 32.10 grandfathered commodity options transactions occurring prior to the effective adoption of original part 32. Revised part 32 would update the current text with a similar grandfather provision for existing commodity options transacted pursuant to current part 32. Generally, commodity options transacted pursuant to current part 32 (and prior to the effective date of any revision to current part 32) will remain enforceable upon the adoption of any revision to part 32.

iii. Subsequent additions to Part 32 – §§ 32.12 and 32.13

a. 32.12 – dealer options

Section 32.12, commonly known as the dealer options exemption, was added to original part 32 on June 1, 1978.[67] The dealer options rules provided an exemption from the Commission's then recently adopted options ban at § 32.11 (recall that the § 32.11 options ban was originally adopted on April 17, 1978).[68] Amended two times shortly after its adoption – once to adjust a net worth requirement[69] and again to include certain reporting requirements[70] – the § 32.12 dealer options rules were intended to grandfather the ongoing businesses of certain commercial option grantors who, as of May 1, 1978, were both in the business of granting options on a physical commodity and in the business of buying, selling, producing, or otherwise utilizing that commodity.

The primary factor in the Commission's determination to withdraw § 32.12 at this time is that the dealer option business has apparently ceased to exist. Since at least

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[67] See 43 FR 23704, June 1, 1978.

[68] See 43 FR 16153, Apr. 17, 1978.

[69] See 43 FR 47492, Oct. 16, 1978.

[70] See 43 FR 52467, Nov. 13, 1978.

September 11, 2001,[71] and likely for at least another decade before that,[72] the Commission has not received a single report required to be filed by an entity transacting dealer options under § 32.12. That observation, in conjunction with the requirement that to rely on § 32.12 a dealer has to have been in this business as of May 1, 1978, implies that no entity is legally relying on § 32.12 for any currently transacted business activity. The Commission is specifically requesting comment as to whether there is any reason not to withdraw § 32.12 in its entirety, and whether any person, group of persons, or class of transactions is prejudiced or otherwise harmed by such action.

b. 32.13 – agricultural trade options

Section 32.13 and agricultural trade options are described in the Background section above. Added to part 32 in 1998,[73] and amended once thereafter,[74] the ATOM registration regime has been largely unused. It has attracted only one registrant, which registrant has since withdrawn its registration. However, the exemption for agricultural trade options meeting certain conditions as specified in § 32.13(g) appears to be widely used. Because the Commission is proposing to authorize agricultural swaps in new part 35, and to re-authorize commodity options to transact as swaps (with no distinction as between agricultural and non-agricultural commodities) in revised § 32.4, the

[71] September 11, 2001 is, of course, the day that the Commission's hard copy records contained in its New York regional office in the World Trade Center were lost. The records would have included any § 32.12 reports, which were required to be filed with and retained at the Commission's New York regional office in hard copy form.

[72] Interviews of long-serving Commission staff indicate no recollections of entities transacting pursuant to the § 32.12 dealer options exemption for at least the past 20 years. The apparent cessation of the dealer options business should not come as a surprise. It was widely expected at the time that when exchange-traded options became available (which happened starting in 1981) the dealer option business would fade away. It appears that this is, in fact, what happened.

[73] See 63 FR 18832, Apr. 16, 1998.

[74] See 64 FR 68011, Dec. 6, 1999.

Commission is proposing to withdraw § 32.13 in its entirety.[75] The primary effect of the change would be to remove the $10 million net worth requirement for parties relying on the § 32.13(g) exemption for agricultural trade options. Under revised § 32.4, parties need only qualify as ECPs, which category would include certain persons with a net worth of less than $10 million.

E. Part 33

As noted above, the Commission is proposing to amend part 33 to remove references to options on physical commodities. All options on physicals would now be regulated as swaps, leaving only exchange-traded options on futures subject to part 33. Treating options on physicals that are traded on a DCM as swaps would have little practical effect since anyone (including non-ECPs) could continue to trade such instruments on a DCM. In addition, qualified persons (ECPs) could trade similar options on physical commodities in the non-DCM environment, including on SEFs, subject to the same rules as other physical commodity swaps.

V. Findings Pursuant to Section 4(c)

As noted above, section 723(c)(3)(A) of the Dodd-Frank Act prohibits swaps in an agricultural commodity. However, section 723(c)(3)(B) of the Dodd-Frank Act explicitly provides that the Commission may permit swaps in an agricultural commodity pursuant to CEA section 4(c), the Commission's general exemptive authority, "under such terms and conditions as the Commission shall prescribe." Accordingly, certain of the amendments proposed herein are proposed for adoption pursuant to section 4(c), as amended by the Dodd-Frank Act.

[75] In addition, the proposal would withdraw § 3.13 in its entirety. Section 3.13 outlines the registration procedures for ATOMs, and will become be moot upon the withdrawal of § 32.13.

Section 4(c)(1) of the CEA authorizes the CFTC to exempt any transaction or class of transactions from any of the provisions of the CEA (subject to exceptions not relevant here) in order to "promote responsible economic or financial innovation and fair competition."[76] The Commission may grant such an exemption by rule, regulation, or order, after notice and opportunity for hearing, and may do so on application of any person or on its own initiative. In enacting section 4(c), Congress noted that the goal of the provision "is to give the Commission a means of providing certainty and stability to existing and emerging markets so that financial innovation and market development can proceed in an effective and competitive manner."[77]

In order to analyze the effect of permitting agricultural swaps to trade under the same terms and conditions as other swaps, it is appropriate to examine some of the major components of the Dodd-Frank Act that apply to swaps generally. Section 727 of the

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[76]New section 4(c)(1) of the CEA, 7 U.S.C. 6(c)(1), as amended by the Dodd-Frank Act, provides in full that:

In order to promote responsible economic or financial innovation and fair competition, the Commission by rule, regulation, or order, after notice and opportunity for hearing, may (on its own initiative or on application of any person, including any board of trade designated or registered as a contract market or derivatives transaction execution facility for transactions for future delivery in any commodity under section 5 of this Act) exempt any agreement, contract, or transaction (or class thereof) that is otherwise subject to subsection (a) (including any person or class of persons offering, entering into, rendering advice or rendering other services with respect to, the agreement, contract, or transaction), either unconditionally or on stated terms or conditions or for stated periods and either retroactively or prospectively, or both, from any of the requirements of subsection (a), or from any other provision of this Act (except subparagraphs (C)(ii) and (D) of section 2(a)(1), except that—

(A) unless the Commission is expressly authorized by any provision described in this subparagraph to grant exemptions, with respect to amendments made by subtitle A of the Wall Street Transparency and Accountability Act of 2010—

(i) with respect to—

(I) paragraphs (2), (3), (4), (5), and (7), paragraph (18)(A)(vii)(III), paragraphs (23), (24), (31), (32), (38), (39), (41), (42), (46), (47), (48), and (49) of section 1a, and sections 2(a)(13), (2)(c)(1)(D), 4a(a), 4a(b), 4d(c), 4d(d), 4r, 4s, 5b(a), 5b(b), 5(d), 5(g), 5(h), 5b(c), 5b(i), 8e, and 21; and

(II) section 206(e) of the Gramm-Leach-Bliley Act (Pub. L. 106–102; 15 U.S.C. 78c note); and

(ii) in sections 721(c) and 742 of the Dodd-Frank Wall Street Reform and Consumer Protection Act; and

(B) the Commission and the Securities and Exchange Commission may by rule, regulation, or order jointly exclude any agreement, contract, or transaction from section 2(a)(1)(D)) if the Commissions determine that the exemption would be consistent with the public interest.

[77] House Conf. Report No. 102-978, 1992 U.S.C.C.A.N. 3179, 3213.

Dodd-Frank Act adds, among other things, a new CEA section 2(a)(13) that mandates that swap transaction and pricing data be made available to the public. Section 723(a)(3) of the Dodd-Frank Act adds a new CEA section 2(h) that provides that the Commission shall determine which swaps are subject to a mandatory clearing requirement. New CEA section 2(h) also provides that swaps that are required to be cleared must be executed on a DCM or SEF, if a DCM or SEF makes the swap available for trading. As noted above, part 35, as it is currently written, does not permit clearing of agricultural swaps and does not contemplate any reporting of agricultural swaps data.

Permitting agricultural swaps to trade under the same terms and conditions as other swaps should provide greater certainty and stability to existing and emerging markets so that financial innovation and market development can proceed in an effective and competitive manner. Treating all swaps, including agricultural swaps, in a consistent manner should provide greater certainty to markets. The Dodd-Frank Act reporting and trade execution requirements should lead to greater market and price transparency, which may improve market competition, innovation, and development. Centralized clearing of agricultural swaps by robustly regulated central clearinghouses should reduce systemic risk and provide greater certainty and stability to markets by reducing counterparty risk.

The Commission is requesting comment on whether swaps in agricultural commodities should be subject to the same legal requirements as swaps in other commodities.

Section 4(c)(2) of the CEA provides: that the Commission may grant exemptions only when it determines that the requirements for which an exemption is being provided should not be applied to the agreements, contracts or transactions at issue; that the

exemption is consistent with the public interest and the purposes of the CEA; that the agreements, contracts or transactions will be entered into solely between appropriate persons; and that the exemption will not have a material adverse effect on the ability of the Commission or Commission-regulated markets to discharge their regulatory or self-regulatory responsibilities under the CEA.[78]

The purposes of the CEA include "ensur[ing] the financial integrity of all transactions subject to this Act and the avoidance of systemic risk" and "promot[ing] responsible innovation and fair competition among boards of trade, other markets and market participants."[79] As noted above, centralized clearing of agricultural swaps (which is not permitted under the current part 35 rules) should reduce systemic risk. Also, allowing agricultural swaps to trade under the general swaps rules contained in the Dodd-Frank Act would allow agricultural swaps to trade on SEFs and DCMs (which is prohibited under the current part 35 rules) which may result in increased innovation and competition in the agricultural swaps market. Reducing systemic risk and increasing innovation and competition by permitting agricultural swaps to trade under the same terms and conditions as other swaps would be consistent with the purposes listed above, the general purposes of the CEA, and the public interest. The Commission is requesting comment on this issue.

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[78] Section 4(c)(2) of the CEA, 7 U.S.C. 6(c)(2), provides in full that:

The Commission shall not grant any exemption under paragraph (1) from any of the requirements of subsection (a) of this section unless the Commission determines that—

(A) The requirement should not be applied to the agreement, contract, or transaction for which the exemption is sought and that the exemption would be consistent with the public interest and the purposes of this Act; and

(B) The agreement, contract, or transaction—

(i) Will be entered into solely between appropriate persons; and

(ii) Will not have a material adverse effect on the ability of the Commission or any contract market or derivatives transaction execution facility to discharge its regulatory or self-regulatory duties under this Act.

[79] CEA section 3(b), (7 U.S.C. 5(b)).

As noted above, the Dodd-Frank Act contains substantial new clearing and trade execution requirements for swaps. The clearing requirement is designed, among other things, to reduce the counterparty risk of a swap, and therefore systemic risk. The swap reporting and trade execution requirements should provide additional market information to the Commission, the markets, and the public. Thus, treating agricultural swaps in the same manner as other swaps may enhance the ability of the Commission or Commission-regulated markets to discharge their regulatory or self-regulatory responsibilities under the CEA.

Section 4(c)(3) of the CEA includes within the term "appropriate persons" a number of specified categories of persons, and also in subparagraph (K) thereof "such other persons that the Commission determines to be appropriate in light of . . . the applicability of appropriate regulatory protections." Section 723(a)(2) of the Dodd-Frank Act adds, among other things, a new CEA section 2(e) that provides: "It shall be unlawful for any person, other than an eligible contract participant, to enter into a swap unless the swap is entered into on, or subject to the rules of, a [DCM]."[80] In light of the comprehensive new regulatory scheme for swaps and the enhancements made to the already robust regulatory system concerning DCMs[81] that are contained in the Dodd-Frank Act, the limitation on participation to eligible contract participants outside of a DCM, and the ability of others to enter into a swap on a DCM, should limit participation to appropriate persons. The Commission requests comment on this issue.

VI. Request for Comments Regarding the Proposed Rules

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[80] New CEA section 2(e), (7 U.S.C. 2(e)).

[81] See, for example, new CEA section 5(d) (7 U.S.C. 7(d)) as added by section 735(b) of the Dodd-Frank Act and amended CEA section 5c (7 U.S.C. 7a-2) as amended by section 745 of the Dodd-Frank Act.

In addition to specifically requesting comment on the foregoing questions related to the issuance of a 4(c) order, and the other questions set out in the preceding sections of this notice of proposed rulemaking, the Commission poses the following questions:

1. Generally, will the rule changes and amendments proposed herein provide an appropriate regulatory framework for the transacting of (a) agricultural swaps, and (b) trade options on all commodities?

2. Does the proposal for new part 35 appropriately address all outstanding issues as they relate to the transaction of swaps in an agricultural commodity?

3. Regarding the proposed revisions to part 32, and specifically the revised § 32.4 trade option exemption, will such revisions significantly affect hedging opportunities available to currently active users of the trade options market? In other words, is there any reason not to revise § 32.4 as proposed? In particular, are there persons who offer or purchase trade options on non-enumerated agricultural commodities (e.g., coffee, sugar, cocoa) under current § 32.4 who would not qualify as ECPs and would therefore be ineligible to participate in such options under revised § 32.4? If so, should such participants be excepted from the general requirement that all swaps participants must be ECPs unless the transaction takes place on a DCM?

4. Regarding the proposed withdrawal of § 32.12 in its entirety, would such action (in conjunction with the adoption of the new rules proposed herein) prejudice or otherwise harm any person, group of persons, or class of transactions? In other words, is there any reason not to withdraw § 32.12 as proposed?

5. Similarly, and regarding the proposed withdrawal of § 32.13 (the agricultural trade option provision) in its entirety, would such action (in conjunction with

the adoption of the new rules proposed herein) prejudice or otherwise harm any person, group of persons, or class of transactions? In other words, is there any reason not to withdraw § 32.13 as proposed?

6. Do the proposals as they relate to part 33 appropriately limit the scope of part 33 to DCM-traded options on futures, leaving DCM-traded options on physical commodities subject to part 32?

7. Do the proposals outlined herein omit or fail to appropriately consider any other areas of concern regarding agricultural swaps and options in any commodity?

VII. Related Matters

A. Cost benefit analysis

Section 15(a) of the CEA[82] requires the Commission to consider the costs and benefits of its actions before issuing a rulemaking under the Act. By its terms, section 15(a) does not require the Commission to quantify the costs and benefits of the rulemaking or to determine whether the benefits of the rulemaking outweigh its costs; rather, it requires that the Commission "consider" the costs and benefits of its actions. Section 15(a) further specifies that the costs and benefits shall be evaluated in light of five broad areas of market and public concern: (1) protection of market participants and the public; (2) efficiency, competitiveness and financial integrity of futures markets; (3) price discovery; (4) sound risk management practices; and (5) other public interest considerations. The Commission may in its discretion give greater weight to any one of the five enumerated areas and could in its discretion determine that, notwithstanding its

[82] 7 U.S.C. 19(a).

costs, a particular rule is necessary or appropriate to protect the public interest or to effectuate any of the provisions or accomplish any of the purposes of the Act.

i. Summary of proposed requirements. The proposed rule would replace the swap exemption in part 35 and the commodity options provisions in part 32 with new rules providing, in general, that agricultural swaps and options (other than options on futures) would be treated the same as all other swaps. The proposed rule would also amend part 33 to remove references to options on physical commodities. While the proposed rule does not contain the substantive requirements that govern swaps generally (those requirements are found in the swaps-related rulemakings that implement the Dodd-Frank Act), for purposes of this analysis, it is appropriate to consider the costs and benefits of treating agricultural swaps and options as all other swaps are treated.

ii. Costs. With respect to costs, the Commission has determined that allowing agricultural swaps to continue to trade under the requirements of the current part 35 would result in substantial costs. The Dodd-Frank Act added numerous provisions to the CEA to protect market participants and the public, such as the segregation of funds for uncleared swaps, swap dealer registration and regulation, including business conduct standards, and limitations on conflicts of interest. Current part 35 exempts qualifying swaps from nearly all sections of the CEA, so that these and other protections contained in Dodd-Frank would not apply to agricultural swaps entered into under part 35.

The Dodd-Frank Act contains numerous provisions designed to improve price discovery and foster sound risk management practices, such as the provisions encouraging the clearing of swaps and trading of swaps on DCMs and SEFs. Current

part 35, by its terms, would not allow for the clearing or trade execution provisions contained in Dodd-Frank.

Other alternatives to current part 35 could include writing a new part that made agricultural swaps subject to some of the provisions contained in the Dodd-Frank Act, but not other provisions, or accepting all of the provisions of Dodd-Frank and adding additional requirements. The costs of either of these alternatives (and of retaining current part 35, as well) would be to the efficiency of markets, of swap participants, and of the Commission. Since many users of agricultural swaps would likely engage in other types of swaps also, those users would be subject to two regulatory regimes and the compliance costs that would accompany following both regimes. Moreover, the Commission would be required to develop and implement two regimes. Also, several of those who commented regarding the ANPRM noted that the new Dodd-Frank Act regulatory regime is robust and comprehensive and provides significant protections to market participants, so that any concerns regarding agricultural swaps that may have existed under the provisions of the CFMA should be allayed. Several commenters noted that agricultural swaps are important risk management tools and that such swaps should be available on the same terms and conditions as other swaps that are used to manage risk.

With respect to options generally, the Commission has determined that retaining the current parts 32 and 33 would have substantial costs. As noted above, new CEA § 1a(47) defines swaps to include options, other than options on futures. The options rules contained in part 32 are a confusing tangle of largely obsolete rules and, even more important, the general option rules in parts 32 and 33 do not conform to the requirements in the Dodd-Frank Act.

iii. Benefits. With respect to benefits, the Commission has determined that replacing parts 32 and 35 with rules that allow agricultural swaps and options to trade under the same terms and conditions as other swaps and amending part 33 to delete references to options on physical commodities will have substantial benefits.

Treating agricultural swaps the same as other swaps would subject those swaps to the numerous provisions in the Dodd-Frank Act that protect market participants and the public, such as the segregation of funds for uncleared swaps, limitations on conflicts of interest, and swap dealer registration and regulation, including business conduct standards. Moreover, the clearing requirement in the Dodd-Frank Act is intended to reduce systemic risk which should further protect the public.

The provisions in the Dodd-Frank Act encouraging the clearing of swaps and trading of swaps on DCMs and SEFs should improve price discovery and foster sound risk management practices. The current provisions of part 35 do not permit such clearing or trade execution.

The Dodd-Frank Act mandates that swap transaction and pricing data be made available to the public. The reporting and trade execution requirements should lead to greater market and price transparency. Also, having a single set of regulations governing all swap transactions should improve efficiency and compliance costs for markets and market participants.

With respect to options generally, the Commission has determined that replacing part 32 and allowing options (other than options on futures) to trade in the same manner as other swaps will have substantial benefits similar to those for agricultural swaps discussed above. Moreover, the current part 32 is outdated and largely obsolete under its

own terms. Finally, the current language of parts 32 and 33 regarding options generally does not comply with the swap provisions of the Dodd-Frank Act and must be replaced.

iv. Conclusion. After considering the section 15(a) factors, the Commission has determined that the benefits of the proposed parts 32 and 35, and the amendments to part 33, outweigh the costs. Accordingly, the Commission has determined to propose parts 32 and 35, and the amendments to part 33. The Commission invites public comment on its cost-benefit considerations. Commenters are also invited to submit any data or other information that they may have quantifying or qualifying the costs and benefits of the Proposal with their comment letters.

B. Regulatory Flexibility Analysis

The Regulatory Flexibility Act ("RFA") requires that agencies consider whether the rules they propose will have a significant economic impact on a substantial number of small entities and, if so, provide a regulatory flexibility analysis respecting the impact.[83] The proposed rule, in replacing part 35, would affect eligible swap participants ("ESPs") (by eliminating the ESP category and requiring agricultural swap participants to be eligible contract participants ("ECPs"), unless the transaction occurs on a designated contract market ("DCM")). Regarding options, the proposed rule, in amending part 33, would affect entities that currently engage in options on physical commodities on a DCM, and, in replacing part 32, would affect those entities that currently engage in options under § 32.4 and § 32.13(g). By mandating that agricultural swaps and options be treated as all other swaps, the effect of the proposed rule has the potential to affect DCMs, derivatives clearing organizations ("DCOs"), futures commission merchants

[83] 5 U.S.C. 601 et seq.

("FCMs"), large traders and ECPs, as well as swap dealers ("SDs"), major swap participants ("MSPs"), commodity pool operators ("CPOs"), swap execution facilities ("SEFs"), and swap data repositories ("SDRs").

i. DCMs, DCOs, FCMs, CPOs, large traders, ECPs, and ESPs. The Commission has previously determined that DCMs, DCOs, FCMs, CPOs, large traders, ECPs, and ESPs are not small entities for purposes of the Regulatory Flexibility Act.[84] Accordingly, the Chairman, on behalf of the Commission, hereby certifies pursuant to 5 U.S.C. 605(b) that the proposed rules will not have a significant economic impact on a substantial number of small entities with respect to these entities.

ii. SDs, MSPs, SEFs, and SDRs. SDs, MSPs, SEFs, and SDRs are new categories of registrant under the Dodd-Frank Act. Therefore, the Commission has not previously addressed the question of whether SDs, MSPs, SEFs, and SDRs are, in fact, "small entities" for purposes of the RFA. For the reasons that follow, the Commission is hereby determining that none of these entities would be small entities. Accordingly, the Chairman, on behalf of the Commission, hereby certifies pursuant to 5 U.S.C. 605(b) that the proposed rules, with respect to SDs, MSPs, SEFs, and SDRs, will not have a significant impact on a substantial number of small entities.

a. SDs: As noted above, the Commission previously has determined that FCMs are not small entities for the purpose of the RFA based upon, among other things, the requirements that FCMs meet certain minimum financial requirements that enhance the protection of customers' segregated funds and protect the financial condition of

[84] See, respectively and as indicated, 47 FR 18618, 18619, Apr. 30, 1982 (DCMs, CPOs, FCMs, and large traders); 66 FR 45604, at 45609, Aug. 29, 2001 (DCOs); 66 FR 20740, 20743, Apr. 25, 2001 (ECPs); and 57 FR 53627, 53630, Nov. 12, 1992 and 58 FR 5587, 5593, Jan. 22, 1993 (ESPs).

FCMs generally.[85] SDs similarly will be subject to minimum capital and margin requirements, and are expected to comprise the largest global financial firms. Entities that engage in a de minimis quantity of swap dealing in connection with transactions with or on behalf of its customers will be exempted from designation as an SD. For purposes of the RFA in this proposed rulemaking, the Commission is hereby determining that SDs not be considered to be "small entities" for essentially the same reasons that FCMs have previously been determined not to be small entities.

b. MSPs: The Commission also has determined that large traders are not small entities for the purpose of the RFA.[86] The Commission considered the size of a trader's position to be the only appropriate test for purposes of large trader reporting.[87] MSPs, among other things, maintain substantial positions in swaps, creating substantial counterparty exposure that could have serious adverse effects on the financial stability of the United States banking system or financial markets. For purposes of the RFA, the Commission is hereby determining that MSPs not be considered to be "small entities" for essentially the same reasons that large traders have previously been determined not to be small entities.

c. SEFs: The Dodd-Frank Act defines a SEF to mean a trading system or platform in which multiple participants have the ability to accept bids and offers made by multiple participants in the facility or system, through any means of interstate commerce, including any trading facility that facilitates the execution of swaps between persons and

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[85] 47 FR, at 18619.

[86] Id. at 18620.

[87] Id.

is not a DCM. The Commission previously determined that a DCM is not a small entity because, among other things, it may only be designated when it meets specific criteria, including expenditure of sufficient resources to establish and maintain adequate self-regulatory programs. Likewise, the Commission will register an entity as a SEF only after it has met specific criteria, including the expenditure of sufficient resources to establish and maintain an adequate self-regulatory program. Accordingly, as with DCMs, the Commission is hereby determining that SEFs are not "small entities" for purposes of the RFA.

d. SDRs: The Commission previously determined DCMs and DCOs not to be small entities because of "the central role" they play in "the regulatory scheme concerning futures trading."[88] Because of the "importance of futures trading in the national economy," to be designated as a contract market or registered as a DCO, the respective entity must meet stringent requirements set forth in the CEA.[89] Similarly, swap transactions that are reported and disseminated by SDRs are an important part of the national economy. SDRs will receive data from market participants and will be obligated to facilitate swaps execution by reporting real-time data.[90] Similar to DCOs and DCMs, SDRs will play a central role both in the regulatory scheme covering swaps trading and in the overall market for swap transactions. Additionally, the Dodd-Frank Act allows DCOs to register as SDRs. Accordingly, for essentially the same reasons that DCOs and DCMs have previously been determined not to be small entities, the

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[88] 47 FR at 18619 (DCMs) and 66 FR at 45609 (DCOs).

[89] See new CEA section 5(d), as added by section 735(b) of the Dodd-Frank Act regarding DCM core principles and new CEA section 5b(c)(2), as added by section 725(c) of the Dodd-Frank Act regarding DCO core principles.

[90] See new CEA section 21, as added by section 728 of the Dodd-Frank Act.

Commission is hereby determining that SDRs are not "small entities" for purposes of the RFA.

iii. Entities Eligible to Engage in Options on Physical Commodities on DCMs under Part 33. Under the current part 33, there is no regulatory financial threshold that must be met in order to engage in options on physical commodities on a DCM, so small entities would be eligible to engage in such transactions. In fact, there is no regulatory financial threshold that must be met in order to engage in any type of transaction on a DCM. As noted above, new CEA section 1a(47) provides that options are swaps, other than options on futures. New CEA section 2(e) provides that non-ECPs may enter into swaps, if the swaps are effected on a DCM. Therefore, even though an option on a physical commodity is defined to be a swap under the Dodd-Frank Act, small entities will continue to be eligible to enter into such options on a DCM under the rules proposed herein, just as they are eligible to enter into such options on a DCM under the current part 33. Thus, the rule will have no effect on the eligibility of small entities to enter into an option on a physical commodity on a DCM. Accordingly, the Chairman, on behalf of the Commission, hereby certifies pursuant to 5 U.S.C. 605(b) that the proposed rules will not have a significant economic impact on a substantial number of small entities with respect to entities eligible to engage in options on physical commodities on DCMs under part 33.

iv. Entities Engaged in Options under § 32.13(g). The Commission has not previously addressed the question of whether entities engaged in agricultural trade options under § 32.13(g) are, in fact, "small entities" for purposes of the RFA. For the reasoning that follows, the Commission is hereby determining that entities engaged in options under § 32.13(g) would not be small entities.

As noted above, the Commission previously has determined that ECPs are not small entities for the purpose of the RFA based upon, among other things, the financial and institutional requirements contained in the definition. Also as noted above, the exemption at § 32.13(g) allows for options on the enumerated agricultural commodities to be sold when: (1) the option is offered to a commercial ("a producer, processor, or commercial user of, or a merchant handling" the underlying commodity); (2) the commercial enters the transaction solely for purposes related to its business as such; and (3) each party to the option contract has a net worth of not less than $10 million. There are two analogous provisions in the ECP definition, new CEA sections 1a(18)(A)(v)(III) and 1a(18)(A)(xi)(II). New CEA section 1a(18)(A)(v)(III) provides that an ECP includes a corporation, partnership, proprietorship, organization, trust, or other entity that has a net worth exceeding $1,000,000 and enters into a swap in connection with the entity's business or to manage the risk associated with an asset or liability owned or incurred or reasonably likely to be owned or incurred by the entity in the conduct of the entity's business. New CEA section 1a(18)(A)(xi)(II) provides that an ECP includes an individual who has assets invested on a discretionary basis, the aggregate of which is in excess of $5,000,000 and who enters the swap in order to manage the risk associated the an asset owned or liability incurred, or reasonably likely to be owned or incurred, by the individual. The participation requirements of § 32.13(g)(1) are similar to, if not more restrictive than, the analogous ECP provisions.

For purposes of the RFA in this proposed rulemaking, the Commission is hereby determining that entities engaged in options under § 32.13(g) not be considered to be "small entities" for essentially the same reasons that ECPs have previously been

determined not to be small entities. Accordingly, the Chairman, on behalf of the Commission, hereby certifies pursuant to 5 U.S.C. 605(b) that the proposed rules, with respect to entities engaged in options under § 32.13(g), will not have a significant impact on a substantial number of small entities.

v. Entities Engaged in Options under § 32.4. The Commission has not previously addressed the question of whether entities engaged in trade options under § 32.4 are, in fact, "small entities" for purposes of the RFA. As noted above, under § 32.4, an option must be offered to a producer, processor, or commercial user of, or a merchant handling, the commodity, who enters into the commodity option transaction solely for purposes related to its business as such. The § 32.4 trade option exemption does not include any net worth requirement.

Because there is no net worth requirement in § 32.4, thus allowing commercial entities of any economic status to effect option transactions, the Commission is not in a position to determine whether entities engaged in options under § 32.4 include a substantial number of small entities on which the proposed rule would have a significant economic impact. Therefore, the Commission offers, pursuant to 5 U.S.C. 603, the following initial regulatory flexibility analysis, which it shall transmit to the Chief Counsel for Advocacy of the Small Business Administration as §603 requires:

- A description of the reasons why action by the agency is being considered.

The Commission is taking this regulatory action to withdraw § 32.4 because the Dodd-Frank Act has defined the term "swap" to include options. This new definition renders § 32.4 obsolete in its current form.

- A succinct statement of the objectives of, and legal basis for, the proposed rule. The objective of the withdrawal of § 32.4 is to make the Commission's regulations comport with the CEA as revised by the Dodd-Frank Act. As stated previously, the legal basis for the proposed withdrawal is the new CEA definition of swap, new section 1a(47)(A)(i), and the agricultural swaps provisions in section 723(c)(3) of the Dodd-Frank Act.

- A description of and, where feasible, an estimate of the number of small entities to which the proposed rule will apply. The small entities to which the proposed withdrawal of § 32.4 may apply are those commercial small entities that would be smaller than an ECP and additionally would have annual receipts of less than $750,000, the threshold for the definition of small entity in the RFA.[91] Because there are no reporting or registration requirements in § 32.4, it is difficult to quantify the exact number of small entities, if any, to which the proposed rule may apply.

- A description of the projected reporting, recordkeeping, and other compliance requirements of the proposed rule, including an estimate of the classes of small entities which will be subject to the requirement and the type of professional skills necessary for preparation of the report or record. The proposed withdrawal of § 32.4 does not contain any reporting, recordkeeping, or other compliance requirements. However, because the Dodd-Frank Act provides that options are swaps, the swaps rules being promulgated under the Dodd-Frank Act in other rulemakings will contain reporting, recordkeeping, and other compliance requirements. However, the withdrawal of 32.4 and the application of the Dodd-Frank Act swaps rules will limit option

[91] 5 U.S.C. 601(6).

transactions to eligible contract participants, which have been determined not to be small entities. Therefore, any entity that is not an ECP will be unable to enter into option transactions except on a DCM. Thus, there will be no reporting, recordkeeping or compliance requirements applicable to any small entity.

- An identification, to the extent practicable, of all relevant Federal rules which may duplicate, overlap or conflict with the proposed rule. Small entities that do not qualify as ECPs will be unable to engage in options transactions except on a DCM under an existing regulatory scheme. Accordingly, there will be no rules applicable to them that could duplicate, overlap, or conflict with any other Federal rules.

- Description of any significant alternatives to the proposed rule which accomplish the stated objectives of applicable statutes and which minimize any significant economic impact of the proposed rule on small entities. These may include, for example, (1) the establishment of differing compliance or reporting requirements or timetables that take into account the resources available to small entities; (2) the clarification, consolidation, or simplification of compliance and reporting requirements under the rule for such small entities; (3) the use of performance rather than design standards; and (4) an exemption from coverage of the rule, or any part thereof, for such small entities.

A potential alternative to limiting trade options under § 32.4 to ECPs would be to create a special rule to allow non-ECPs to engage in such transactions. However, the vast majority of commenters responding to the ANPRM, including both agricultural and non-agricultural interests,[92] supported treating agricultural swaps the same as other swaps,

[92] See summary of comments at III B above.

which would entail limiting participation in trade options (other than options on a DCM) to ECPs.

Given these facts, the Commission has determined to treat all trade options in the same manner as any other swap and thus limit participation to ECPs, unless the swap is transacted on a DCM.

C. Paperwork Reduction Act

Under the Paperwork Reduction Act (PRA),[93] an agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a currently valid control number from the Office of Management and Budget (OMB). The Commission believes that these proposed rules will not impose any new information collection requirements that require approval of OMB under the PRA. The Commission notes that these proposed rules will involve the withdrawal of certain provisions related to Commission forms, and will ultimately result in the expiration, cancellation, or removal of such forms.[94] Because the proposals would ultimately result in removing or deleting form filing and/or recordkeeping burdens, it will not result in the creation of any new information collection subject to OMB review or approval under the PRA.

As a general matter, these proposed rules would allow agricultural swaps and options to trade under the same terms and conditions as all other swaps and these proposed rules do not, by themselves, impose any new information collection requirements. Collections of information that may be associated with engaging in

[93] 44 U.S.C. 3501 et seq.

[94] The affected forms include any forms that relate to the agricultural trade option rules in current 17 CFR 32.13 and the dealer option rules in current 17 CFR 32.12.

agricultural swaps or options are, or will be, addressed within each of the general swap-related rulemakings implementing the Dodd-Frank Act. The Commission invites public comment on the accuracy of its estimate that no additional information collection requirements or changes to existing collection requirements would result from the rules proposed herein.

VIII. Proposed Rules

List of Subjects

17 CFR Part 3

Administrative practice and procedure, Brokers, Commodity futures, Reporting and recordkeeping requirements.

17 CFR Part 32

Commodity futures, Consumer protection, Fraud, Reporting and recordkeeping requirements.

17 CFR Part 33

Commodity futures, Consumer protection, Fraud, Reporting and recordkeeping requirements.

17 CFR Part 35

Commodity futures.

In consideration of the foregoing and pursuant to the authority contained in the Act, as indicated herein, the Commission hereby proposes to amend chapter I of title 17 of the Code of Federal Regulations as follows:

PART 3—REGISTRATION

1. Remove and reserve § 3.13 as follows:

§ 3.13 [Reserved.]

PART 32—REGULATION OF COMMODITY OPTION TRANSACTIONS

2. Revise part 32 to read as follows:

PART 32—REGULATION OF COMMODITY OPTION TRANSACTIONS

Sec.

32.1 Scope.

32.2 [Reserved.]

32.3 [Reserved.]

32.4 Commodity option transactions; general authorization.

32.5 [Reserved.]

32.6 [Reserved.]

32.7 [Reserved.]

32.8 Unlawful representations; execution of orders.

32.9 Fraud in connection with commodity option transactions.

32.10 Option transactions entered into prior to the effective date of this part.

32.11 [Reserved.]

32.12 [Reserved.]

32.13 [Reserved.]

Authority: 7 U.S.C. 1a, 2 note, 6c(b), and 6(c), unless otherwise noted.

§ 32.1 Scope.

Scope. The provisions of this part shall apply to all commodity option transactions, except for commodity option transactions on a contract of sale of a

commodity for future delivery conducted or executed on or subject to the rules of either a designated contract market or a foreign board of trade.

§ 32.2 [Reserved.]

§ 32.3 [Reserved.]

§32.4 Commodity option transactions; general authorization.

Subject to the provisions of this part, any person or group of persons may offer to enter into, enter into, confirm the execution of, maintain a position in, or otherwise conduct activity related to any transaction in interstate commerce that is a commodity option transaction, subject to all provisions of the Act, including any Commission rule, regulation, or order thereunder, otherwise applicable to any other swap.

§ 32.5 [Reserved.]

§ 32.6 [Reserved.]

§ 32.7 [Reserved.]

§ 32.8 Unlawful representations; execution of orders.

It shall be unlawful for:

(a) Any person required to be registered with the Commission in accordance with the Act expressly or impliedly to represent that the Commission, by declaring effective the registration of such person or otherwise, has directly or indirectly approved such person, or any commodity option transaction solicited or accepted by such person;

(b) Any person in or in connection with an offer to enter into, the entry into, or the confirmation of the execution of, any commodity option transaction expressly or impliedly to represent that compliance with the provisions of this part constitutes a guarantee of the fulfillment of the commodity option transaction;

(c) Any person, upon receipt of an order for a commodity option transaction, unreasonably to fail to secure prompt execution of such order.

§ 32.9 Fraud in connection with commodity option transactions.

It shall be unlawful for any person directly or indirectly:

(a) To cheat or defraud or attempt to cheat or defraud any other person;

(b) To make or cause to be made to any other person any false report or statement thereof or cause to be entered for any person any false record thereof; or

(c) To deceive or attempt to deceive any other person by any means whatsoever; in or in connection with an offer to enter into, the entry into, or the confirmation of the execution of, any commodity option transaction.

§ 32.10 Option transactions entered into prior to the effective date of this part.

Nothing contained in this part shall be construed to affect any lawful activities that occurred prior to the effective date of this part.

§ 32.11 [Reserved.]

§ 32.12 [Reserved.]

§ 32.13 [Reserved.]

PART 33—REGULATION OF DOMESTIC EXCHANGE TRADED COMMODITY OPTION TRANSACTIONS

3. Revise the part heading to read as follows:

PART 33—REGULATION OF COMMODITY OPTION TRANSACTIONS THAT ARE OPTIONS ON CONTRACTS OF SALE OF A COMMODITY FOR FUTURE DELIVERY

4. Revise paragraph (b) of § 33.2 to read as follows:

§ 33.2 Applicability of Act and rules; scope of part 33.

* * * * *

(b) The provisions of this part apply to commodity option transactions that are options on contracts of sale of a commodity for future delivery except for commodity option transactions that are options on contracts of sale of a commodity for future delivery conducted or executed on or subject to the rules of a foreign board of trade.

* * * * *

§ 33.4 Designation as a contract market for the trading of commodities.

5. Amend § 33.4 as follows:

a. Remove the words "or for options on physicals in any commodity regulated under the Act," in the introductory text;

b. Remove and reserve paragraph (a)(4) of § 33.4;

c. Remove and reserve paragraph (a)(5)(iv) of § 33.4;

d. Remove the words "or underlying physical" from paragraph (b)(1)(iii) of § 33.4; and

e. Remove the words ", options on physicals," from paragraph (d)(3) of § 33.4.

§ 33.7 Disclosure.

6. Amend § 33.7 as follows:

a. Revise the second paragraph of the Options Disclosure Statement in paragraph (b) of § 33.7 to read as follows:

* * * * *

(b) * * *

BOTH THE PURCHASER AND THE GRANTOR SHOULD KNOW THAT THE OPTION IF EXERCISED, RESULTS IN THE ESTABLISHMENT OF A FUTURES CONTRACT (AN "OPTION ON A FUTURES CONTRACT").

* * *

b. Remove the words "or underlying physical commodity" from paragraph (b)(1) of § 33.7 each time the words appear;

c. Remove the words "(e.g., commitment to sell the physical)" from paragraph (b)(1) of § 33.7 the first time the words appear;

d. Revise the final paragraph of paragraph (b)(1) of § 33.7 to read as follows:

(1) * * *

The grantor of a put option on a futures contract who has a short position in the underlying futures contract is subject to the full risk of a rise in the price in the underlying position reduced by the premium received for granting the put. In exchange for the premium received for granting a put option on a futures contract, the option grantor gives up all of the potential gain resulting from a decrease in the price of the underlying futures contract below the option strike price upon exercise or expiration of the option.

* * *

e. Remove the words "or physical commodity" from the introductory text of paragraph (b)(2) and in paragraph (b)(2)(i) of§ 33.7;

f. Remove the words "or underlying physical commodity" paragraph (b)(5) of § 33.7 both times the words appear and revise the final paragraph of paragraph (b)(5) to read as follows:

(5) * * *

Also, an option customer should be aware of the risk that the futures price prevailing at the opening of the next trading day may be substantially different from the futures price which prevailed when the option was exercised.

* * *

g. Remove the words "or underlying physical commodity" from paragraph (b)(6) of § 33.7;

h. Remove the words "or the physical commodity" and the words "or underlying physical commodity" from paragraph (b)(7)(ii) of § 33.7;

i. Remove and reserve paragraph (b)(7)(iv) of § 33.7;

j. Remove the words "or underlying physical commodity" from paragraph (b)(7)(v) of § 33.7; and

k. Remove the words "or underlying physical commodity" from paragraph (b)(7)(x) of § 33.7.

PART 35—EXEMPTION OF SWAP AGREEMENTS

7. Revise part 35 to read as follows:

PART 35—SWAPS IN AN AGRICULTURAL COMMODITY (AGRICULTURAL SWAPS)

Sec.

35.1 Agricultural swaps, generally.

Authority: 7 U.S.C. 2 note, 6c(b), and 6(c), unless otherwise noted.

§ 35.1 Agricultural swaps, generally.

(a) Any person or group of persons may offer to enter into, enter into, confirm the execution of, maintain a position in, or otherwise conduct activity related to, any transaction in interstate commerce that is a swap in an agricultural commodity subject to all provisions of the Act, including any Commission rule, regulation, or order thereunder, otherwise applicable to any other swap; and

(b) In addition to § 35.1(a), any transaction in interstate commerce that is a swap in an agricultural commodity may be transacted on a swap execution facility, designated contract market, or otherwise in accordance with all provisions of the Act, including any Commission rule, regulation, or order thereunder, applicable to any other swap eligible to be transacted on a swap execution facility, designated contract market, or otherwise.

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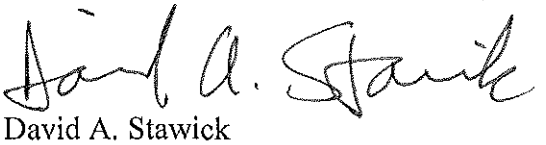
Issued in Washington, DC, on January 20, 2011, by the Commission.



David A. Stawick
Secretary of the Commission

Appendices to Commodity Options and Agricultural Swaps—Commission Voting Summary and Statements of Commissioners

NOTE: The following appendices will not appear in the Code of Federal Regulations

Appendix 1—Commission Voting Summary

On this matter, Chairman Gensler and Commissioners Dunn, Sommers, Chilton and O'Malia voted in the affirmative; no Commissioner voted in the negative.

Appendix 2—Statement of Chairman Gary Gensler

I support the proposed rulemaking to authorize agricultural swap and commodity option transactions and subject them to the same rules applicable to all other swaps. The Dodd-Frank Act prohibits such transactions if the Commission does not specifically authorize them. The Commission was informed on this proposal by the public comments received in response to an advanced notice of proposed rulemaking published in September of last year that addressed agricultural swaps. Those comments overwhelmingly supported treating agricultural swaps similarly to the treatment of other swaps brought under regulation by the Dodd-Frank Act. Agricultural producers, packers, processers and handlers will benefit from the ability to use agricultural swaps to hedge their risk and also will benefit from the transparency brought forth under the Dodd-Frank Act. I believe this proposed rulemaking provides an appropriate regulatory framework for the transaction of agricultural swaps and commodity options, and I look forward to hearing the public's views on this matter.