# The Role of Agricultural Over-the-Counter (OTC) Markets -- Legal Overview

What is an "Agricultural Commodity" for Purposes of the Commodity Exchange Act (CEA) and Why is "Agricultural Commodity" Status So Important to Regulators and Market Participants?

# Impact of the Commodity Futures Modernization Act of 2000 (CFMA)

- The CFMA established a tiered system whereby the degree of regulation depends on the commodities traded, the participants and the method of trading (e.g., intermediated trading vs. principal-to-principal trading; trading facility vs. bilateral trading).

- In this regulatory system, commodities that are more susceptible to manipulation (e.g., physical commodities) are subject to greater regulatory oversight than financial commodities, which are recognized as being less susceptible to manipulation.

- Whether or not a given commodity constitutes an "agricultural commodity" can, therefore, determine where and how it may be traded.

# The CEA Recognizes Three Types of Commodities

- An "excluded commodity" – An interest or exchange rate, a security, a macroeconomic index or other financial commodity (§ 1a(13)).

- An "exempt commodity" – "A commodity that is not an excluded commodity or an agricultural commodity." (e.g., energy commodities and metals) (§ 1a(14)).

- An "agricultural commodity," which term is not defined in the Act.

# CEA Provisions Relevant to Defining the Term, "Agricultural Commodity"

- The enumerated agricultural commodities listed in § 1a(4) of the CEA clearly are "agricultural commodities."

- These include, among other things, wheat, corn, cotton, rice, the soybean complex, livestock and livestock products.

- However, the concept is clearly broader than just the list of enumerated commodities.

- The House Report on H.R. 4541 – the closest thing we have to a "legislative history" of the CFMA – states that, "…[T]he Committee intends 'agricultural commodity' to include all agricultural commodities, whether or not such agricultural commodities are specifically enumerated in the definition of 'commodity' in section 1a of the CEA."

# CEA Provisions Relevant to Applying the Term, "Agricultural Commodity"

- Section 2(g) of the Act (the "swaps exclusion") completely excludes certain swap transactions from all provisions of the CEA, but the exclusion applies only to a "transaction in a commodity **other than an agricultural commodity**…"

- Section 2(h)(1) of the Act exempts certain bilateral transactions in "exempt commodities" from most provisions of the CEA.

- Section 2(h)(3) likewise exempts certain transactions in "exempt commodities" executed on an electronic trading facility (an exempt commercial market) from most CEA provisions.

- In both examples involving § 2(h), "agricultural commodities" may not be traded because an exempt commodity is, by definition, "**not…an agricultural commodity.**"

# The Regulatory Swaps Exemption CFTC Regulations, Part 35
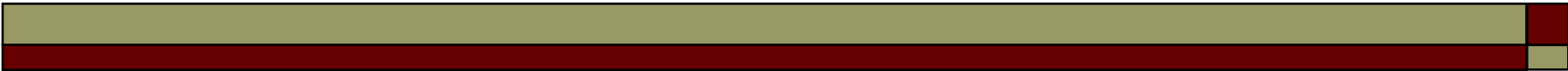
- Part 35, the "regulatory swaps exemption" that was in effect prior to the CFMA, remains on the books.

- By its terms, Part 35 applies to all swaps.

- However, with respect to non-agricultural commodities, Part 35 has been superseded by the CFMA (which added new § 2(g) to the CEA).

- As a practical matter, therefore, Part 35 applies only to agricultural swaps.

- The Part 35 conditions are similar to the § 2(g) swaps exclusion conditions, with one difference.

# Terms and Conditions Applicable to Agricultural Swaps Under Part 35

- Entered into solely between "eligible swap participants" (institutional and other sophisticated investors, including natural persons with assets exceeding $10,000,000).
  - Equivalent to "eligible contract participants," § 2(g)(1).
- The swap is "not part of a fungible class of agreements that are standardized as to their material economic terms."
  - Equivalent to "subject to individual negotiation," § 2(g)(2).
- The swap is "not entered into and traded on or through a multilateral transaction execution facility."
  - Equivalent to "not executed … on a trading facility," § 2(g)(3).
- The creditworthiness of any party to the swap "would be a material consideration" in entering into the swap.
  - In other words, the swap is not cleared – **there is no equivalent restriction in § 2(g).**

# Issues Affected by the Question: "What is an Agricultural Commodity?"

- For example, is denatured ethanol, which is derived from corn, an agricultural commodity?

  - If ethanol **is** an agricultural commodity, ethanol swaps may only be traded pursuant to the restrictions of Part 35.

    - Thus, for example, the swaps could not be cleared absent special exemptive relief from the Commission.

  - If ethanol is **not** an agricultural commodity, ethanol swaps meeting the § 2(g) conditions may be traded (and/or cleared) pursuant to § 2(g), excluded from all other provisions of the Act.

  - Furthermore, if ethanol is **not** an agricultural commodity, (or an excluded commodity) ethanol may also be traded on an exempt commercial market pursuant to § 2(h)(3) of the CEA.

# Additional Questions
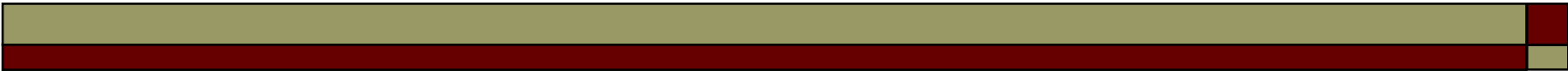
- Are coffee, sugar and cocoa agricultural commodities?

- Are pulp and paper agricultural commodities?

- Are corn basis swaps agricultural commodities?

- Are OTC contracts for items such as beef cuts or nonfat dry milk, which are intended to be submitted to an exchange for clearing, contracts for agricultural commodities?

# Additional Questions

- In each case, the status of a commodity as an "agricultural commodity" determines whether, and how, these commodities can be traded. As with ethanol:

  - If these **are** agricultural commodities, swaps involving the commodities may only be traded under the restrictions of Part 35.

    - Among other things, applying Part 35 would mean that OTC transactions involving the commodities could not be cleared (absent Commission exemptive relief).

  - If these are **not** agricultural commodities, swaps involving the commodities may be traded (and/or cleared) pursuant to § 2(g), excluded from all other provisions of the Act.

  - If these are **not** agricultural commodities (or excluded commodities), the commodities are "exempt commodities," eligible be traded on an exempt commercial market pursuant to § 2(h)(3) of the CEA.

# Drawing the Line Between Agricultural and Non-Agricultural

□ Some possible tests for distinguishing an agricultural vs. a non-agricultural commodity:

- **By source** – is it grown or cultivated; is it or was it alive?
- **By use or function** – is it used for human or animal food?
- **By correlation with other commodities** – does the market for the commodity behave like an agricultural market or a non-agricultural market? (For example, does ethanol trade more like corn or like an energy commodity?)
- **By degree of processing** – how much can a commodity be changed and still retain its status as an "agricultural commodity?"

# Drawing the Line Between Agricultural and Non-Agricultural

- For example, soybeans, soybean oil and soybean meal are all enumerated agricultural commodities. However, soybeans also provide the building blocks for hundreds of other products, from candles to crayons, fabric softeners to flooring, shampoos to solvents. Should any of these products be considered "agricultural commodities?"

# Options for the CFTC to Address the "Agricultural Commodity" Issue

- ☐ Propose a comprehensive definition of "agricultural commodity."

- ☐ Grant exemptions to clear agricultural swaps on a case-by-case basis in response to industry petitions involving individual products.

- ☐ Grant exemptions to clear agricultural swaps on a "class-by-class" basis, again in response to petitions (e.g., grant a blanket exemption permitting the clearing of livestock product swaps, such that swaps involving various types of beef cuts are all entitled to an exemption as involving "agricultural commodities," without requiring a separate petition for each product).

- ☐ Grant a blanket exemption making agricultural swaps subject to the same restrictions as non-agricultural swaps (i.e., subject to the § 2(g) exclusion), rendering the question, "what is an agricultural commodity?" moot, at least in the swaps context.