

CFTC letter No. 03-36
November 4, 2003
Interpretation
Division of Market Oversight

Robert S. Nichols, Esq.
Piper Rudnick
1200 Nineteenth Street, N.W.
Washington, D.C. 20036-2085

Re: Interpretation with regard to exemption under Rule 32.13(g)

Dear Mr. Nichols:

This is in response to your letter dated September 15, 2003, to the Division of Market Oversight (the "Division") as well as conversations with Division staff. By your correspondence you request, on behalf of your client, the Australian Wheat Board ("AWB"), an interpretive letter authorizing AWB's wholly-owned subsidiary, AWB (USA), Inc. ("AWBUS"), to conduct over-the-counter trading, both as an offeror and an offeree of agricultural trade option contracts, in accordance with the exemptive provisions of Section 32.13(g) of the Commission's regulations.

The Facts

We understand the facts to be as follows: AWB is Australia's major national grain asset manager and one of the world's largest wheat managers and marketers. AWB's core business is to serve the needs of Australian wheat growers by financing and marketing their grain. AWB is responsible for managing and marketing all Australian bulk wheat exports and is the world's second largest wheat exporter, with a 16% global market share (based on 2001-2002 figures). AWB has historically relied on U.S. futures markets to help manage market risk in connection with its operations, and has a long history of cooperation with the Commodity Futures Trading Commission ("Commission") and sensitivity to the requirements of Commission regulations.

AWB owns a number of subsidiaries, including AWB International, AWB Australia, and its US subsidiary, AWBUS, located in Portland, Oregon. Collectively, AWB and its various subsidiaries are known as the AWB Group. AWB's subsidiaries are involved in various aspects of AWB's core business, including grower services, grain trading, and international grain marketing and sales. All of AWB's subsidiaries are sophisticated merchants handling grain commodities, either directly or indirectly.

AWB is in the process of restructuring its Group-wide funding and supporting security arrangements. Under this restructuring, AWBUS would become part of a "commercial operations" business stream supported by the AWB Group's equity base. To facilitate its grain trading business, AWB seeks to

expand the functions of AWBUS to include trading in over-the-counter wheat options. It is anticipated that AWBUS would act as both an offeror and an offeree of such options and would enter into transactions with other affiliated AWB companies as well as other commercial counterparties. While AWBUS would not be directly producing, processing, using or handling grain commodities, it would be performing related market-making financial transactions. As stated in your September 15 letter:

In connection with its option trading activities:

- AWBUS, when acting as the **offeree** of an option, will comply with the conditions of 17 CFR §§ 32.13(g)(1)(i) and (ii). As further explained below, AWBUS will be, in effect, acting similarly to “a merchant handling” the wheat that is the subject of the options and will be entering into option transactions “solely for purposes related to its business as such.”
- AWBUS, when acting as the **offeror** of an option, will take steps to assure that it is dealing only with counterparties who meet the conditions of §§ 32.13(g)(1)(i) and (ii).
- AWBUS will at all times meet the \$10 million net worth requirement of § 32.13(g)(1)(iii), through either its net worth or a guarantee provided by AWB.
- AWBUS will deal only with counterparties who also meet the net worth requirement of § 32.13(g)(1)(iii).

As your letter further explains,

... while not, strictly speaking, a “first handler” of wheat, AWBUS will, in effect, be acting similarly to “a commercial user” or “a merchant handling” the wheat that is the subject of the option contracts, and it will be entering into option transactions “solely for purposes related to its business as such.”

That is because AWBUS will be entering into option transactions solely for the purpose of facilitating AWB’s wheat-trading businesses viewed as a whole. AWBUS is an integral part of what AWB calls its “Trading Group,” consisting of all its commercial grain trading operations, including the numerous companies that will continue to be conventional producers, processors, commercial users and merchants handling wheat commodities. As a result AWBUS is part of a network of closely related companies whose primary business purpose, collectively, is the commercial trading of wheat commodities.

Like the other AWB affiliates comprising the Trading Group, AWBUS is sophisticated in the wheat trade, and it would have the means, through one or more of its affiliated companies, to tender or accept physical delivery were it ever necessary to do so.

Legal Analysis

The legislative and regulatory history relating to options on agricultural commodities is long and rather convoluted.^[1] In 1936, responding to a history of price disruptions in the futures markets attributed to speculative trading in options, Congress completely prohibited options trading, both on- and off-exchange, in the specific list of enumerated agricultural commodities then under regulation (including

wheat).^[2] In 1974, Congress passed the Commodity Futures Trading Commission Act, creating the Commission and giving it jurisdiction over futures trading in all commodities, as well as plenary authority to regulate the offer and sale of commodity options. The Commission undertook various regulatory initiatives with respect to options on the newly regulated commodities.^[3] The Commission's actions included exempting "trade options" from most regulation, except for the prohibition on fraud.^[4] However, the earlier prohibition on options trading in the enumerated agricultural commodities remained in place as a consequence of both statutory provision and Commission rule. *See* Commission Regulation 32.2. This prohibition extended to both exchange-traded options on agricultural commodities and off-exchange agricultural trade options.

In 1982, responding to the success of a Commission pilot program that had allowed exchange-traded options in the non-enumerated commodities, Congress repealed the statutory ban on options in the enumerated agricultural commodities. The following year, the Commission implemented a pilot program allowing the reintroduction of exchange-traded options on the enumerated agricultural commodities.^[5] However, "in light of the lack of recent experience with agricultural options and because the trading of exchange-traded options is subject to more comprehensive oversight"^[6] the Commission left in place the regulatory ban on (off-exchange) agricultural trade options.

In June of 1997, the Commission published an advance notice of proposed rulemaking^[7] seeking comment on whether it should lift the prohibition on agricultural trade options and, if so, subject to what conditions. In November of 1997, the Commission published proposed rules to allow agricultural trade options.^[8] In April of 1998, the Commission published Interim Final Rules entitled, "Trade Options on the Enumerated Agricultural Commodities."^[9] The rules lifted the ban on agricultural trade options, but permitted only those entities that handled the commodity in normal cash market channels to buy or sell such options and required vendors of such options to register with the Commission as "agricultural trade option merchants" ("ATOMs") subject to various reporting, recordkeeping, disclosure and other requirements. However, the rules included an exemption^[10] for individuals and entities meeting a substantial net worth test and certain other requirements.^[11]

The issue raised by your letter is, then, whether AWBUS's proposed option trading activities would fall within the terms of the § 32.13(g) exemption. It is the Division's conclusion that AWBUS itself, and the agricultural trade option activities it proposes to undertake, as described in your letter, would fall within the § 32.13(g) exemption.

The primary issue is whether AWBUS, when acting as an offeree of agricultural trade options, would qualify as a "producer, processor, or commercial user of, or a merchant handling" wheat, which is entering into the option "solely for purposes related to its business as such," and which meets the \$10 million net worth standard.

With respect to the “producer, processor, or commercial user of, or a merchant handling” test, the April 1998 Interim Final Rules use exactly the same language to describe eligible vendors who (provided they also met the other requirements of the regulations) would be allowed to register as ATOMS. The preamble to the Interim Final Rules makes clear that the scope of the “producer, processor, merchant ...” language is not limited to “first handlers” of a commodity.

Although first handlers typically would be eligible to become agricultural trade option merchants, other categories of commercial users would also be eligible to apply for registration. ... Accordingly, grain merchants, investment bankers with active commodity trading operations and various types of agricultural processors or commercial users of the commodity might be eligible to register to operate as an agricultural trade option merchant.^[12]

Clearly, as used in the agricultural trade option regulations, the phrase, “producer, processor, or commercial user of, or a merchant handling” a commodity was intended to apply more broadly than to just first handlers of commodities. The Division believes that AWBUS’s proposed commercial wheat trading activities clearly fall within the Commission’s intent, as indicated by the above-quoted preamble language, in particular because: (1) AWBUS will be entering into option transactions solely for the purpose of facilitating the wheat trading activities of its corporate parent and affiliates; (2) the collective primary business purpose of AWBUS and its corporate parent and affiliates is the commercial trading of wheat commodities; and (3) AWBUS is sophisticated in the wheat trade and would have the means to tender or accept physical delivery of wheat, if necessary. Thus, the Division believes that AWBUS would fulfill the “producer, processor, merchant ...” and “business purposes” elements of the § 32.13(g) exemptive test.

With respect to the \$10 million net worth element of the test, AWBUS has pledged that it will at all times meet the requirement itself, through either its own net worth or a guarantee provided by AWB, and will deal only with counterparties who likewise meet the requirement.

Therefore, it is the Division’s opinion that AWBUS’s proposed agricultural trade option dealings, as described in your letter, would fall within the § 32.13(g) exemption. The position taken herein is based upon the representations you have made to the Division. Any different, changed, or omitted facts or conditions might require the Division to reach a different conclusion. You must notify the Division immediately in the event that there is any significant change from the facts presented to us concerning AWBUS’s agricultural trade options activities, as described in your letter. Further, this letter represents the position of the Division of Market Oversight only and does not necessarily represent the views of the Commission or any other division or office of the Commission.

If you have any questions concerning this correspondence, please contact Donald H. Heitman, an attorney on my staff, at (202) 418-5041.

Very truly yours,

Michael Gorham
Director

[1] For a comprehensive review of this history, see the preamble to the Commission’s Interim Final Rules for Trade Options on the Enumerated Agricultural Commodities, 63 FR 18821 (April 16, 1998).

[2] The specific agricultural commodities (generally referred to as the “enumerated commodities”) listed in the 1936 Commodity Exchange Act (“the Act”) included the grains, cotton, butter, eggs and potatoes. Later amendments to the Act added fats and oils, livestock, soybeans and other agricultural commodities.

[3] These newly-regulated commodities, which first came under Commission jurisdiction under the 1974 Act, included financial instruments, currencies, energy products, metals and “non-enumerated” agricultural commodities such as coffee, sugar and cocoa.

[4] A “trade option” is an off-exchange (over-the-counter) option offered to a commercial user who is entering into the option solely for purposes related to its business as such. *See* Commission Regulation 32.4.

[5] 48 FR 46800 (October 14, 1983).

[6] *Id.*

[7] 62 FR 31375 (June 19, 1997).

[8] 62 FR 59624 (November 4, 1997).

[9] 63 FR 18821 (April 16, 1998).

[10] §32.13(g) Exemption.

(1) The provisions of §§ 3.13, 32.2, 32.11 of this chapter and this section shall not apply to a commodity option offered by a person which has a reasonable basis to believe that:

(i) The option is offered to a producer, processor, commercial user of, or a merchant handling, the commodity which is the subject of the commodity option transaction, or the products or byproducts thereof;

(ii) 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; and

(iii) Each party to the option contract has a net worth of not less than \$10 million or the party's obligations on the option are guaranteed by a person which has a net worth of \$10 million and has a majority interest in, is owned by, or is under common ownership with, the party to the option.

(2) Provided, however, that § 32.9 [prohibiting fraud] continues to apply to such option transactions.

[\[11\]](#) Subsequently, the Commission proposed (64 FR 47452, August 31, 1999) and adopted (64 FR 68011, December 6, 1999) amendments to the agricultural trade option rules allowing cash settlement of agricultural trade options and further streamlining the regulatory requirements for ATOMs. The amendments did not, however, change the terms of the exemptive provisions.

[\[12\]](#) Id. 63 FR 18824.