

History and Current Policy on Agricultural Swaps and Agricultural Trade Options

Before the
Commodity Futures Trading Commission
Agricultural Advisory Committee
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Introduction

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History of Agricultural Swaps

- Pre-1989 – swap agreements (including agricultural swaps) subject to considerable legal uncertainty
- 1989 – Commission issues “Swaps Policy Statement,” creating a non-exclusive safe harbor for transactions meeting the statement’s criteria
- 1992 – CFTC reauthorization legislation gives the CFTC broad exemptive authority (§ 4(c)); Congress urges the Commission to issue an exemption promoting legal certainty for swaps
- 1993 – CFTC adopts Part 35, exempting swaps meeting certain criteria from the exchange trading requirement of the CEA
 - Part 35 applies to swaps on all commodities
 - Part 35 conditions covered on a later slide

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- 2000 – The Commodity Futures Modernization Act (CFMA) includes new § 2(g), the “swaps exclusion,” which supersedes Part 35 for most commodities
 - Section 2(g) applies to transactions in “a commodity other than an agricultural commodity;” § 2(g) conditions include:
 - Between “eligible contract participants”
 - Subject to individual negotiation by parties
 - Not executed or traded on a “trading facility”
 - **Part 35 remains in effect for “agricultural commodities”**

Policy: Conditions Governing Part 35 Agricultural Swaps

1. Entered into solely between “eligible swap participants” (ESPs)
 - ESP definition (§ 35.1(b)(2)(vi)) includes an entity “not formed solely for the specific purpose of constituting an ESP” with a net worth of \$1 million that enters into the swap to manage a risk in connection with its business
2. Not part of a fungible class of agreements that are standardized as to their material economic terms
3. Creditworthiness of any party would be a material consideration in entering the swap (i.e., not cleared)
4. Not entered into and traded on or through a multilateral transactions execution facility (i.e., not traded on an exchange)

Part 35 Does Not Apply to Options

- Part 35 defines a “swap agreement” to include “an agreement ... which is ... a commodity swap ... (including any option to enter into any of the foregoing).”
- However, the preamble to the original ATO rules notes that a commenter asked for clarification that the Part 35 swaps exemption (and not the § 32.13(g) exemption from the ATO rules) applies to off-exchange agricultural options
- The Commission replied: “Any off-exchange option on an enumerated agricultural commodity must comply with Commission rule 32.13(g) for exemption from the Act and Commission rules, and **no other exemptive provision is available.**”

Clearing of Agricultural Swaps

- Under criteria 2 & 3 of the Part 35 conditions, a swap on an agricultural commodity cannot be cleared (absent special relief)
 - Criterion 2 – fungibility
 - Criterion 3 – creditworthiness
- Clearing agricultural swaps would require an exemption under the Commission's general exemptive authority (§ 4(c) of the Act)

CME Group Petition

- On April 21, 2008, the CME Group submitted a petition asking the CFTC to exercise its § 4(c) authority to permit the clearing of corn basis swaps and corn, wheat and soybean calendar swaps
 - The petition was published for comment on July 7, 2008 (73 FR 38403)
 - The comment deadline is August 21, 2008
- On May 21, 2008, the CME Group submitted a more general petition asking the Commission to exercise its § 4(c) exemptive authority to amend Part 35 “to permit the clearing of standardized over-the-counter (‘OTC’) agricultural swaps, subject to appropriate condition to protect the market and market participants.”
 - The May 21 petition has not been published for comment

Ethanol swaps

- The Commission has already allowed the clearing of ethanol swaps without a § 4(c) petition
- This represents an implicit finding that ethanol is not an “agricultural commodity” for purposes of the CEA and, therefore, falls within the general § 2(g) swaps exclusion

Agricultural Trade Options

Trade Options Generally

Trade Option Definition:

A commodity option offered by a person which has a reasonable basis to believe that the option 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 byproducts 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.

(CFTC Regulations, § 32.4)

Regulatory Exemption

- Trade options are exempt from all CFTC regulations except:
 - § 32.8, prohibiting unlawful representations;
 - § 32.9, prohibiting fraud; and
 - § 32.2, a general prohibition against options in the “designated” agricultural commodities named in the Commodity Exchange Act (CEA), (including wheat, corn, oats, the soybean complex, livestock products and cotton), except as provided in the ATO regulations (§ 32.13)

Agricultural Trade Options

A Special Case

- As evidenced by the § 32.2 prohibition, agricultural trade options are subject to stricter regulatory treatment than trade options on other commodities, such as metals or energy products.
- The unique status of ATOs is a function of their statutory and regulatory history.

Statutory and Regulatory History of Agricultural Trade Options

- 1936 – Market problems blamed on speculative abuses result in the CEA including a ban on all options trading (on or off-exchange) in the then regulated designated agricultural commodities
- 1974 – CFTC is created and is given plenary authority over options trading in newly-regulated commodities (but statutory ban on options in designated agricultural commodities remains in place)

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- 1981 – Commission initiates pilot program in exchange-traded options in non-agricultural commodities
 - 1982 – Congress amends the CEA to delete statutory ban on agricultural options
 - 1984 – Exchange-traded agricultural options added to pilot program, but due to “lack of recent experience with agricultural options,” ATO prohibition remains in place

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- 1987 – Exchange-traded option program is made permanent (ATO prohibition remains)
 - 1991 – Commission proposes amending its regulations to lift the ban on ATOs (would have allowed ATOs to trade like trade options in other commodities, subject only to rules against misrepresentation and fraud)
 - 16 comments received, 9 for, 7 against

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- Opposing commenters include:
 - Chicago Board of Trade
 - National Grain Trade Council
 - National Grain and Feed Association
 - Cargill, Inc.
 - Proposed rules never acted upon
 - 1995 – Commission holds roundtable regarding ATO prohibition
 - 1997 – Commission publishes staff white paper, “Policy Alternatives Relating to ATOs and other Agricultural Risk-Shifting Contracts”

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- 1997 – Commission publishes Advance notice of proposed rulemaking (June) and then proposed rules (November) to permit ATOs subject to regulatory constraints
 - 1998 – Initial ATO regulations issued, including rules regarding: registration, risk disclosure, minimum financial requirements, reporting and recordkeeping, an exemption for parties with a \$10 million net worth, and a requirement that options must be settled by physical delivery
 - No firms seek registration under the program

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- 1999 – ATO rules revised to streamline reporting and disclosure requirements and to allow cash settlement
 - Only one firm registers as an Agricultural Trade Option Merchant (ATOM)
 - The registration is later withdrawn
 - There are currently no ATOM registrants and the ATO program is, effectively, inactive
 - 2000 – Commodity Futures Modernization Act (CFMA) modernizes futures regulation (from prescriptive rules to principles-based)

Current Regulatory and Market Situation

- The agricultural community needs all possible risk management tools to deal with current highly volatile agricultural markets
- The existing ATO program clearly is not helping anybody
- Producers and agribusiness interests have had an additional 10 plus years to develop further risk management expertise

Possible Alternative Approaches

1. Leave the present ATO rules in place

- Pro: easiest, the path of least resistance
- Con: does not address the agricultural community's risk management needs

2. Modify the ATO rules to make them more acceptable to potential registrants

- Pro: acceptable if workable regulations are possible
- Con: hard to visualize workable regulations
 - The current regulations have already been pared down to the bone
 - The only obvious potential logical change, reducing the net worth requirement to \$1 million, would disenfranchise smaller producers without reviving the ATO program

3.Revoke the ATO rules and allow ATOs to trade like other trade options

- **Pro:**

- Opens up new risk management possibilities for the agricultural community;
- Resolves legal uncertainty about existing products that may or may not be ATOs; and
- Reverses the CEA's paternalistic attitude and treats farmers like the operators of any other business

- **Con:** Opens producers up to the possibility of fraud and economic loss in a new, less-regulated environment

CFTC Staff Recommendations for ATOs

- Staff plans to recommend to the Commission a proposed rule amendment withdrawing the ATO regulations
- If approved by the Commission, the proposal would be published for comment in the Federal Register
- Members of the AAC are encouraged to comment orally at today's meeting and to file written comments in response to the Federal Register notice

The Status of ATOs if the ATO Regulations were to be Withdrawn:

- ATOs would be subject to the same conditions as trade options on all other (non-agricultural) commodities:
 - They could be offered only to a commercial, in connection with its business as a commercial
 - They would be exempt from all CFTC regulations except:
 - § 32.8, prohibiting unlawful representations; and
 - § 32.9, prohibiting fraud