



April 4, 2011

**Via Electronic Submission**

David A. Stawick, Secretary  
Commodity Futures Trading Commission  
Three Lafayette Centre  
1155 21st Street, NW  
Washington, DC 20581

**Re: Notice of Proposed Rulemaking Regarding Commodity Options and Agricultural Swaps (RIN 3038-AD21)**

Dear Mr. Stawick:

On February 3, 2011, the Commodity Futures Trading Commission (“CFTC” or “Commission”) published a Notice of Proposed Rulemaking regarding Commodity Options and Agricultural Swaps (“Proposed Rule”)<sup>1</sup> pursuant to Sections 721 and 723(c)(3) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”).<sup>2</sup> The Gavilon Group, LLC (“Gavilon”) appreciates the opportunity to provide the Commission with its comments regarding the Proposed Rule.

**I. Description of Gavilon and its Interest in the Proposed Rule**

Gavilon has a broad perspective as both an end-user of various over-the-counter and exchange-traded derivatives for hedging its commercial risk, and as a proprietary trader of such products. Gavilon is an active participant in the wholesale, physical commodity markets, including the markets for agricultural and energy commodities.

Gavilon’s agricultural operations serve farmers, livestock producers, the commercial food industry, dairy producers, feed manufacturers and industrial users. Gavilon provides origination and distribution, physical merchandising, storage, transportation, and logistics services for a variety of agricultural and fertilizer products, including: (i) corn products, such as distillers dried grains with solubles, wet distillers grain, hominy, gluten feed and corn oil; (ii) wheat products such as wheat midds, midd pellets, red dog, wheat bran, wheat germ and second clear flour; (iii) animal products such as beef meal, pork meal, bone meal, blood meal, feather meal, edible and inedible tallow, edible lard, choice white grease and yellow grease; (iv) oilseed products such as whole cottonseed, cottonseed meal, cottonseed hulls, canola meal, soy meal and soy hulls; (v) oil products such as cottonseed oil, corn oil, palm oil, canola oil and soybean oil; and (vi) dairy products. In addition, Gavilon operates a fertilizer distribution network and provides wholesalers with a wide array of bulk fertilizer products including nitrogen-based, phosphate-based and potash-based fertilizers. Gavilon’s energy operations provide physical storage and

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<sup>1</sup> *Commodity Options and Agricultural Swaps*, 76 Fed. Reg. 6095 (Feb. 3, 2011).

<sup>2</sup> Pub. L. No. 111-203, 124 Stat. 1376 (2010) (to be codified as an amendment to the Commodity Exchange Act (“CEA”) in various sections of 7 U.S.C. ch. 1).

transportation services at major North American hubs for crude oil, ethanol, natural gas and natural gas liquids, and provide a range of risk management and hedging services associated with inventory positions and forward contracts.

Gavilon uses futures, swaps and other derivatives products to manage the risks that it incurs as a commercial participant in the agricultural and energy commodity markets. In certain circumstances, Gavilon currently provides its physical agricultural and energy market customers with ancillary risk management services related to their cash market business. These transactions, which naturally flow from and are ancillary to Gavilon's physical commodity businesses, help Gavilon's agricultural and energy market customers to manage their commercial risk in an efficient and cost-effective manner. Gavilon then uses futures and swaps to manage its exposure associated with these ancillary risk management transactions.

Gavilon has an important interest in how the Commission regulates agricultural swaps and commodity options. The CFTC's rules governing agricultural swaps and commodity options will have a significant impact on the risk management alternatives available to Gavilon and its counterparties and, thus, their ability to provide a reliable supply of competitively priced agricultural products to consumers throughout the country.

## **II. Summary of Comments**

Gavilon respectfully submits that the Commission should adopt a final rule that:

- Treats agricultural swaps and other commodity swaps consistently and expressly permits eligible contract participants ("ECPs") to trade agricultural swaps on swap execution facilities; and
- Excludes from the definition of swap all commodity options that by their terms require physical delivery when exercised or, in the alternative, issue an order under CEA Section 4c(b) allowing market participants to enter into physically settled options subject to commercially reasonable conditions.

## **III. Treatment of Agricultural Swaps under the Proposed Rule**

Gavilon supports the Commission's decision to treat agricultural swaps and other commodity swaps consistently under the Proposed Rule.<sup>3</sup> Gavilon believes that such treatment is consistent with how agricultural swaps have historically been regulated under the CEA, and how

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<sup>3</sup> The treatment of agricultural swaps under the Proposed Rule is generally consistent with comments Gavilon filed in response to the Advance Notice of Proposed Rulemaking issued on September 28, 2010. *See Agricultural Swaps*, 75 Fed. Reg. 59666 (Sept. 28, 2010), Gavilon Comments to Agricultural Swaps Advance Notice of Proposed Rulemaking and Agricultural Commodity Definition Notice of Proposed Rulemaking at 4 (filed Oct. 28, 2010).

Congress intended for these transactions to be regulated under the Dodd-Frank Act.<sup>4</sup> Under Section 723(c)(3) of the Dodd-Frank Act, agricultural swaps only may be entered into pursuant to an exemption issued by the Commission under CEA Section 4(c).<sup>5</sup> CEA Section 4(c)(2) provides that the Commission shall not grant an exemption unless it finds that: (i) the exemption is consistent with the public interest; (ii) the agreement, contract or transaction will be entered into between “appropriate persons”; and (iii) the agreement, contract or transaction will not have a material adverse effect on the ability of the Commission or any designated contract market to discharge its duties under the CEA.<sup>6</sup>

The Dodd-Frank Act introduces a robust regulatory regime and provides for increased oversight of all swaps. Gavilon respectfully submits that this new regulatory regime, if applied to agricultural swaps, would satisfy each of the criteria in CEA Section 4(c).<sup>7</sup> Accordingly, there is no reason to impose additional obligations on agricultural swaps. On the contrary, imposing additional obligations on agricultural swaps could disrupt an otherwise well-functioning market. Gavilon believes that the costs associated with additional regulation would outweigh the potential benefits and could inadvertently result in fewer hedging alternatives for agricultural market participants seeking to manage their commercial risk.

#### **IV. The Commission Should Interpret the Definition of Swap to Exclude Physical Options**

Under the Proposed Rule, “[a]ll options on physicals would now be regulated as swaps . . . .”<sup>8</sup> According to the Commission, regulating all commodity options in the same

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<sup>4</sup> Current Part 35 provides an exemption for bilateral agricultural swaps between eligible swap participants that is similar to the exemption Congress provided for swaps in exempt commodities between ECPs under the Commodity Futures Modernization Act of 2000.

<sup>5</sup> Dodd-Frank Act § 723(c)(3) (“Except as provided in subparagraph (B), no person shall offer to enter into, enter into, or confirm the execution of, any swap in an agricultural commodity . . . . Notwithstanding [the above], a person may offer to enter into, enter into, or confirm the execution of any swap in an agricultural commodity pursuant to Section 4(C) of the [CEA] or any rule, regulation, or order issued thereunder . . . by the [Commission] to allow swaps under such terms and conditions as the Commission shall prescribe.”). *See also* 76 Fed. Reg. at 6097. Although CEA Section 4(c) was amended by the Dodd-Frank Act, its function and effect have not changed for the purposes of the Proposed Rule. *See* 76 Fed. Reg. at 6101, n.49.

<sup>6</sup> CEA § 4(c)(2), 7 U.S.C. § 6(c).

<sup>7</sup> Applying the same regulatory regime to agricultural swaps is in the public interest as it will promote regulatory certainty in commodity markets by allowing market participants to structure documentation and compliance protocols consistently across commodity desks. In addition, under the Dodd-Frank Act all swaps may only be entered into by ECPs. By applying this requirement to agricultural swaps, the Commission would ensure that the exemption applies to “appropriate persons.” Moreover, consistent treatment of all swaps would actually assist the Commission and exchanges discharge their duties under the CEA by bringing more transparency to the OTC derivatives markets. The Commission will also retain its authority to prevent manipulation, as the Proposed Rule would not exempt agricultural swaps or commodity options from the anti-manipulation provisions of the CEA and the CFTC’s Regulations.

<sup>8</sup> 76 Fed. Reg. at 6103.

manner, regardless of whether a transaction is intended to be physically or financially settled, is appropriate because all “commodity options (other than options on futures) clearly fall within the Dodd-Frank Act definition of swap.”<sup>9</sup> Gavilon respectfully submits that Congress did *not* intend for all “options on physical commodities . . . [to be included] within the Dodd-Frank swap definition.”<sup>10</sup> Rather, Gavilon believes that when the definition of “swap” is read in its entirety it is apparent that Congress intended for the Commission to regulate commodity options and swaps in a manner that distinguishes between financial products (*e.g.*, options and other swaps that by their terms require financial settlement) and physical products (*e.g.*, options that by their terms require physical delivery when exercised (“Physical Options”) and forward contracts). Such an interpretation is consistent with the plain language of the Dodd-Frank Act, the CFTC’s own long-standing precedent, and the risk management practices of many commercial commodity market participants.

CEA Section 1a(47) defines “swap” broadly to encompass many common types of financial derivatives, including any agreement, contract or transaction:

“for the exchange, on a fixed or contingent basis, of 1 or more payments based on the value or level of 1 or more . . . commodities . . . and that transfers, as between the parties to the transaction . . . the *financial* risk associated with a future change in any such value or level without also conveying a current or future direct or indirect ownership interest in an asset . . . ;”<sup>11</sup> or

“that is . . . [an] option of any kind . . . for the purchase or sale, or based on the value, of 1 or more . . . commodities . . . or other *financial* or *economic* interests or property of any kind.”<sup>12</sup>

The definition of “swap” also expressly excludes “any sale of a *nonfinancial* commodity or security for deferred shipment or delivery, so long as the transaction is intended to be *physically* settled.”<sup>13</sup> When read as a whole, the definition of “swap” effectively distinguishes between two basic categories of commodity market activity: *financial* transactions, which are subject to regulation under the CEA; and *physical* transactions, which are generally excluded from, or in the case of options, subject to different, regulation by the CFTC. The text and structure of the Dodd-Frank Act indicates that Congress only intended to include options that require financial settlement and other financial products in the definition of “swap.”

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<sup>9</sup> *Id.* at 6101.

<sup>10</sup> *Id.* at 6095.

<sup>11</sup> Dodd-Frank Act § 721(a)(21) (to be codified at CEA § 1a(47)(A)(iii)) (emphasis added). Read literally, this provision would include *every* option contract for the purchase or sale of property, potentially including options to purchase real estate and countless other contractual arrangements that are wholly unrelated to derivatives markets. Gavilon doubts that the Commission intends such a result.

<sup>12</sup> *Id.* at § 721(a)(21) (to be codified at CEA § 1a(47)(A)(i)) (emphasis added).

<sup>13</sup> *Id.* at § 721(a)(21) (to be codified at CEA § 1a(47)(B)(ii)) (emphasis added).

Gavilon believes that, consistent with the distinction between financially and physically settled transactions in the Dodd-Frank Act, Physical Options should be treated as a separate category of transactions comparable to forward contracts excluded from the definitions of future delivery and swap. Commodity market participants use Physical Options and forward contracts to manage similar commercial needs and risks. For example, commercial entities use Physical Options to guarantee that they will be able to make or take delivery of an essential physical commodity at a predetermined price, place, and time. This type of risk management activity takes various forms, but is based on the ability to physically settle the transaction:

- A grain elevator may purchase a series of physical call options on wheat to ensure that it has sufficient supply to meet the demand of its wholesale customers. If the grain elevator's standard source of wheat is disrupted, it can exercise its call options to guarantee that a sufficient supply of the physical commodity will be available to meet its commercial needs.
- A biofuel refinery may purchase ethanol put options to protect against an unexpected decline in demand for its product. Volatility in gasoline prices may temporarily prevent the refinery from selling its product economically. If the refinery has limited storage capacity, its inability to sell the ethanol it has produced could force the facility to curtail its operations. However, if the refinery exercises its put options it will be able to sell its ethanol and, more importantly, avoid the costs associated with capacity constraints and production curtailment by continuing to operate at full productivity.

As both examples demonstrate, commercial entities that use Physical Options physically settle these transactions when the option is exercised. Like forward contracts where actual delivery of the commodity may, at times, be deferred for purposes of commercial convenience or necessity, Physical Options are "intended to be physically settled" subject only to the condition that the option holder elects to exercise its right to make or take delivery.<sup>14</sup> Indeed, the ability to make or take delivery of a physical commodity is what distinguishes Physical Options from financial products and makes them an important risk management instrument for many commercial entities.

Regulating all options as swaps would subject Physical Options to regulatory requirements that are incompatible with how physical commodity transactions have been

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<sup>14</sup> 156 Cong. Rec. H5247 (daily ed. Jun. 30, 2010) (statement by Rep. Peterson); *The Regulation of Leverage Transactions as Contracts for Future Delivery or Otherwise*, Exhibit 1 – Memorandum from the Office of the General Counsel to the Commission, September 5, 1978, as amended September 17, 1978, 44 Fed. Reg. 13494, 13498 (Mar. 12, 1979); Dodd-Frank Act § 721(a)(21) (to be codified at CEA § 1a(47)(B)(ii)).

regulated by the CFTC and are currently used by commercial entities to manage risk.<sup>15</sup> For example, some commercial entities in the commodity markets offer Physical Options to their cash market customers as an ancillary risk management service. Physical Options allow end-users of agricultural and energy commodities to manage their exposure to supply and price disruptions in an efficient and cost-effective manner by providing a physical hedge that can be highly customized in terms of the specific type of commodity, the specific delivery location, and the specific delivery time. Currently, market participants can enter into Physical Options subject only to the condition 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 the entity is offered or enters into the transaction solely for purposes related to its business.<sup>16</sup> However, under the Proposed Rule, even though the commercial entities that provide Physical Options are not “dealers” in any conventional sense, Physical Options would be treated as swaps, potentially causing these entities to fall within the Commission’s proposed broad definition of “swap dealer.”

To avoid the significant regulatory requirements associated with registering as a swap dealer, some commercial entities may stop entering into Physical Options, reducing the market for this product. Without a customized, cost-effective method for managing physical commodity risk, market participants will be required to rely on more costly, uncertain, and less-efficient hedging alternatives.<sup>17</sup> Gavilon believes that this would be disruptive to commercial entities that currently rely on Physical Options and contrary to the risk-reducing objectives of the Dodd-Frank Act.<sup>18</sup>

In the alternative, Gavilon urges the Commission to issue an order pursuant to CEA Section 4c(b) that allows commercial entities to enter into Physical Options subject only to

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<sup>15</sup> Over-the-counter physical options historically have been treated differently from futures contracts and other financial products. *See, e.g., Characteristics Distinguishing Cash and Forward Contracts and “Trade” Options*, 50 Fed. Reg. 39656, 39657 (Sept. 30, 1985).

<sup>16</sup> 17 C.F.R. § 32.4.

<sup>17</sup> In addition, Gavilon believes that Physical Options, as they are currently used by commodity market participants, are not compatible with the standardized, exchange-based model contemplated for swaps under the Dodd-Frank Act. It would be impractical for designated contract markets and swap execution facilities to support physical delivery in a timely manner for most of the commodities and delivery locations currently used by commercial market participants. Although the Dodd-Frank Act permits the Commission to determine that a swap, group of swaps, or class of swaps is not subject to mandatory clearing (and, therefore, mandatory exchange trading) under certain circumstances, it is unclear when the Commission would, in fact, determine that a class of transactions is not subject to mandatory clearing. Dodd-Frank Act § 723(a)(3) (to be codified at CEA § 2(h)(2)(D)(ii)(II)). Given the unique complexities associated with physical commodity transactions, Gavilon believes that the simpler and more practical approach is for Commission to follow Congress’s intent and exclude Physical Options from the definition of “swap.”

<sup>18</sup> The Commission has explained that the Dodd-Frank Act amended the CEA “to establish a comprehensive new regulatory framework . . . to reduce risk, increase transparency, and promote market integrity within the financial system . . . .” 76 Fed. Reg. at 6095.

conditions that are comparable to the requirements in current Part 32.4.<sup>19</sup> CEA Section 4c(b) prohibits commodity options except pursuant to a “rule, regulation, or order of the Commission . . . allowing any such transaction under such terms and conditions as the Commission shall prescribe.”<sup>20</sup> If Physical Options are not excluded from the definition of “swap,” Gavilon believes that it would be in the public interest for the Commission to use its authority under Section 4c(b) to permit market participants to enter into Physical Options if certain conditions are satisfied. For example, relief under CEA Section 4c(b) could be limited to Physical Options that are entered into between two ECPs provided that they maintain Commission-specified records.<sup>21</sup>

## V. Conclusion

Gavilon appreciates the Commission’s efforts to implement the various provisions of the Dodd-Frank Act in a manner that minimizes the burdens for commercial entities and other market participants. We submit our comments to ensure that the Commission has a fuller understanding of how the markets for physical commodities operate so that it may craft its rules in a way that avoid unintended adverse effects on the markets.

We welcome the opportunity to discuss these issues further with the Commission and its Staff. Please contact the undersigned at 402-889-4026, if you have any questions regarding Gavilon’s comments.

Respectfully submitted,



Lance Kotschwar  
Senior Attorney

cc: Honorable Gary Gensler, Chairman  
Honorable Michael Dunn, Commissioner  
Honorable Jill E. Sommers, Commissioner  
Honorable Bart Chilton, Commissioner  
Honorable Scott O’Malia, Commissioner  
Dan M. Berkovitz, General Counsel

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<sup>19</sup> CEA § 4c(b).

<sup>20</sup> *Id.*

<sup>21</sup> *See* CEA § 4c(b). Even if it excludes Physical Options from the definition of “swap,” CEA Section 4c(b) still provides the Commission with the authority to prohibit any option that is “contrary to any rule, regulation, or order of the Commission.” *Id.*