

April 11, 2011

By Electronic SubmissionDavid A. Stawick
Secretary
Commodity Futures Trading Commission
1155 21st Street, N.W.
Washington, DC 20581**Re: Commodity Options and Agricultural Swaps
Notice of Proposed Rulemaking (RIN 3038-AD21)**

Dear Mr. Stawick:

We submit these comments on behalf of our clients, the Commodity Options and Agricultural Swaps Working Group (the "Working Group") in response to the Commodity Futures Trading Commission's ("Commission" or "CFTC") February 3, 2011, Notice of Proposed Rulemaking regarding agricultural commodity swaps and commodity options (the "Proposed Rule").¹ The Working Group is comprised of diversified financial institutions that provide risk management and investment products, including commodity options and swaps, to producers, processors, merchants handling, and users of physical commodities. The Working Group supports the Commission's efforts to promote market integrity within the commodity markets, and appreciates the opportunity to comment on the appropriate framework for rules governing the trading of commodity options and agricultural swaps.

I. SUMMARY OF COMMENTS

Section 723(c)(3) of Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act")² prohibits market participants from entering into swaps based on agricultural commodities except pursuant to an exemption or rules issued by the Commission under Section 4(c) of the CEA, as amended.³ The Commission's Proposed Rule would apply the same rules and regulations to agricultural swaps that apply to all other swaps. In addition, new CEA § 1a(47)(A)(i) includes within the definition of "swap" certain options transactions. The Proposed Rule would regulate all commodity options as swaps.

¹ Commodity Options and Agricultural Swaps, 76 Fed. Reg. 6095 (Feb. 3, 2011).

² Pub. L. No. 111-203 (2010) (to be codified as an amendment to the Commodity Exchange Act ("CEA") in 7 U.S.C. ch.1).

³ 7 U.S.C. § 6(c).

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The Working Group supports the Commission's proposal to implement a uniform regulatory scheme for all swaps. Regulating all swaps, including agricultural swaps, in the same manner will increase legal certainty and enable market participants to structure and manage their businesses in an efficient manner.

The Working Group requests, however, that the Commission reconsider its proposal to regulate options on physical commodities as swaps. In the Dodd-Frank Act, Congress preserved the Commission's authority under CEA 4c(b) to regulate options on physical commodities as a third category of transaction separate from swaps and futures. To maintain this commercially practical regulatory approach that market participants have relied upon for decades, the Commission should issue an order, pursuant to its statutory authority under Section 4c(b) of the CEA, permitting options on physical commodities to be traded subject only to the conditions that the transaction: (1) is intended to be physically settled upon exercise, and (2) meets the requirements currently set forth in Commission Regulation 32.4 for trade options. If the Commission does not accept the Working Group's recommendation, it should defer issuing a rule governing transactions in options on physical commodities until after the Commission has issued final regulations defining the term "swap." Finally, we request that the Commission clarify that the "prompt execution" requirement in proposed Rule 32.8(c) does not apply to OTC commodity options that are formed following bilateral negotiations between market participants transacting at arm's-length.

II. THE PROPOSED RULE'S TREATMENT OF AGRICULTURAL SWAPS

A. Regulating Agricultural Swaps Consistently as Other Commodity Swaps is in the Public Interest

The Working Group supports the Commission's Proposed Rule as an appropriate regulatory framework for transacting in agricultural swaps. Given the increased oversight of all swaps under the Dodd-Frank Act, regulating agricultural swaps on an equivalent basis with other commodity swaps is consistent with the Dodd-Frank Act's stated goal of bringing more transparency to the over-the-counter ("OTC") derivatives markets.⁴ It also will make it possible for market participants to conduct their businesses subject to a uniform set of rules across commodities. By applying the same regulatory structure and requirements to agricultural swaps as to other commodity swaps, the Proposed Rule will promote legal certainty and an efficient allocation of compliance resources.

⁴ Treating bilaterally executed agricultural swaps on an equivalent basis with other commodity swaps also is consistent with the manner in which they historically have been regulated under the CEA. For example, Part 35 of the Commission's rules currently provides an exemption for bilateral agricultural swaps between eligible swap participants that is very similar to the exemption that Congress provided for swaps in exempt commodities between ECPs in the Commodity Futures Modernization Act.

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There is no public policy reason to impose different or additional regulatory requirements on the agricultural swaps market. Under the Proposed Rule, agricultural swaps will be subject to the same comprehensive regulation as all other swaps. The costs of imposing an alternative regulatory structure on this important and well-functioning market would substantially outweigh any potential benefits. It also could make it more difficult for agricultural market participants to hedge their commercial risks – a result that would be inconsistent with the goals of the Dodd-Frank Act.

B. Regulating Agricultural Swaps Consistently with Other Commodity Swaps Meets the Statutory Requirements for an Exemption

Section 4(c)(2) of the CEA provides that the Commission shall not exempt an agreement, contract or transaction from particular requirements of the CEA unless it determines that:

- the requirement should not be applied to the agreement, contract, or transaction for which the exemption is sought and the exemption is consistent with the public interest and the purposes of the CEA;
- the agreement, contract or transaction will be entered into between “appropriate persons;” and
- the agreement, contract or transaction will not have a material adverse effect on the ability of the Commission or any designated contract market (“DCM”) to discharge its duties under the CEA.

The Commission’s proposed regulations for agricultural swaps satisfy each of these requirements.

As in other industries, many agricultural market participants rely on swaps to hedge because the commodity-type, volume, tenor or delivery point of the underlying risk may not equate precisely to standardized futures contracts. Allowing market participants to enter into customized agricultural swaps on the same basis as other commodity swaps is consistent with the public interest because it will enable them to hedge commercial risks that they cannot otherwise hedge using futures contracts. In addition, as the Commission correctly notes in the Proposed Rule, “[p]ermitting 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.”⁵

⁵ 76 Fed. Reg. at 6103.

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Under the Proposed Rule, only appropriate persons could enter into agricultural swaps because both parties must be ECPs. Moreover, the Proposed Rule will not have a material adverse effect on the ability of the Commission or any DCM to discharge its duties under the CEA because agricultural swaps would be subject to the full panoply of regulations applicable to all other swaps. For all of these reasons, the Commission should issue those portions of the Proposed Rule applicable to agricultural swaps as proposed.

III. THE PROPOSED RULE'S TREATMENT OF COMMODITY OPTIONS

The Working Group respectfully requests that the Commission reconsider its proposal to regulate all options on physical commodities as swaps, including those that are intended to be physically settled upon exercise ("Physical Commodity Options"). We recommend instead that the Commission should issue an order, pursuant to its plenary authority to regulate commodity options under Section 4c(b) of the CEA, permitting market participants to trade Physical Commodity Options subject to specified terms and conditions. Otherwise, we request that the Commission defer issuing final regulations for transacting in such options until after the Commission has further defined the term "swap."

A. Congress Maintained the Commission's Authority to Regulate Physical Commodity Options as a Separate Category of Transactions

Section 4c(b) of the CEA, which delineates the Commission's authority to regulate commodity option transactions, provides that "no person shall offer to enter into, enter into or confirm the execution of, any transaction involving any commodity . . . which is commonly known in the trade as an 'option' . . . contrary to any rule, regulation, or order of the Commission . . . allowing any such transaction under such terms and conditions as the Commission shall prescribe."⁶

Congress, when it enacted the Dodd-Frank Act, did not eliminate or amend Section 4c(b). If Congress had intended to regulate all options on physical commodities as swaps, it would have deleted or revised the CFTC's authority in CEA Section 4c(b) to regulate the terms and conditions under which market participants can enter into such transactions.⁷ Instead, Congress

⁶ 7 U.S.C. § 6c(b).

⁷ The Commission has consistently regulated commodity options as a separate category of transaction. In 1976, the Commission issued Rule 32.4, known as the "Trade Option Exemption," which specifies the conditions under which persons can enter into options on all commodities other than enumerated agricultural commodities. The applicability of Rule 32.4 to Physical Commodity Options is apparent from its requirement that an option only be 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." 17 C.F.R. § 32.4. This requirement demonstrates the CFTC's historic approach of imposing different requirements on "commercial commodity option transactions with certain users, producers or consumers." See Proposed Amendments Concerning Trade Options and Other Exempt Commodity Options, 56 Fed. Reg. 43,560 (proposed Sep. 3, 1991).

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retained the Commission's authority to regulate options as a separate category of transaction. To give effect to its continuing authority to regulate options on physical commodities, the Commission should not regulate such options as swaps to the extent that the parties intend to physically settle them by delivering the commodity purchased. Otherwise, it will render Section 4c(b) meaningless.

In addition to retaining the CFTC's 4c(b) plenary authority to regulate options, Congress repeatedly included separate references to "option" and "swap" in the same sections of the CEA as amended by the Dodd-Frank Act.⁸ If Congress had intended that all commodity options be regulated as swaps, the separate references to an option throughout the CEA would not have been necessary. The language of a statute "should be construed so that effect is given to all its provisions, so that no part will be inoperative or superfluous, void or insignificant, and so that one section will not destroy another unless the provision is the result of obvious mistake or error."⁹ The Commission should give effect to all provisions of the CEA applicable to options by exercising its authority under 4c(b) to regulate Physical Commodity Options as a separate category of transactions.¹⁰

B. Physical Commodity Options Should Not be Regulated as Swaps

The buyer of a commodity option that calls for physical settlement would exercise the option if it is in the money, *i.e.*, the cost of buying the commodity in the spot market is greater than the purchase price of the commodity under the option. Once exercised, an option on a physical commodity becomes a spot (or forward) commodity contract that is excluded from the

⁸ See, e.g., 7 U.S.C. §§ 6c(a)(1), (3)(B) and (C), (4)(A)(ii) and (iii), (4)(B)(ii) and (iii), (4)(C)(ii) and (iii); see also CEA § 2(a)(1) (providing the CFTC with exclusive jurisdiction over "accounts, agreements (including any transaction which is of the character of, or is commonly known to the trade as, an option, . . .), and transactions involving swaps . . . "); 7 U.S.C. § 6a(a)(7) (the CFTC can exempt from Commission set position limits "any swap or class of swaps, . . . [or] any option or class of options. . .").

⁹ Norman J. Singer and J.D. Shambie Singer, *Sutherland Statutory Construction*, 2A § 46:6 (7th ed. 2007).

¹⁰ The Commission also could construe the definition of "swap" as excluding options on physical commodities. Historically, Congress and the CFTC have differentiated between physical and financial transactions, in part, through the forward contract exclusion in the definition of "future delivery" in CEA Section 1a(27). In the Dodd-Frank Act, Congress retained the forward contract exclusion. It also provided an express exclusion in the definition of the term "swap" for "any sale of a nonfinancial commodity . . . for deferred shipment or delivery, so long as the transaction is intended to be physically settled." This language supports the conclusion that Congress intended to exclude from the definition of swap, transactions that the parties intend to settle by physical delivery. As noted above, options on physical commodities, by their terms, require physical delivery once exercised. Moreover, Congress' use of the clause "financial or economic" to describe the interests or property underlying those options included within the definition of "swap," instead of the term "option" as defined in CEA Section 1a(36), provides the Commission with further support to conclude that Congress intended to exclude options on physical commodities from the definition of swap.

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CFTC's jurisdiction. For the same reasons that spot and forward contracts are not considered futures contracts, we believe that Physical Commodity Options should not be regulated as swaps.

Since trade options entered into for physical settlement are offered to and entered into with producers, processors, merchants handling, or commercial users of, the physical commodity, all of which are end users, including Physical Commodity Options within the term "swap" would not further the public policy goals of mandatory transaction execution and clearing under the Dodd-Frank Act. Because end users are eligible for the end user clearing exception, the liquidity necessary to make Physical Commodity Options available to trade on swap execution facilities or clear through DCOs would not develop, especially since they call for physical delivery. Once exercised, those options give the holder the right to deliver or receive the underlying commodity at the specified delivery point. Focusing just on agricultural, metals, and energy commodities, there are potentially tens of thousands of delivery points specified in options on physical commodities. Aside from the question of liquidity, DCOs are not an efficient forum for the delivery process for physical commodities at thousands of delivery points throughout the United States.¹¹ Because the Dodd-Frank Act maintained the Commission's authority to regulate options on physical commodities, and because of the inefficiencies of regulating Physical Commodity Options as swaps, the Commission should regulate such options as a separate category of transaction.

C. The Commission Should Issue an Order Permitting Parties to Transact in Physical Commodity Options Subject to Specified Terms and Conditions

As the Commission emphasizes in the Proposed Rule, "commodity options have been subject to the Commission's plenary authority under CEA Section 4c(b)."¹² Pursuant to this authority, the Commission historically has determined the conditions required for trading in commodity options.

The Working Group recommends that the Commission continue to regulate options on physical commodities separately from swaps and futures contracts. The Commission should issue an order, pursuant to Section 4c(b), permitting market participants to trade in options on physical commodities subject only to the conditions that the transaction is intended to be

¹¹ Furthermore, transactions that might be viewed as the sale of options on electricity (such as the sale of power plant capacity) and natural gas are subject to the jurisdiction of the Federal Energy Regulatory Commission. In Texas, transactions that might be viewed as the sale of electricity options are regulated by the Public Utilities Commission of Texas. In new CEA Section 4(c)(6), Congress gave the CFTC express authority to exempt transactions made pursuant to a FERC-approved tariff from some or all requirements of the CEA and the Commission's regulations.

¹² 76 Fed. Reg. at 6098.

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physically settled upon exercise, and meets the requirements currently set forth in Part 32.4 for trade options.

D. In the Alternative, the Commission Should Defer Issuing a Final Regulation Applicable to Physical Commodity Options Until the Commission Further Defines the Term “Swap”

If the Commission does not use its authority under Section 4c(b) to regulate Physical Commodity Options as a separate category of transactions, the Working Group respectfully requests that the Commission defer issuing any final regulations with respect to Physical Commodity Options until after the Commission has issued a final rule further defining the term “swap.” The Commission’s decision about whether to include Physical Commodity Options in the definition of swap will have a significant impact on market participants who transact in options on physical commodities. Market participants can provide more meaningful comments on the Commission’s Proposed Rule once the Commission provides more clarity about the definition of the term “swap.”

IV. THE COMMISSION SHOULD REMOVE OR MODIFY RULE 32.8(c) REGARDING THE EXECUTION OF COMMODITY OPTIONS

Rule 32.8(c) requires that upon receipt of an order for an OTC commodity option, one must not reasonably fail to secure prompt execution. The Working Group respectfully submits that such a requirement is appropriate for transactions executed by brokers for their customers. It should not be applied to OTC commodity options that are formed following bilateral negotiations between market participants transacting at arm’s-length. As a result, the Working Group requests that a “prompt execution” requirement not apply to bilaterally-negotiated OTC commodity options.

V. CONCLUSION

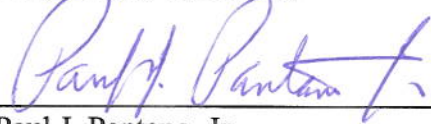
The Working Group supports the Commission’s proposed regulatory regime for agricultural swaps. We request, however, that the Commission exercise its authority under Section 4c(b) to regulate Physical Commodity Options as a separate category of transactions, and allow market participants to enter into Physical Commodity Options subject to the specified terms and conditions that we have proposed above. If the Commission does not adopt the Working Group’s recommendations, the Commission should defer issuing final regulations for transacting in such options until the Commission further defines “swap.” Finally, we request that the Commission not apply a prompt execution requirement to OTC commodity options.

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Please contact me at the number listed above, or my colleague Athena Eastwood at 202-862-2294, if you have any questions about the Working Group's comments.

Respectfully submitted,



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Agricultural Commodity Swaps Working Group

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