Client Update
CFTC Proposes to Reduce Reporting and Recordkeeping Requirements for End-Users of Trade Options

NEW YORK
Byungkwon Lim
blim@debevoise.com

Aaron J. Levy
ajlevy@debevoise.com

On April 30, 2015, the Commodity Futures Trading Commission (the "CFTC") issued proposed rules (the "Proposed Rules"),[1] which would modify the reporting and recordkeeping requirements applicable to entities that are not swap dealers or major swap participants and that enter into trade options ("non-SD/MSP counterparties"). The proposed amendments would reduce the reporting and recordkeeping requirements for such non-SD/MSP counterparties.

With respect to reporting, the Proposed Rules would eliminate the Form TO annual notice reporting requirement for otherwise unreported trade options. Instead, a non-SD/MSP counterparty would only be required to either (1) provide notice to the CFTC's Division of Market Oversight ("DMO") within 30 days after entering into trade options (whether or not reported) having an aggregate notional value in excess of $1 billion in any calendar year or (2) provide notice by email to DMO that it reasonably expects to enter into trade options (whether or not reported) having an aggregate notional value in excess of $1 billion during any calendar year. In addition, the Proposed Rules provide that non-SD/MSPs would not be subject to the reporting requirements in part 45 of the CFTC regulations in connection with their trade options.

With respect to recordkeeping, the Proposed Rules provide that non-SD/MSP counterparties would need only comply with a limited set of recordkeeping requirements, provided that such a non-SD/MSP counterparty must obtain a legal entity identifier ("LEI") and provide such LEI to each of its counterparties that is a swap dealer ("SD") or major swap participant ("MSP").

---

[1] The text of the Proposed Rules is available at: http://www.cftc.gov/PressRoom/PressReleases/pr7166-15#.

Comments on the Proposed Rules must be received by the date that is 30 days after the Proposed Rules are published in the Federal Register.

BACKGROUND

Commodity Options and the Trade Option Exemption

The term "swap" under the Commodity Exchange Act ("CEA") includes commodity options. In April 2012, the CFTC adopted final part 32 rules on commodity options, which require that, in general, commodity option transactions be conducted in compliance with the same rules applicable to any other swap.

At the same time, the CFTC adopted an interim final rule providing an exception to this general rule for physically delivered commodity options on exempt commodities (such as energy and metal commodities) and agricultural commodities (such as grain and soft commodities) entered into by commercial users of such physical commodities, subject to certain conditions (the "trade option exemption").[2]

While most swap regulations do not apply with respect to trade options that satisfy the conditions for the exemption, certain swap regulations will apply to each trade option counterparty. They include: part 20 (large trader reporting); part 151 (position limits); subparts F and J of part 23 (certain recordkeeping, reporting, and risk management duties applicable to SDs and MSPs); section 4s(e) of the CEA (capital and margin requirements for SDs and MSPs); and any applicable antifraud and anti-manipulation provisions.

In addition, the interim final rule provides that counterparties to a trade option must comply with the part 45 recordkeeping requirements, and also with the

[2] In order to rely on the trade option exemption, (1) the offeror of a commodity option must be either an eligible contract participant or a producer, processor, or commercial user of, or merchant handling the commodity that is the subject of the commodity option, or the products or by-products thereof, and such offeror must be offering or entering into the commodity option solely for purposes related to its business as such; (2) the offeree must be (and the offeror must reasonably believe the offeree to be) such a producer, processor, commercial user or merchant of such commodity, and must be offered or entering into the commodity option solely for purposes related to its business as such; and (3) the commodity option must be intended to be physically settled.

For more information on the CFTC's final rule on commodity options and the interim final rule on the trade option exemption, please see our client memorandum "CFTC Final Rules on Commodity Options", available at: http://www.debevoise.com/insights/publications/2012/04/cftc-final-rules-on-commodity-options.

part 45 reporting requirements to the extent one counterparty has become obligated to comply with such reporting requirements (as a part 45 reporting party) during the 12-month period preceding the date of execution of the trade option in connection with any swap other than a trade option. Therefore, if only one counterparty has previously complied with such reporting obligations, such counterparty must report the information on the trade option, while if both counterparties have previously done so, then the part 45 rules will determine the reporting party. If neither party has previously complied with such reporting obligations, the trade option need not be reported under part 45, but in that case, both counterparties will be required to complete and submit an annual Form TO filing providing notice that the counterparty has entered into one or more unreported trade options during the prior calendar year.[3]

Existing No-Action Relief from Trade Option Exemption Conditions

In the year following the CFTC's adoption of the trade option exemption, DMO issued a series of no-action letters granting relief from certain part 32 requirements with respect to trade options entered into by non-SD/MSP counterparties. One such letter, CFTC No-Action Letter No. 13-08 (which is still in effect),[4] grants relief to non-SD/MSP counterparties relying on the trade option exemption from the CFTC's part 45 reporting requirements, provided that such non-SD/MSP counterparties meet certain conditions, including reporting such exempt commodity option transactions via Form TO and notifying DMO no later than 30 days after entering into trade options having an aggregate notional value in excess of $1 billion during any calendar year. This no-action letter also grants relief from certain swap recordkeeping requirements in part 45 for a non-SD/MSP that complies with applicable recordkeeping requirements in CFTC regulation 45.2,[5] provided that if the counterparty to the

---

[3] Counterparties to otherwise unreported trade options must submit a Form TO filing by March 1 following the end of any calendar year during which they entered into one or more unreported trade options. Form TO will include information on the category of commodities underlying the relevant trade options and on the approximate aggregate value of commodities delivered or received in connection with the exercise of such trade options.

[4] Our client memorandum on this no-action letter is available at: http://www.debevoise.com/insights/publications/2012/08/cftc-grants-temporary-noaction-relief-for-person__.

[5] CFTC regulation 45.2 requires non-SD/MSPs to keep records of their swaps in a form and manner prescribed by the CFTC, [including records demonstrating that they are entitled to elect the end-user exception from the clearing requirement under section 2(h)(7) of the CEA].

trade option at issue is an SD or MSP, the non-SD/MSP must obtain a LEI pursuant to CFTC regulation 45.6.

Proposed Rules

In response to comments from market participants asserting that certain part 32 requirements are overly burdensome for commercial end-users and have discouraged commercial end-users from entering into trade options to hedge their commercial and risk management needs (thereby reducing liquidity and raising prices), the CFTC issued Proposed Rules which would modify the recordkeeping and reporting requirements in CFTC regulation 32.3(b) for non-SD/MSP counterparties to trade options. The CFTC explains in the proposing release that these amendments are intended to facilitate use of trade options by commercial market participants by relaxing reporting and recordkeeping requirements where two commercial parties enter into trade options with each other in connection with their respective businesses, while maintaining regulatory insight into the market for unreported trade options.

The Proposed Rules would amend CFTC regulation 32.3(b) such that a non-SD/MSP would under no circumstances be subject to part 45 reporting requirements with respect to its trade option activities and would not be required to report otherwise unreported trade options on Form TO.[6] (The Proposed Rules also delete Form TO from appendix A to part 32.)

The Proposed Rules would further amend CFTC regulation 32.3(b) by adding a requirement that non-SD/MSP counterparties must either:

- provide notice by email to DMO within 30 days after entering into trade options (whether or not reported) that have an aggregate notional value in excess of $1 billion in any calendar year (the "$1 Billon Notice"); or
- provide notice by email to DMO that it reasonably expects to enter into trade options (whether or not reported) having an aggregate notional value in excess of $1 billion during any calendar year (the "Alternative Notice").

[6] In the proposing release, the CFTC notes that while it believes there are surveillance benefits from Form TO data, completing Form TO imposes costs and burdens on non-SD/MSPs, especially small end-users. The CFTC also notes that under the Proposed Rules, non-SD/MSPs would remain subject to the recordkeeping requirements in CFTC regulation 45.2 (including the requirement to open their records to CFTC inspection, upon request), allowing the CFTC to collect additional information concerning unreported trade options, as necessary.

For purposes of these proposed notice requirements, the aggregate notional value of trade options entered into, or expected to be entered into, should be calculated by multiplying (1) the maximum volume of the commodities that could be bought or sold pursuant to the trade options entered into by (2) the strike or exercise price per unit of the commodity. If the strike or exercise price is not fixed in the trade option agreement and instead is determined pursuant to a reference price source that is not determinable at the time the trade option is entered into, then the foregoing calculation could be based on the current market price of the reference commodity at the time the option is entered into.[7]

The Proposed Rules would also amend CFTC regulation 32.3(b) to codify the relief provided in No-Action Letter 13-08 with respect to recordkeeping requirements. Under the Proposed Rules, the only part 45 recordkeeping requirements applicable to non-SD/MSP counterparties with respect to their trade options would be those set forth in CFTC regulation 45.2 and the requirement to obtain an LEI under CFTC regulation 45.6 and provide such LEI to its counterparty if such counterparty is an SD or MSP. Therefore, non-SD/MSP counterparties would not be required to identify their trade options in all recordkeeping by means of either a unique swap identifier ("USI") or a unique product identifier ("UPI"), as would otherwise be required by operation of the current CFTC regulation 32.3(b).

In addition, the Proposed Rules make a non-substantive amendment to CFTC regulation 32.3(c) to eliminate the reference to the now-vacated part 151 position limits requirements.

* * *

Please do not hesitate to contact us with any questions.

[7] As an example, the CFTC notes in the proposing release that if a trade option involves crude oil that is deliverable on (or similar to) crude oil that is deliverable on NYMEX, then the price of the nearby NYMEX crude oil futures contract may be used as the market price of the commodity at the time the trade option is entered into.