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CFTC Adopts Definition of Agricultural Commodity and Rules Concerning Agricultural Swaps

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) provides that no person shall “offer to enter into, enter into, or confirm the execution of, any swap in an agricultural commodity (as defined by the [CFTC])” except as permitted by a rule, regulation or order of the CFTC. *See* Dodd-Frank Act § 723(c)(3)(A).¹ In separate rulemakings, the CFTC recently has adopted rules that define the term “agricultural commodity” and provide that swaps on agricultural commodities (agricultural swaps) are to be regulated in the same manner as interest rate, currency and all other swaps. This memorandum explains these two regulatory developments.

1. Agricultural Commodity Definition

On July 7, 2011, the CFTC approved final rules to define the term “agricultural commodity.” *See* Agricultural Commodity Definition, [76 Fed. Reg. 41048](#) (July 13, 2011). Subject to a minor revision to the commodity-based index provision (Category 4 below), the final definition is nearly identical to the definition proposed by the CFTC last fall. *See* Agricultural Commodity Definition, [75 Fed. Reg. 65586](#) (Oct. 26, 2010). The final rules will take effect on September 12, 2011.

A. Which commodities will be considered “agricultural commodities”?

The final rules set out four categories of agricultural commodities:

- The commodities specifically enumerated in the definition of a “commodity” found in Section 1a of the CEA (including corn, wheat, cotton and soybeans);
- All other commodities that are, or once were, or are derived from, living organisms, including plant, animal and aquatic life, which are generally fungible, within their respective classes, and are used primarily for human food, shelter, animal feed or natural fiber;
- Tobacco, products of horticulture and such other commodities used or consumed by animals or humans as the CFTC may designate by rule, regulation or order after notice and opportunity for a hearing; and
- Commodity indexes based wholly or principally on underlying agricultural commodities.

Category 1: Enumerated Agricultural Commodities

Category one includes the agricultural commodities specified in Section 1a(9) of the CEA as amended by the Dodd-Frank Act.² Although there will be considerable overlap

¹ The term “agricultural commodity” historically has been undefined for purposes of the Commodity Exchange Act (CEA) and CFTC regulations. However, certain provisions of the pre-Dodd-Frank Act CEA reference agricultural commodities. The Dodd-Frank Act deleted two of these provisions, Sections 2(g) and 5a(b)(2)(F). *See* 76 Fed. Reg. at 41049.

² The enumerated commodities include the following: wheat, cotton, rice, corn, oats, barley, rye, flaxseed, grain sorghums, mill feeds, butter, eggs, *Solanum tuberosum* (Irish potatoes), wool, wool

between Category 1 and Category 2, the CFTC notes that some of the enumerated commodities do not qualify as “agricultural commodities” under Category 2. For example, “fats and oils” include plant-based oils used solely for industrial purposes, so they would not satisfy Category 2. 76 Fed. Reg. at 41053.

Category 2: Operative Definition of Agricultural Commodities

In Category 2, the CFTC seeks to distinguish between 1) products derived from living organisms that are used for human food, shelter, animal feed or natural fiber (which are included in the definition); and 2) products that are produced through processing plant or animal-based inputs to create products largely used as industrial inputs (which are outside the definition). The CFTC notes that this category is self-executing. 76 Fed. Reg. 41053.

The preamble to the agricultural commodity definition defines the following Category 2 terms:

Generally fungible – This means substitutable or interchangeable within general classes. For example, flax and mohair are generally fungible natural fibers that would be agricultural commodities under Category 2. But linen garments made from flax or sweaters made from mohair are not generally fungible and would not be agricultural commodities under Category 2. 76 Fed. Reg. at 41053.

Used primarily – This means any amount of usage over 50 percent. 76 Fed. Reg. at 41053.³

Human food – Will include drink. 76 Fed. Reg. at 41053.

Natural fiber – This term means any naturally occurring fiber that is capable of being spun into yarn or made into fabric by bonding or by interlacing, and which is the basic structural element of textile products. 76 Fed. Reg. at 41053.

Category 3: Other Agricultural Commodities

Category 3 includes commodities that do not fit neatly into Categories 1 or 2 but that would still be widely recognized as commodities of an agricultural nature. These commodities will be determined on a case-by-case basis. 76 Fed. Reg. at 41054.

Category 4: Commodity-Based Indexes

Any index made up of more than 50 percent of agricultural commodities is itself considered to be an agricultural commodity for purposes of the agricultural commodity definition. This portion of the definition differs from the CFTC’s proposal, which would have included only indexes based only or principally on a *single* underlying agricultural commodity. Under the proposal, a commodity-based index composed of 20 percent each of wheat, corn, soybeans, crude oil and gold would not have been an agricultural commodity; under the final rules, however, such an index would be an agricultural commodity.⁴ 76 Fed. Reg. at 41054.

tops, fats and oils (including lard, tallow, cottonseed oil, peanut oil, soybean oil, and all other fats and oils), cottonseed meal, cottonseed, peanuts, soybeans, soybean meal, livestock, livestock products, and frozen concentrated orange juice, but not onions. The CFTC also notes that the “fats and oils” referenced in the “commodity” definition do not include petroleum products.

3 The CFTC notes that Category 2 includes fruits and fruit juices; vegetables and edible vegetable products; edible products of enumerated commodities, such as wheat flour and corn meal; poultry; milk and milk products; eggs; cocoa beans, cocoa butter and coco; coffee beans and ground coffee; sugarcane, sugar beets, beet pulp, raw sugar, molasses and refined sugar; honey; beer and wine; shrimp; silk, flax and mohair; stud lumber; plywood; strand board; and structural panels. The CFTC further notes that biofuels, fertilizer and agricultural chemicals would not fall within the definition because they are not food, shelter, animal feed or natural fiber.

4 The CFTC notes that its proposed treatment of indexes could have permitted “gaming” by allowing an index based principally on agricultural commodities to evade any potential limitations on trading agricultural swaps.

Treatment of Onions

The CFTC notes that onions are the only agricultural product specifically excluded from the list of enumerated commodities in Section 1a of the CEA. The CFTC states that because onions are not commodities they can not be agricultural commodities. However, the definition of swap in Section 1a(47) of the amended CEA is not limited to transactions based upon “commodities.” The CFTC reasons that because swaps may be based upon an item that is not defined as a “commodity,” onion swaps would be permissible.⁵ 76 Fed. Reg. at 41054.

B. What is the impact of the CFTC’s rulemaking?

The agricultural commodity definition may have little practical effect, at least initially. Although the Dodd-Frank Act permits agricultural swaps only as allowed by the CFTC, the CFTC’s agricultural swap rules would regulate such swaps in the same manner as all other swaps. As discussed in more detail below, this means that agricultural swaps may be subject to the Dodd-Frank Act’s clearing and exchange-trading mandates, and market participants who enter into these swaps must comply with reporting and recordkeeping requirements generally applicable to swaps.

2. Agricultural Swaps

On August 4, 2011, the CFTC adopted final rules to govern trading in agricultural swaps. *See* Agricultural Swaps, 76 Fed. Reg. 49291 (Aug. 10, 2011). The final rules, which will take effect December 31, 2011, are identical to the rules the CFTC proposed in February. *See* Commodity Options and Agricultural Swaps, 76 Fed. Reg. 6095 (Feb. 3, 2011) (Proposed Rules).⁶

A. Part 35 of the CFTC’s regulations authorizes agricultural swaps today.

Today, Part 35 of the CFTC’s regulations provides a broad-based exemption for certain swap agreements, including agricultural swaps. The CFTC adopted the Part 35 exemption in 1993, pursuant to its authority under Section 4(c) of the CEA. Section 4(c)(1) of the CEA provides that, to “promote responsible economic or financial innovation and fair competition, the [CFTC] ... may ... exempt any agreement, contract or transaction” from any provision of the CEA, subject to certain exceptions. As a prerequisite for granting relief under Section 4(c), the CFTC must determine that: i) the exemption is consistent with the public interest; ii) any agreement, contract or transaction affected by the exemption would be entered into by “appropriate persons”; and iii) any agreement, contract or transaction effected by the exemption would not have a material adverse affect on the ability of either the CFTC or any designated contract market (DCM) to discharge its regulatory or self-regulatory duties under the CEA.

The CFTC intended that Part 35 “exempt from regulation (to the full extent permissible by the [CEA]) all swap agreements” that satisfy certain requirements.⁷ With the exception of three outstanding exemptive orders relating to cleared agricultural basis and calendar swaps, Part 35 is the sole existing

⁵ Although the CFTC does not address the point directly, it would appear that the same logic would apply to motion picture box office receipts which, like onions, are specifically excluded from the definition of “commodity.”

⁶ This date coincides with the expiration of the Section 4(c) transition relief promulgated by the CFTC to facilitate the phasing in of the Dodd-Frank Act swap rules. *See* Effective Date for Swap Regulation, 76 Fed. Reg. 42508 (July 19, 2011). A summary of this release can be viewed at: <http://skadden.com/Index.cfm?contentID=51&itemID=2481>.

⁷ *See* Exemptions for Certain Swap Agreements, 58 Fed. Reg. 5587, 5589 (Jan. 22, 1993). Specifically, Part 35 provides eligible swap participants with a general exemption from the CEA for a swap that is not part of a fungible class of agreements that are standardized as to their material economic terms, where the creditworthiness of each counterparty is a material consideration in entering into or determining the terms of the swap, and the swap is not entered into and traded on or through a multilateral transaction execution facility.

authority under which market participants may engage in agricultural swaps that are not options. 76 Fed. Reg. at 49292-93.

B. The Dodd-Frank Act permits the CFTC to establish special rules for agricultural swaps.

The Dodd-Frank Act amended the CEA to create a new regulatory regime for swaps. For example, under the amended CEA, only eligible contract participants (ECPs) may enter into a swap, unless the swap is traded on a DCM. The amended CEA also permits the CFTC to determine which swaps are subject to a clearing mandate and provides that such swaps also must be executed on a DCM or swap execution facility (SEF), if a DCM or SEF makes such swaps available for trading. Other provisions of the amended CEA impose reporting and recordkeeping obligations on parties to swap transactions.

Certain Dodd-Frank provisions apply specifically to agricultural swaps. As discussed, Section 723(c)(3)(A) of the Dodd-Frank Act provides that agricultural swaps are prohibited unless entered into pursuant to a CFTC rule, regulation or order adopted under Section 4(c) of the CEA.⁸ In addition, Section 733 of the Dodd-Frank Act provides that a SEF may not list for trading or confirm the execution of any agricultural swaps except pursuant to a CFTC rule or regulation allowing such transactions.

C. The CFTC's agricultural swap rules require equal treatment for agricultural swaps.

The CFTC's agricultural swap rules repeal existing Part 35 and replace it with new regulations that would allow agricultural swaps to transact subject to the same rules as other swaps. In particular, new Rule 35.1 specifies that market participants may transact in agricultural swaps subject to all provisions of the CEA, including any CFTC rule, regulation or order otherwise applicable to any other swaps. Rule 35.2 specifies that agricultural swaps may be executed on a SEF, DCM or otherwise, to the same extent that all other swaps may trade on DCMs, SEFs or otherwise.

The CFTC cited numerous reasons for adopting these rules. First, most commenters supported treating agricultural swaps the same as other swaps. The CFTC also found that treating agricultural swaps the same as all other swaps would "promote responsible economic or financial innovation and fair competition," as required by Section 4(c)(1) of the CEA. 76 Fed. Reg. 49296. Specifically, the CFTC noted that by permitting agricultural swaps to trade under the same terms and conditions as other swaps, agricultural swaps may be subject to the clearing and exchange-trading mandates in Section 2(h) of the amended CEA.⁹ In the CFTC's view, the centralized clearing of agricultural swaps should reduce systemic risk and exchange-trading of these instruments could increase innovation in the agricultural swap markets. Moreover, because only ECPs are permitted to execute swaps outside of a DCM, the CFTC notes that only "appropriate persons" should be able to enter into agricultural swaps. Lastly, the CFTC concluded that treating agricultural swaps in the same manner as other swaps may enhance the ability of the CFTC or CFTC-regulated markets to discharge their regulatory or self-regulatory responsibilities under the CEA, in part because the CEA's reporting requirements would apply to agricultural swaps.

⁸ However, Section 723(c)(3)(B) of the Dodd-Frank Act would allow Part 35 to remain in effect.

⁹ In its current form, Part 35 does not permit clearing of agricultural swaps and does not contemplate any reporting of agricultural swaps data.

Despite the consensus of public comments supporting agricultural swaps on the same terms as all other swaps, one commenter offered the view that agricultural swap trading would lead to excessive speculation that would hurt the interests of producers. 76 Fed. Reg. at 49295.¹⁰ Because that commenter offered no reasoned basis for the asserted conclusion, the CFTC did not express any concern in disregarding the comment.

D. Do the final rules address commodity options?

Although the Proposed Rules addressed both commodity options and agricultural swaps, the final rules concern agricultural swaps only. The Proposed Rules would treat commodity options as swaps for regulatory purposes, including agricultural commodity options. In the preamble to the final rules, the CFTC states that the Proposed Rules for commodity option transactions will be addressed at a later date. Thus, it is still not certain whether agricultural options will be treated differently than agricultural swaps when the CFTC finalizes its rules.

¹⁰ See also [Comment Letter](#) to the CFTC by Prof. Michael Greenberger, J.D., Univ. of Maryland School of Law.