

# Client Alert

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October 2, 2013

## CFTC Staff Issues Commodity Option Frequently Asked Questions (“FAQs”)

By **Julian E. Hammar and Michael R. Sorrell, Jr.**

On September 30, 2013, the CFTC’s Division of Market Oversight (“DMO”) issued a Commodity Option FAQ document. A copy of the FAQs is available [here](#). While the document largely contains information already set forth in prior CFTC releases, it does contain helpful clarifications of potential interest to clients who enter into commodity options. These clarifications generally relate to the CFTC’s “Form TO,” the annual reporting form for trade options. They include what trade options must be reported, the reporting period for the first annual Form TO filing, the calculation of the notional amount of embedded options in forward contracts, and the applicability of the Form TO filing requirement to cross-border situations.

A summary of these clarifications is set forth below.

### BACKGROUND

As discussed in the FAQ, commodity options are swaps because they come within the Commodity Exchange Act’s (“CEA”) definition of the term “swap.” Transactions involving an option on a nonfinancial, or “physical,” commodity may nevertheless be subject to a narrower set of regulations than those otherwise applicable to swaps. For example, a forward contract with an embedded option that either (1) adjusts the forward price but does not affect the delivery term and meets the 3-part test for such contracts in the CFTC’s Product Definitions release or (2) adjusts the delivery term (volumetric option) and meets the 7-part test in the CFTC’s Product Definitions release, may be treated as a forward contract excluded from regulation under the CEA (except the anti-fraud and anti-manipulation provisions). And, as discussed further below, trade options—in general, transactions involving an option on a physical commodity between commercial participants that fail to satisfy either the 3-part or 7-part tests contained in the Product Definitions release—are exempt from the majority of Dodd-Frank requirements.

In order to qualify for the trade option exemption, a commodity option must involve a nonfinancial commodity (*i.e.*, an exempt or agricultural commodity) and meet the following conditions:

- The option is offered by either an “eligible contract participant” as defined in the CEA (generally, a financially sophisticated entity) or a producer, processor, commercial user of, or merchant handling, the underlying physical commodity;
- The option is offered to a producer processor, commercial user of, or merchant handling the underlying physical commodity; and
- The option is intended to be physically settled, so that, if exercised, the option would result in the sale of an exempt or agricultural commodity for immediate or deferred shipment or delivery.

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Trade options that meet these conditions are exempt from many of the regulations applicable to swaps and are subject only to certain requirements specified in CFTC Regulation 32.3. These requirements include reporting, recordkeeping, swaps large trader reporting, position limits, certain requirements applicable to trade options offered by swap dealers or major swap participants (“MSPs”), and anti-fraud and anti-manipulation rules. The FAQ’s clarifications largely address the reporting requirements applicable to trade options.

Under the trade option exemption, a trade option must be reported to a swap data repository (or, if one is not available, the CFTC) in accordance with Part 45 of the CFTC’s regulations, if, during the 12 months prior to the trade option being entered into, one of the counterparties has been obligated to report a non-trade option swap under Part 45. If neither counterparty has had to report non-trade option swaps under Part 45 during that period, then both counterparties may report their trade option transactions annually on the CFTC’s Form TO. This form is less burdensome to market participants than Part 45 reporting because it only needs to be filed annually (and therefore not on a transaction-by-transaction basis) and only requires aggregate data (as opposed to data for each transaction). Eligibility to use Form TO has been extended pursuant to a CFTC staff no-action letter so that if one of the parties were required to report non-trade option swaps under Part 45 during the 12-month period (and thus could not use Form TO under the rule) and that party is not a swap dealer or MSP, then it may use Form TO, provided that it notifies CFTC staff no later than 30 days after entering into trade options having an aggregate notional value in excess of \$1 billion in any calendar year by sending an email to [TOreportingrelief@cftc.gov](mailto:TOreportingrelief@cftc.gov).

### CLARIFICATIONS

The Commodity Option FAQ includes the following clarifications regarding reporting requirements under Form TO:

*What options are reported—options “entered into” or options “exercised”?*

CFTC Rule 32.3(b)(2) and Form TO require that trade options that are “entered into” during the prior calendar year be reported on the form. The form also requires that the approximate total value of physical commodities that the reporting counterparty purchased and/or delivered in connection with options that were “exercised” during the prior calendar year be reported. The FAQ clarifies that trade options that are “entered into” during the calendar year must be reported on Form TO. Accordingly, if a counterparty entered into trade options in 2012 or prior years, did not enter into any trade options during 2013, and exercised its prior year trade options during 2013, it has no reporting obligation under Form TO for 2013. By contrast, if a counterparty with prior-year trade options enters into trade options in 2013, then it must file Form TO and report the approximate amount of trade options exercised, whether entered into in prior years or 2013.

*What is the reporting period for the first annual filing due on March 1, 2014?*

Form TO must be filed annually, with the first compliance date being March 1, 2014. One question that has arisen involves the reporting period for the filing, which generally is the prior calendar year. The preamble to the Trade Options Exemption and the instructions to Form TO indicate that trade options entered into from January 1, 2013, through December 31, 2013, must be reported on Form TO for the first filing due on March 1, 2014. However, the compliance date for reporting swaps under Part 45 of the CFTC’s rules was April 10, 2013, and trade options are not subject to historical reporting for swaps entered into prior to April 10, 2013, under Part 46 of

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the CFTC's rules. The FAQ states that the reporting period for the first Form TO filing is for the period from **April 10, 2013, through December 31, 2013**, rather than as stated in the form instructions. The FAQ reasons that reporting for trade options would not have been required under Part 45 of the CFTC's rules prior to April 10, 2013, and accordingly is not required under Form TO. Similarly, the FAQ clarifies that for 2013 the calculation of the \$1 billion aggregate notional value of trade options entered into to be reported under the CFTC no-action letter begins with trade options entered into only on or after April 10, 2013.

*How are forwards with embedded volumetric optionality (that fail the 7-part test) and open-ended options calculated for purposes of Form TO and the CFTC staff no-action letter?*

The FAQ clarifies that, for purposes of reporting under Form TO and the CFTC staff no-action letter \$1 billion notional threshold, a forward with an embedded volumetric option that fails the 7-part test should count toward that notional amount only the amount of the commodity that is subject to the option. This means that the fixed amount delivered or received under the contract need not be reported along with the additional amount delivered or received from the exercise of the volumetric option.

The FAQ also clarifies that the gross notional value of an open-ended option with no maximum amount should be calculated with reference to the maximum volume of the commodity that could be bought or sold under the contract (e.g., the difference between the baseload amount and historical maximum amount used over the same period). To calculate the fair market value of such amount when the option states a reference price rather than a fixed price, an entity should use the current price of the referenced contract.

*Do Form TO reporting obligations apply to non-U.S. counterparties?*

The FAQ states that Form TO requirements do apply to non-U.S., non-swap dealer/MSP counterparties with respect to trade options with U.S. non-swap dealer/MSP counterparties (i.e., trade options between a non-U.S. commercial end user and a U.S. commercial end user). The non-U.S. commercial end user would only be required to report trade options entered into with U.S. commercial end users in its Form TO filing if those trade options have not otherwise been reported to an SDR. Trade options between two non-U.S. non-swap dealer/MSPs are not subject to the CEA or any trade option requirements.

### Contact:

**Julian Hammar**  
(202) 887-1679  
[jhammar@mofo.com](mailto:jhammar@mofo.com)

**Michael Sorrell**  
(202) 887-8795  
[msorrell@mofo.com](mailto:msorrell@mofo.com)

**David Kaufman**  
(212) 468-8237  
[dkaufman@mofo.com](mailto:dkaufman@mofo.com)

**Daniel Nathan**  
(202) 887-1687  
[dnathan@mofo.com](mailto:dnathan@mofo.com)

**Robert Fleishman**  
(202) 887-8768  
[rfleishman@mofo.com](mailto:rfleishman@mofo.com)

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