



April 17, 2014

**VIA ONLINE SUBMISSION**

Melissa Jurgens, Secretary  
Commodity Futures Trading Commission  
Three Lafayette Center  
1155 21<sup>st</sup> Street, N.W.  
Washington, D.C. 20581

**RE: Energy and Agricultural Trade Association Comments on April 3, 2014 CFTC Staff Public Roundtable to Discuss Dodd-Frank End-User Issues (“April End-User Roundtable”) and Request for Clarification Regarding Forward Contracts with Embedded Volumetric Optionality**

Dear Ms. Jurgens:

By this letter, the Commodity Markets Council (“CMC”), the National Corn Growers Association (“NCGA”), and the Natural Gas Supply Association (“NGSA”), (hereafter “Joint Associations”) respectfully submit these comments in response to the U.S. Commodity Futures Trading Commission (the “CFTC” or “Commission”) staff’s April End-User Roundtable panel addressing forward contracts with embedded volumetric optionality and specifically the regulatory uncertainty stemming from the Further Definition of “Swap,” et al., 77 Fed. Reg. 48,208 (Aug. 13, 2012) (the “Swap Definition Rule”) seven-element interpretation regarding exclusion of forward contracts with embedded volumetric optionality from swap regulation (“Seven Element Interpretation”). References herein to the Commodity Exchange Act (“CEA”) refer to that statute as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the “Dodd-Frank Act” or “Act”). Correspondence regarding this submission should be directed to:

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The concerns and uncertainties with the Swap Definition Rule’s Seven Element Interpretation create real – not merely hypothetical – problems for physical transactions with embedded volumetric optionality. Definitive, reliable interpretive guidance that clarifies the intent and specifically addresses the uncertainties in the Seven Element Interpretation is essential. The core uncertainty is not whether physical commodity transactions with embedded volumetric options actually include “options.”<sup>1</sup> The threshold question is whether the transactions are intended to be physically settled, which is the statutory standard to determine whether or not a transaction falls within the definition of “swap”. As published, the Seven Element Interpretation creates significant uncertainty with respect to that threshold question. However, if clarified in a manner consistent with the recommendations below, the Seven Element Interpretation can provide the necessary guidance for both the Commission and market participants.

The seventh element of the Seven Element Interpretation (“element 7”) provides:

7. The exercise or non-exercise of the embedded volumetric optionality is based primarily on physical factors, or regulatory requirements, that are outside the control of the parties and are influencing demand for, or supply of, the nonfinancial commodity.<sup>2</sup>

The participants in the April End-User Roundtable made it clear to the Commission that the real world ambiguity about what the clause “primarily on physical factors or regulatory requirements, that are outside the control of the parties and are influencing demand for, or supply of, the nonfinancial commodity” actually means is causing serious confusion among physical end-users who are the principal parties to such contracts. Physical end-users need these contracts to address supply input or production output uncertainty associated with the operation of a physical business. Stated differently, these contracts exist to permit end-users to have agreements in place so that they can effectively and economically manage the purchase or sale of commodities related to their commercial businesses, not as a substitute for a financially settled contract or for speculative purposes.

The roundtable participants pointed out several issues that stem from the ambiguity of element 7. These issues include:

- some end-users labeling most forward contracts with embedded volumetric optionality as “swaps,” even when they are not, in fact, swaps;
- parties to a transaction disagreeing on whether or not a transaction is a swap;
- parties being asked for vague (and, therefore, potentially unenforceable) representations in master agreements, or in relation to requests for proposals cannot be relied upon;<sup>3</sup>

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<sup>1</sup>To be clear, many of these transactions contain embedded features that are options.

<sup>2</sup> Swap Definition Rule at 48238.

<sup>3</sup> This would occur because the question of the reason for exercise of volumetric optionality can vary from transaction to transaction and is not known until the time of exercise. Many transactions are done under a single master agreement, which is often in place for many years. Moreover, due to the vague nature of

- uncertainty as to whether end-users with more than one supply choice are always exercising optionality within their control;
- problematic Form TO reporting, in terms of identifying which transactions qualify for reporting; and
- parties walking away from deals due to regulatory uncertainty, among others.

Because element 7 hinges on the volumetric option holder’s motivation at the time of “exercise,” element 7 has no bearing on the statutory test for excluding a contract from the definition of swap (that is, the intent for physical settlement). The simple reality is that it is impossible for the reason behind the decision to exercise an embedded volumetric option to alter the already established “intent of the parties” because intent to physically settle is established when the agreement is executed. For this reason, we believe that element 7 should simply be eliminated. Element 7 is not consistent with the statutory exclusion from the swap definition—the exclusion was meant to exclude transactions intended to be physically settled. However, if the Commission believes it necessary to maintain element 7, the Joint Associations propose that the Commission clarify as follows:

*When elements 1 through 6 of the Swap Definition Rule’s Seven Element Interpretation are satisfied, element 7 is interpreted as being satisfied:*

- *when the optionality – whether a put or a call – is intended to meet the commercial production, consumption, or merchandizing requirements of the option owner’s business, where these requirements can be reasonably affected by supply or demand conditions;*
- *regardless of whether the option owner arranges for multiple alternatives to address these requirements;*
- *including cases where business judgment is exercised in choosing among alternatives for which the value is driven primarily by external factors, including qualitative factors.*

Regardless of how the Commission chooses to address this problem, it is important that it do so in as clear a manner as possible. End-users need to understand clearly what is a swap and what is not a swap. In day-to-day business, there is generally not time for a facts and circumstances review that involves counsel and an in-depth analysis of CFTC precedent. The above language would provide the clarity needed to allow the physical commodity industry to conduct business with a good understanding, not present today, of whether a forward contract with embedded optionality is a swap.

In addition, as noted in the comments filed by many market participants in October 2012, there is a technical problem with elements 4 and 5 of the Seven Element Interpretation. The drafting of elements 4 and 5 has the effect of excluding “puts.” Because there is no expressed Commission intent to exclude puts in the Swap Definition Rule, and various other sections of the

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such representations, it is not clear what regulatory or contractual consequences, if any, may arise if a party later violates such a representation, whether knowingly or accidentally.

Swap Definition Rule appear to contemplate puts, the exclusion of puts in elements 4 and 5 appears to be a drafting flaw. To correct this error, the Joint Associations propose interpretative language along the following lines:

*Recognizing that, upon exercise of an option that calls for physical delivery of a commodity, the owner of the option is obligated to make delivery if the option is a put, but to take delivery if the option is a call, with the seller of the option bearing the opposite obligation in each instance, elements 4 and 5 of the Seven Element Interpretation are satisfied if:*

- each party intends to satisfy its delivery obligations if the option is exercised, and*
- the respective delivery obligations are consistent with the character of the embedded option as a put or a call.*

These clarifications are consistent with Congressional intent and the Commission's historical interpretation regarding the CEA's forward contract exclusion and with the Commission's stated design for the Seven Element Interpretation in the Swap Definition Rule. Regarding Congressional intent, the Commission has recognized that:

[T]he underlying postulate of the [forward] exclusion is that the [CEA's] regulatory scheme for futures trading simply should not apply to private commercial merchandising transactions which create enforceable obligations to deliver but in which delivery is deferred for reasons of commercial convenience or necessity.<sup>4</sup>

Additionally, the Commission's historical interpretation has been that forward contracts to be excluded under the forward contract exclusion are "commercial merchandizing transactions."<sup>5</sup> With respect to the inclusion of embedded volumetric optionality in such contracts, the CFTC has recognized that "supply and demand requirements cannot always be accurately predicted" and that embedded volumetric optionality can be a "commercially reasonable way to address [such] uncertainty."<sup>6</sup> With respect to element 7 in particular, the Commission stated:

It is designed to ensure that the volumetric optionality is primarily driven by physical factors or regulatory requirements that influence supply and demand and that are outside the parties' control, and that the optionality is a commercially reasonable way to address uncertainty associated with those factors.<sup>7</sup>

The requested clarifications are fully consistent with these interpretations and intentions regarding the forward contract exclusion and are necessary to ensure the continued efficient use of forward contracts containing embedded volumetric optionality, which the Commission has

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<sup>4</sup> Swap Definition Rule at 48228.

<sup>5</sup> Swap Definition Rule at 48228.

<sup>6</sup> Swap Definition Rule at 48238-39.

<sup>7</sup> Swap Definition Rule at 48239.

recognized “offer a great deal of value to commercial participants.” This is true for the Joint Associations’ members. Additionally, the requested clarifications are essential to sound compliance and would eliminate regulatory uncertainty that is negatively affecting many energy and agriculture market participants.

In setting forth the Seven Element Interpretation, the Commission specifically requested comments regarding whether element 7 was sufficiently clear and unambiguous and, if not, what adjustments would be appropriate. The Joint Associations, individually and collectively, submitted comments within the regulatory comment period requesting clarification of the seventh element—explaining that ambiguities in element 7 were likely to cause significant practical difficulties for market participants engaging in many widely-used forms of forward contracts in physical commodities. The Joint Associations have not yet received a formal response from the Commission or its staff to their comments. As a result, Joint Associations’ members have had to proceed with their commercial activities in the midst of significant uncertainty regarding the regulatory status of many commercial merchandizing transactions. It has become increasingly evident that such uncertainty is interfering with the efficient functioning of energy and agriculture commodity markets. For this reason, the Joint Associations submit this letter seeking clarification of elements 4, 5 and 7 of the Seven Element Interpretation. Absent the clarifications, the Joint Associations request that the Commission staff not proceed with enforcement action against a market participant who proceeds according to this proposed interpretation of elements 4, 5 and 7 of Seven Element Interpretation of the Swap Definition Rule.

CMC is the leading trade association for commodity futures exchanges and their industry counterparts. CMC provides the access, forum, and action for exchanges and exchange users to lead our industry in addressing global market and risk management issues. CMC advocates for an open, competitive marketplace by combining the expertise, knowledge, and resources of our members to develop and support market-based policy. CMC addresses industry issues focusing on agriculture, energy, finance, infrastructure, and transportation

Founded in 1957, the National Corn Growers Association represents more than 40,000 dues-paying corn farmers nationwide. NCGA and its 48 affiliated state organizations work together to create and increase opportunities for their members and their industry.

Established in 1965, NGSA represents integrated and independent companies that produce and market approximately 30 percent of the natural gas consumed in the United States. NGSA encourages the use of natural gas within a balanced national energy policy and promotes the benefits of competitive markets to ensure reliable and efficient transportation and delivery of natural gas and to increase the supply of natural gas to U.S. customers.

Because of the potential for the Dodd-Frank Act to impede what are and have been healthy, competitive, and resilient commodity markets, the Joint Associations played an active role in the shaping of the Act during its passage and wish to continue this role in ensuring the Act’s successful implementation.

## **CONCLUSION**

For all of the reasons set forth above and the comments made at the April End-User Roundtable, the Joint Associations respectfully request an interpretative statement clarifying that: (i) element 7 is eliminated from the Seven Element Interpretation, or is satisfied when the embedded volumetric optionality is intended to meet the commercial production, consumption or merchandizing requirements that are affected by changing supply or demand conditions, regardless of whether the option owner arranges for multiple alternatives to address these requirements, and will be exercised based on business judgment at such time; and (ii) elements 4 and 5 of the Seven Element Interpretation include puts.

Absent issuance of the requested clarification, the Joint Associations request that the Commission staff not pursue any enforcement action against a market participant who proceeds according to the interpretation of elements 4, 5 and 7 that is set forth in this letter. In the event that future guidance from the Commission or Commission staff differs from such interpretation, such guidance should be enforced prospectively only, and applied to transactions entered into after such guidance is issued.

The Joint Associations welcome the opportunity to further discuss this request with the Commission. If we can provide any additional information, please do not hesitate to contact us.

Respectfully submitted,

Commodity Markets Council  
National Corn Growers Association  
Natural Gas Supply Association