December 22, 2014

Mr. Christopher Kirkpatrick
Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, NW
Washington, DC 20581

Re: ***Forward Contracts With Embedded Volumetric Optionality; Proposed Interpretation (RIN 3235-AK65)***

I. Introduction

The Coalition for Derivatives End-Users (the "Coalition") is pleased to respond to the request for comments by the Commodity Futures Trading Commission ("CFTC" or the "Commission") for the proposed interpretation titled *Forward Contracts With Embedded Volumetric Optionality* (the "Proposal").[1] The Coalition represents end-user companies that employ derivatives to manage risks. Hundreds of companies have been active in the Coalition on both legislative and regulatory matters and our message is straightforward: financial regulatory reform measures should promote economic stability and transparency without imposing undue burdens on derivatives end-users. Imposing unnecessary regulation on derivatives end-users, who did not contribute to the financial crisis, would fuel economic instability, restrict job growth, decrease productive investment and hamper U.S. competitiveness in the global economy.

The Coalition appreciates the Commission's sensitivity to the needs of end-users to effectively and efficiently operate their businesses and hedge associated risks. Accordingly, we thank the Commission for the Proposal, which would provide some additional clarity with respect to the treatment of forward contracts with embedded volumetric optionality in certain circumstances; however, we remain concerned that certain supply contracts for physical delivery, that are used by end-user companies to ensure that their businesses have the physical commodities necessary to operate, would nonetheless be treated as swaps. In particular, we remain concerned that while the clarifications to the seventh element of the volumetric optionality analysis in the Proposal are helpful, the seventh element remains burdensome—and ultimately unnecessary—for end-users with respect to evaluating their supply contracts.[2] We also are concerned that certain types of supply

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[1] 79 Fed. Reg. 69,073 (Nov. 20, 2014).

[2] The Proposal provides that a forward contract with embedded volumetric optionality must meet the following seven elements in order to qualify for the Forward Contract Exclusion: "1. The embedded optionality does not undermine the overall nature of the agreement, contract, or transaction as a forward contract; 2. The predominant feature of the agreement, contract, or

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contracts for physical delivery, such as peaking supply contracts, will nonetheless be treated as swaps under the analysis.

II. The seventh element of the embedded volumetric optionality analysis should be removed

In the Product Definitions Rule,[3] the CFTC explained that the reason for the Dodd-Frank Act's[4] regulatory framework for swaps was "to reduce risk, increase transparency and promote market integrity within the financial system."[5] Treating an end-user's supply contract with embedded volumetric optionality as a swap merely because it fails the seventh element will not achieve any of these policy goals. Further, requiring supply contracts with embedded volumetric optionality to be reported as "swaps" will not increase transparency or price discovery as supply contracts between a supplier and a buyer lack the fungibility of swaps. Finally, an end-user's supply contracts with embedded volumetric optionality do not threaten the market integrity of the financial system or introduce systemic risk because supply contracts involve commercial parties and

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transaction is actual delivery; 3. The embedded optionality cannot be severed and marketed separately from the overall agreement, contract, or transaction in which it is embedded; 4. The seller of a nonfinancial commodity underlying the agreement, contract, or transaction with embedded volumetric optionality intends, at the time it enters into the agreement, contract, or transaction to deliver the underlying nonfinancial commodity if the embedded volumetric optionality is exercised; 5. The buyer of a nonfinancial commodity underlying the agreement, contract[,] or transaction with embedded volumetric optionality intends, at the time it enters into the agreement, contract, or transaction, to take delivery of the underlying nonfinancial commodity if the embedded volumetric optionality is exercised; 6. Both parties are commercial parties; and 7. The embedded volumetric optionality is primarily intended, at the time that the parties enter into the agreement, contract, or transaction, to address physical factors or regulatory requirements that reasonably influence demand for, or supply of, the nonfinancial commodity." *Id*. at 69,074.

[3] *See* Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement"; Mixed Swaps; Security-Based Swap Agreement Recordkeeping, 77 Fed. Reg. 48,208 (Aug. 13, 2012) (the "Product Definitions Rule").

[4] *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law 111–203, 124 Stat. 1376 (2010).

[5] *See* 77 Fed. Reg. at 48,209.

physical deliveries and are not entered into for speculative purposes, but rather to obtain the nonfinancial commodity to operate a business.[6]

The term "swap" in Commodity Exchange Act ("CEA") Section 1a(47) excludes "any sale of a nonfinancial commodity . . . for deferred shipment or delivery, so long as the transaction is intended to be physically settled."[7] Accordingly, given that nothing in this statutory exclusion (the "Forward Contract Exclusion") refers to optionality or limits the use of the exclusion if the contracts contain embedded volumetric optionality, we do not believe that Congress intended for physical commodity forwards with embedded volumetric optionality to be considered "swaps." Moreover, under the terms of the statute, a contract that is both a commodity option and that also qualifies under the Forward Contract Exclusion would not be a "swap." Accordingly, any interpretive analysis adopted by the CFTC should not focus on the intent of the parties in including volumetric optionality provisions in a forward contract "so long as the transaction is intended to be physically settled."[8] Such an approach is consistent with the statutory language of the Forward Contract Exclusion.

This approach is also consistent with the CFTC's historical interpretation of the Forward Contract Exclusion. In the Product Definitions Rule, which initially set forth the CFTC's embedded volumetric optionality analysis, the CFTC stated that its "historical interpretation has been that forward contracts . . . are 'commercial merchandising transactions.'"[9] The CFTC went on to

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6 The Commission explained in the Product Definitions Rule that certain "commercial agreements" that involve customary business arrangements may nonetheless be excluded from the definition of "swap." *See id*. at 48,246-50. The Commission provided a non-exhaustive list of transactions that may be customary business arrangements falling outside the definition of "swap," so long as certain criteria specified by the Commission are met. *Id.* at 48,247. In that list, the CFTC notes that transactions for "[t]he purchase [or] sale [of] . . . equipment, or inventory" are customary business arrangements and therefore may not be swaps, depending on the facts and circumstances. *Id.* The Commission recognized that a commercial transaction containing embedded optionality may not undermine the overall nature of the customary business arrangement, noting that certain "commercial loans or mortgages with embedded interest rate options" are customary business arrangements that may be excluded from the definition of swap. *Id.* Similarly, the Coalition requests that the Commission confirm that embedded volumetric optionality in an end-user's supply contract does not detract from its nature as a customary business arrangement that will fall outside the definition of "swap" under this exclusion.

7 CEA Section 1a(47)(B)(ii), 7 U.S.C. § 1a(47)(B)(ii).

8 *Id.*

9 *Id.* at 48,228.

reaffirm 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."[10]

In addition, in the Product Definitions Rule, the CFTC relied upon its *In re Wright* decision to establish standards for the treatment of forward contracts with embedded volumetric optionality.[11] In the *In re Wright* decision, the CFTC reasoned that the particular forward contract for a nonfinancial commodity with embedded optionality, based upon the facts and circumstances of such transaction, would be an excluded forward contract because the embedded option: (1) could be used to adjust the forward contract price, but did not undermine the overall nature of the contract as a forward contract; (2) did not target the delivery term, so the "predominant feature" of the contract was actual delivery; and (3) could not be severed and marketed separately from the overall forward contract in which was embedded.[12] Further, the 1985 Interpretive Statement issued by the CFTC's Office of the General Counsel[13] also found that physical commodity forward contracts entered into by commercial parties in the ordinary course of business, even though they include optionality, should not be subject to regulatory oversight.

Commercial end-users do not enter into supply contracts with forward delivery for speculative purposes, but rather to receive, in the future, delivery of goods needed to operate their businesses. These forward supply contracts may contain embedded volumetric optionality wherein the delivery amount can vary based on the exercise of the option. While the reasons for including optionality in forward supply contracts vary, the overall nature of these contracts is to receive physical delivery of a commodity.

Because of the broad definition of "commodity" in the CEA,[14] virtually any supply contract with embedded volumetric optionality that provides for forward deliveries must meet all seven elements of the analysis or else it could be classified as a "swap." In this regard, end-users are particularly concerned that the broad definition of "commodity" could require analysis of virtually

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10 *Id.*

11 *See id.* at 48,237.

12 *Id.* (citing *In the Matter of Roger J. Wright, et al.*, CFTC Docket No. 97-02, at 12 (Oct. 25, 2010)).

13 CFTC, Characteristics Distinguishing Cash and Forward Contracts and "Trade Options," Interpretative Statement of the Office of the General Counsel, 50 Fed. Reg. 39,656 (Sep. 30, 1985).

14 *See* CEA Section 1a(9), 7 U.S.C. § 1a(9).

every supply contract. While the first six elements of the volumetric optionality analysis can be applied in a relatively straightforward fashion, the seventh element, even with the changes set forth in the Proposal, would require an end-user company to examine every one of its supply contracts to determine whether each contract has embedded volumetric optionality, and, if so, the intent for including such optionality in that contract at the time it was entered into. Requiring a contract-by-contract legal and compliance review to determine whether the seventh element was complied with for all such supply contracts would require significant costs and operational burdens on derivatives end-users. The number of such supply contracts for some multinational companies can be substantial, and oftentimes supply contracts are entered into and negotiated through the procurement group, whereas decisions to address physical factors or regulatory requirements is done through the treasury group, which can greatly complicate such an analysis.

The cross-border nature of certain supply contracts could also raise significant operational burdens for multinational corporations. For example, a multinational corporation would first have to examine its and its global affiliates' existing supply contracts to determine whether there is "a direct and significant connection with activities in, or effect on, commerce of the United States," which could subject the contract to the CFTC's jurisdiction.[15] Second, if a supply contract has a "direct and significant connection" with the United States, the multinational corporation would have to conduct—itself or through outside counsel—a legal analysis of whether the contract contains embedded volumetric optionality. Even contracts with no U.S. nexus may require review for purposes of determining compliance with position limits and any other requirements that apply on an aggregate basis to an entity and its affiliates. Third, for those contracts that have embedded volumetric optionality, the company would have to determine whether such contracts meet all seven elements of the volumetric optionality analysis. To this end, the multinational company would need to review each such supply contract with embedded volumetric optionality to determine, among other things, whether the embedded optionality was "primarily intended, at the time that the parties enter[ed] into the . . . contract . . . to address physical factors or regulatory requirements that reasonably influence demand for, or supply of, the nonfinancial commodity."[16] The task of trying to determine the intent behind the inclusion of such embedded volumetric optionality at the time of execution of the supply contract would be extremely difficult and, in some cases, impossible.

For new contracts, the multinational corporation would need to establish a global compliance system that would require every business person to notify a company legal or compliance officer whenever the business person intended to enter into a supply contract that included embedded volumetric optionality, and to determine whether the contract has a "direct and significant" connection to the United States and whether the inclusion of such optionality term was made primarily for "physical factors or regulatory requirements." Given the strict compliance regimes at multinational corporations, books and records memorializing such justification would

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[15] CEA Section 2(i), 7 U.S.C. § 2(i).

[16] 79 Fed. Reg. at 69,074.

need to be maintained. Each of the above compliance steps for new and existing supply contracts would involve a significant amount of resources and would slow considerably business decisions and actions to a degree that could impede U.S. competitiveness.[17]

The seventh element would require that companies can only make business decisions regarding the amount of a nonfinancial commodity purchased or sold under a supply contract if such embedded optionality is based primarily "on physical factors or regulatory requirements" or else such supply contract could be treated as a "swap" and could become subject to a host of regulatory burdens. The troubling result is that the seventh element, and the costly operational burdens to monitor it, incentivizes U.S. companies to draft supply contracts with less flexibility to address valid business concerns in an effort to avoid the regulatory risk of such contracts being considered "swaps." Such a result decreases the nimbleness of U.S. companies to react to changes in their business environment and restrains effective business management.

While the Proposal attempts to clarify the scope of the seventh element, application of the seventh element remains unclear. "Physical factors" may include any business reason, other than price, that "could reasonably influence" demand of or supply for the relevant nonfinancial commodity.[18] But many such business reasons are not physical factors such as weather, transportation or demographics, which are the examples provided in the Proposal, and price is a factor in virtually all business decisions. Accordingly, it is very difficult for an end-user company to parse out what percentage of a business decision is based on such physical factors versus the price of the commodity that is being purchased; such calculations are bound to be subjective and yet could expose a company to regulatory risk. This analysis is further complicated by trying to assess, at the time of contract initiation, the end-user's primary intent for including a volumetric optionality provision.

The Proposal explains that "'physical factors'" should be construed broadly to include any fact or circumstance that could reasonably influence supply of or demand for the nonfinancial commodity . . . ."[19] However, there are many legitimate business reasons why a company may determine to buy less of a product and want the flexibility to do so by building into its supply contracts optionality that may not be based primarily on physical or regulatory factors. For example, if a supplier does not meet quality standards, does not deliver as fast as competitors, has suffered a material reputational hit, is subject to regulatory action or threat, has key personnel leave, has unsatisfactory personnel, has material lawsuits against it, has reported financial problems or is

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[17] The Coalition notes that non-legal/compliance personnel are more equipped to determine the first six elements of the volumetric optionality analysis, while the seventh element, being more subjective and complex, would need to be reviewed by internal or external legal counsel.

[18] *See, e.g.*, 79 Fed. Reg. at 69,075.

[19] *Id.*

rumored to be considering exiting the business or to be acquired by another company, an end-user company may choose to take less of a nonfinancial commodity from that supplier. Different factors may also result in a buyer wanting to buy more from a supplier. Further, a buyer may have changes in its quality standards, its production needs, its personnel dealing with the supplier, its plans for staying in a particular business, its reputation or its finances, each of which may legitimately influence whether the buyer, or a supplier to such buyer, desires to continue to order/supply the maximum amount initially intended to be delivered.

For the reasons discussed herein, including the considerable unnecessary costs and operational burdens that will be imposed on end-users, we request that the seventh element of the embedded volumetric optionality analysis be deleted. In the alternative, we ask that the seventh element be replaced with the following: "The embedded volumetric optionality is primarily intended, at the time that the parties enter into the agreement, contract, or transaction, to address physical factors or regulatory requirements that reasonably influence demand for, or supply of, the nonfinancial commodity and/or other business needs of one or both of the parties."

III. Forward contracts with embedded volumetric options that permit nominal delivery should not be considered "swaps" in certain circumstances.

We respectfully request the Commission to recognize that certain supply contracts with embedded volumetric optionality that permit for nominal or no deliveries in the event the options are not exercised should not be considered "swaps." As a regular part of their business, end-users enter into supply arrangements involving different types of contracts in order to ensure physical delivery of the nonfinancial commodities required to run their businesses. Taken as a whole and in the context of the end-user's commercial business, this set of contracts ensures access to needed physical commodities and do not provide a means for end-users to speculate on commodity prices. Nevertheless, as a result of the ability to receive nominal or no deliveries, any individual contract within this set may not satisfy one of the seven elements of the Commission's analysis, even though the purpose and use of the contract in context is no different than any other excluded forward contract. To avoid the confusing effect of such a technicality, the Coalition urges the Commission to continue to take a pragmatic, contextual approach to the characterization of such contracts and exclude them from the definition of "swap."

In particular, the Coalition is concerned that certain supply contracts that exclusively provide for physical delivery of a nonfinancial commodity but do not require delivery of any amounts or require nominal delivery of such nonfinancial commodity unless the end-user's commercial circumstances require it (e.g., there is the possibility for zero delivery under a contract) nonetheless could be considered "swaps" since they could fail the second element of the volumetric optionality analysis. These contracts, however, merely ensure the commercial end-user will obtain supply of nonfinancial commodities at the spot market price during certain operational contingencies. In the absence of such contingencies, the contracts have no utility and the end-user therefore has no need for delivery.

One example of this type of supply contract is a natural gas peaking supply contract, which is not entered into for speculative purposes but instead is entered into because the end-user's normal

supplier may not be able to guarantee the availability of natural gas that will be needed on any particular day in the future. Typically, these types of contracts provide an end-user of natural gas the right to take delivery of natural gas up to the maximum daily quantity agreed to by contract on any day during the term of the contract for up to a specified quantity of gas at the then-current market price. End-users enter into peaking supply contracts to ensure that they can maintain the supply of a commodity needed to operate their businesses, particularly in situations where their customary supplier is not able to deliver. If the end-user elects to take zero delivery on any given day there is no cash settlement—rather, the delivery right is simply extinguished for that day. The end-user's right to take delivery, moreover, is generally not transferrable.

While the CFTC has noted that peaking supply contracts may qualify as forward contracts with embedded optionality "provided they meet the elements of the CFTC's proposed interpretation,"[20] we are concerned that the restrictive wording of the second element of the CFTC's proposed interpretation could prevent many peaking supply contracts from qualifying for the Forward Contract Exclusion. The second element of the test restricts the scope of analysis as to whether actual delivery is occurring to a *particular* agreement, contract or transaction rather than assessing the entire set of contractual arrangements to ensure adequate supply of a non-financial commodity. In the case of the peaking contracts described above, the end-user would have the ability to receive zero delivery, yet, provided the facts and circumstances, the predominant feature of the contractual arrangements taken together would be actual delivery of natural gas (i.e., to ensure that there is sufficient natural gas available to meet an end-user's commercial need for the product).

In our view, it would contradict the purpose of the Forward Contract Exclusion to treat such contracts as "swaps" because the predominant feature of the end-user's arrangement, as a whole, is actual delivery. Moreover, without clarification, an anomalous result could occur whereby a contract with a minimum delivery requirement would be treated as an excluded forward contract, yet an otherwise identical contract that does not contain a minimum delivery requirement would be treated as a swap, even if the intent of both contracts at the time of execution is to receive actual physical delivery of a nonfinancial commodity. This is even more troubling because peaking supply contracts, for example, are not "options" in the normal sense that they provide a right to buy or sell at a price more favorable than the market. Rather, they assure the availability of the commodity, but at the then current market price.[21] They do not have any value as instruments of

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[20] *See* 79 Fed. Reg. at 69,076, n.24 (citing 77 Fed. Reg. at 48,240).

[21] Accounting treatment of supply contracts with volumetric optionality provides a useful analogy. The Financial Accounting Standards Board ("FASB") considers a forward contract that contains embedded volumetric optionality that "permits the holder only to purchase or sell additional quantities at the market price at the date of delivery" as within the scope of the "normal purchases and normal sales scope exception" and not as a derivative instrument. FASB Accounting Standards Codification paragraph 815-10-15-42. So, too, we request that the

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speculation: all they do is ensure that gas will be available, as and if needed by the end-user, in order to ensure continuity of its normal commercial business.

The CFTC has recognized that "contextual factors" may be considered in determining whether a contract qualifies as a forward contract.[22] In particular, the Commission noted that such factors may include: "a demonstrable commercial need for the product, the underlying purpose of the contract (e.g., whether the purpose of the claimed forward was to sell physical commodities, hedge risk, or speculate), the regular practices of the commercial entity with respect to its general commercial business and its forward and swap transactions more specifically, or whether the absence of physical settlement is based on a change in commercial circumstances."[23] In addition, the Commission has noted that additional contextual factors should be considered in the analysis, such as whether such contracts are entered into out of necessity to ensure that an end-user company can operate its business efficiently despite day-to-day variations in demand. The Commission should, consistent with its historical approach to evaluating forward contracts, consider the contextual facts and circumstances for determining whether forward contracts with embedded volumetric optionality qualify for the Forward Contract Exclusion. More particularly, we urge the Commission to clarify that including the ability to take zero or nominal delivery of a physical commodity in a supply contract, as described above, will not disqualify such contract from the Forward Contract Exclusion.

IV. Use of the trade option exemption

The Commission invites comment on whether the approach in the Interim Final Rule for Commodity Options (the "IFR"),[24] which would treat such supply contracts as trade options, provides sufficient relief for such contracts.[25] The Coalition does not believe that the IFR provides a clear or sufficient mechanism for regulatory relief for contracts with volumetric optionality. While we appreciate the trade option relief, treatment of an end-user's supply contracts as trade options also imposes significant and unnecessary compliance burdens on end-users. And, even determining whether a supply contract will qualify as a trade option requires yet another,

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Commission recognize that certain volumetric optionality not transform a supply contract into a swap for regulatory purposes.

[22] 77 Fed. Reg. at 48,231.

[23] *Id.*

[24] *See* Commodity Options, 77 Fed. Reg. 25,320 (Apr. 27, 2012).

[25] 79 Fed. Reg. at 69,076.

complicated test.[26] Accordingly, the CFTC should ensure that the embedded volumetric optionality analysis is modified, as discussed in this comment letter, such that end-users' supply contracts are not unnecessarily treated as "swaps" or "trade options."

For those supply contracts that fail the seven element analysis but qualify as trade options under the IFR, the company would need to file a Form TO with the CFTC, monitor the notional levels of trade options and comply with other CFTC rules with respect to such contracts. This includes establishing processes and controls to track "exercises" of volumetric optionality, a metric not typically tracked by counterparties to physical forwards that have never treated these products like swaps. Given the global nature of a multinational corporation's supply contracts, such end-users would need to continuously monitor, on a global basis, whether the amount of such supply contracts trigger certain swap regulatory thresholds, such as the proposed thresholds for margin for uncleared swaps, the relief provided under CFTC Letter No. 13-09 and any position limits which may be adopted by the CFTC.[27] Because supply contracts with embedded volumetric optionality are not financial transactions and do not increase systemic risk, there is no reason to include them in such threshold determinations.

Complying with the IFR requirements for supply contracts that are treated as trade options will be a significant and costly compliance burden for derivatives end-users. Each of the above steps involves significant resources, considerably slows and impedes business decisions and actions and, therefore, impacts the competiveness of U.S. companies. Accordingly, the Coalition urges the

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[26] To qualify for the trade option exemption, the following three elements must be satisfied: (1) The seller of the option (the offeror) must be either (a) an eligible contract participant or (b) a producer, processor, or commercial user of, or a merchant handling the commodity that is the subject of the commodity option transaction, or the products or byproducts thereof, and is entering into the commodity option transaction solely for purposes related to business as such; (2) the offeror must have a reasonable belief that the purchaser of the option (the offeree) is a producer, processor, or commercial user of, or a merchant handling the commodity that is the subject of the commodity option transaction, or the products or byproducts thereof, and is entering into the commodity option transaction solely for purposes related to business as such; and (3) the parties must intend for the option to be physically settled so that, if exercised, the option would result in the sale of a nonfinancial commodity for immediate or deferred shipment or delivery. *See* 17 C.F.R. § 32.3(a).

[27] For example, the prudential regulators' and CFTC's re-proposals with respect to margin requirements for uncleared swaps would require that an end-user with an affiliate that is a "financial end user" must aggregate the notional amount of swaps activities across all affiliates, including nonfinancial affiliates to determine whether the financial end user affiliate has "material swaps exposure." *See, e.g.,* Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants, 79 Fed. Reg. 59,898, 59,904 (Oct. 3, 2014); Margin and Capital Requirements for Covered Swap Entities, 79 Fed. Reg. 57,348, 57,391 (Sept. 24, 2014).

Commission to revise the Proposal's embedded volumetric optionality analysis as discussed herein so that end-users are not burdened by having supply contracts with the intent to physically deliver unnecessarily treated as swaps or trade options. Further, the Commission should make clear that trade options should not be considered in the threshold analysis for position limits, margin requirements and other regulatory requirements meant for swaps.

VII. Conclusion

We thank the CFTC for the opportunity to comment on this important Proposal. The Coalition appreciates the Commission's efforts to set clear definitions and guidance that serve to strengthen the derivatives market without unduly burdening end-users and the economy at large. We are available to meet with the CFTC to discuss these issues in more detail.

Thank you for your consideration of these very important issues to derivatives end-users. Please contact Michael Bopp at 202-955-8256 or mbopp@gibsondunn.com if you have any questions or concerns.

Yours sincerely,

Agricultural Retailers Association
Business Roundtable
Commodity Markets Council
Financial Executives International
National Association of Corporate Treasurers
National Association of Manufacturers
U.S. Chamber of Commerce