From: Sweeney, R. Michael <rsweeney@hunton.com>
Sent: Monday, September 20, 2010 4:09 PM
To: JointSEC <JointSEC@CFTC.gov>
Cc: secretary <secretary@CFTC.gov>
Subject: Definitions Contained in Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act - Definition of Swap
Attach: CFTC ANOPR_FINAL Letter for Definition of Swap_(32289516)_(15).pdf; Sweeney, R. Michael.vcf

---

Via Electronic Delivery

Dear Secretary Stawick:

On behalf of the Working Group of Commercial Energy Firms (the "Working Group"), Hunton & Williams LLP hereby submits this letter in response to the request for comments set forth in the advanced notice of proposed rulemaking published in the *Federal Register* on August 20, 2010, addressing the definition of "Swap" adopted in Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act").

The Working Group is a diverse group of commercial firms in the energy industry whose primary business activity is the physical delivery of one or more energy commodities to others, including industrial, commercial and residential consumers. Members of the Working Group include energy producers, marketers and utilities. The Working Group considers and responds to requests for public comment regarding legislative and regulatory developments with respect to the trading of energy commodities, including derivatives and other contracts that reference energy commodities.

The Working Group appreciates the opportunity to submit these comments and looks forward to working with the Commodity Futures Trading Commission and Securities and Exchange Commission to further define and clarify this definition as part of the formal rulemaking process implementing Title VII of the Act.

If you have any questions, or if the Working Group may be of further assistance, please do not hesitate to contact me directly at the number listed below.

-- Respectfully submitted,

R. Michael Sweeney, Jr.

<<CFTC ANOPR_FINAL Letter for Definition of Swap_(32289516)_(15).pdf>>

R. MICHAEL SWEENEY, JR.

HUNTON & WILLIAMS LLP

1900 K STREET, N.W.

SUITE 1200

WASHINGTON, D.C.

(202) 955-1944

rsweeney@hunton.com

This communication is confidential and is intended to be privileged pursuant to applicable law. If the reader of this message is not the intended recipient, or the employee or agent responsible to deliver it to the intended recipient, you are hereby notified that any dissemination, distribution or copying of this communication is strictly prohibited. If you have received this message in error, please notify Hunton & Williams LLP immediately by telephone (877-374-4937) and by electronic mail to: help_desk@hunton.com and then delete this message and all copies and backups thereof.

<<Sweeney, R. Michael.vcf>>

HUNTON & WILLIAMS LLP
1900 K STREET, N.W.
WASHINGTON, D.C. 20006-1109

TEL 202 • 955 • 1500
FAX 202 • 778 • 2201

FILE NO: 76142.2

September 20, 2010

David A. Stawick, Secretary
Commodity Futures Trading Commission
Three Lafayette Center
1155 21st Street, NW
Washington, DC 20581

VIA ELECTRONIC MAIL

Re: *Definitions and Required Rulemakings Contained in Title VII of Dodd-Frank Wall Street Reform and Consumer Protection Act - Definition of Swap*

Dear Secretary Stawick:

I. INTRODUCTION.

On behalf of the Working Group of Commercial Energy Firms (the "Working Group"), Hunton & Williams LLP respectfully submits this letter in response to the Advanced Notice of Proposed Rulemaking jointly issued by the Commodity Futures Trading Commission ("CFTC") and the Securities and Exchange Commission ("SEC") (collectively, the "Commissions") published in the *Federal Register* on August 20, 2010, concerning the further definition of certain key terms (specifically "Swap," "Security-Based Swap," "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant," "Eligible Contract Participant," and "Security-Based Swap Agreement").[1]

The Working Group is a diverse group of commercial firms in the energy industry whose primary business activity is the physical delivery of one or more energy commodities to others, including industrial, commercial and residential consumers. Members of the Working Group are energy producers, marketers and utilities. The Working Group considers and responds to requests for public comment regarding legislative and regulatory developments with respect to the trading of energy commodities, including derivatives and other contracts that reference energy commodities.

[1] Definitions Contained in Title VII of Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, 75 Fed. Reg. 51,429 (Aug. 20, 2010) ("ANOPR").

The comments herein specifically address the definition of "Swap" set forth in new Section 1a(47) of the Commodity Exchange Act (the "CEA") as adopted in Title VII, Subtitle A, Section 721(a) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act"), and in particular the exclusion from the definition of "Swap" of contracts for the "sale of a nonfinancial commodity…for deferred shipment or delivery, so long as the transaction is intended to be physically settled," (the "Physical Delivery Exclusion").[2] The Working Group appreciates the opportunity to submit these comments in response to the ANOPR and looks forward to working with the Commissions to further define the term "Swap" as part of the formal rulemaking process for implementing this and other key definitions contained in Title VII.

II. EXECUTIVE SUMMARY.

Physical delivery transactions in energy commodities, such as physical delivery forwards and physical delivery options, should be excluded from the definition of Swap under the Physical Delivery Exclusion.

The term Swap should be defined in a manner that is consistent with the forward contract exclusion in the CEA.[3] In addition, the definition of Swap should not include options on the physical delivery of a commodity. Physical delivery forwards that contain elements of options or embedded options should be considered one contract, the characterization of which should be a physical delivery forward.

In addition, physical delivery forwards and physical delivery options in "environmental commodities" should be excluded from the definition of Swap under the Physical Delivery Exclusion.

Finally, the definition of Swap should include documents commonly understood by the markets to constitute an entire Swap contract. However, documents not considered by the market as part of such contract should be excluded from the definition of Swap.

---

[2] New CEA Section 1a(47)(B)(ii).

[3] *See* CEA Section 1a(19), 7 U.S.C. § 1a(19) and 17 C.F.R. § 32.4, respectively.

III. COMMENTS OF THE WORKING GROUP OF COMMERCIAL ENERGY FIRMS.

A. GENERAL COMMENTS.

Title VII of the Act grants the Commissions jurisdiction to oversee and regulate the over-the-counter ("OTC") derivatives markets. Congress imposed such oversight and regulation to, among other things, "mitigate cost and risks to taxpayers and the financial system."[4]

The instruments over which the CFTC has jurisdiction pursuant to the Act are Swaps. New Section 1a(47) of the CEA sets forth a broad and inclusive definition of Swap that captures a substantial portion of OTC derivatives, including many energy-based derivatives. The definition of Swap includes, among other things, any agreement:

> "(i) …that is a put, call, cap, floor, collar, or similar option of any kind that is for the purchase or sale, or based on the value, of one or more interest or other rates, currencies, commodities, securities, instruments of indebtedness, indices, quantitative measures, or other financial or economic interests or property of any kind; . . .
>
> "(iv) that is, or in the future becomes, commonly known to the trade as a swap; . . . [or]
>
> "(vi) that is any combination or permutation of, or option on, any agreement, contract, or transaction described in any of clauses (i) through (v)."[5]

New Section 1a(47) of the CEA excludes several things from the definition of Swap, including futures and securities. The Physical Delivery Exclusion from the definition of Swap covers contracts for the "sale of a nonfinancial commodity . . . for deferred shipment or delivery, so long as the transaction is intended to be physically settled." As discussed below, this exclusion is analogous to the definition in CEA Section 1a(19) for "future delivery"[6] that is commonly known as the "forward contract exclusion."

Energy markets rely on a number of forms of transactions that are intended to be physically settled, including physical delivery forwards and physical delivery options on energy commodities. These transactions are not speculative in nature. On the contrary, such transactions are critical for energy companies and consumers of energy commodities to make or take physical delivery of energy commodities and to manage various commodity risks. The imposition of Title VII of the Act's regulatory requirements upon these transactions will

---

4 S. Rep. No. 111-176, at 92 (2010).

5 New CEA Section 1a(47)(A).

6 "(19) Future delivery - The term "future delivery" does not include any sale of any cash commodity for deferred shipment or delivery." 7 U.S.C. § 1a(19).

hinder the efficient operation of energy markets, which is a perverse result as these transactions do not pose systemic risk to the financial system of the United States.

Physical delivery transactions in the energy markets, whether forward transactions or options to deliver a physical commodity, do not, by structure and design, require the same type of regulation as do OTC derivatives transactions in securities, interest rates or other financial markets. The energy markets are unique and tied to a physical market structure, where the participants have the capability to make and take delivery of the transactions' underlying commodities. Further, in some cases, the physical market and its participants are already subject to robust regulatory oversight, operational controls, and mandatory reliability guidelines. Any additional regulation by the CFTC will be at best duplicative and at worst contradictory. Such regulation might make transacting in these markets overly complex, imposing an unnecessary regulatory burden on energy market participants, possibly leading to higher costs for consumers.

The CFTC and Congress have previously recognized both the importance and unique characteristics of certain forwards and options transactions related to energy commodities.[7] It is critical that the Commissions continue such recognition and clarify that physical delivery forwards and physical delivery options on energy commodities are "intended to be physically settled" and within the Physical Delivery Exclusion.

Separately, the definition of Swap should not include transactions taking place in organized wholesale energy markets administered by regional transmission organizations or independent system operators pursuant to the terms and conditions of tariffs, market rules, or other rate schedules approved by, and on file with, the Federal Energy Regulatory Commission ("FERC") or state regulatory agencies, such as the Public Utility Commission of Texas ("PUCT"). In addition, the Commissions should clarify that forward and option transactions involving instruments such as greenhouse gas emission allowances and offset credits and renewable energy certificates are not Swaps.

B. PHYSICAL DELIVERY FORWARDS.

The Commissions should issue guidance that the Physical Delivery Exclusion covers forward contracts that contain an obligation for physical delivery of a commodity. Under current law, physical delivery forwards are distinguished from futures. Physical delivery forwards should be distinguished from Swaps under identical standards.

Congress intended the application of the Physical Delivery Exclusion "be consistent with the forward contract exclusion that is currently in the Commodity Exchange Act and the CFTC's established policy and orders on this subject, including situations where commercial

---

7 *See* Statutory Interpretation Concerning Forward Transactions, 55 Fed. Reg. 39,188-92 (Sept. 25, 1990), reprinted at [1990-1992 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 24,925.

parties agree to 'book-out' their physical delivery obligations under a forward contract."[8] There is no policy rationale to afford different legal treatment of physical delivery forwards under the forward contract exclusion and the Physical Delivery Exclusion. Having separate standards will only add unnecessary confusion to the markets.

Congress intended to apply, and the CFTC and courts have applied, the forward contract exclusion under CEA Section 1a(19) to "private commercial merchandising transactions which create enforceable obligations to deliver but in which delivery is deferred for reasons of commercial convenience or necessity."[9] Transactions such as these involve two parties in the commercial marketing chain seeking to reduce the risks and costs associated with transacting in the underlying commodity. Each party likely is trying to minimize risk associated with a physical exposure. These transactions ensure the efficient delivery of nonfinancial commodities to companies that require them to conduct their core business. Physical delivery forwards thus, do not pose a systemic risk or offer any other basis for the application of the comprehensive regulatory regime for Swaps established under Title VII of the Act.

The Seventh Circuit Court of Appeals in *Nagel v. ADM Investor Services Inc.*[10] set out a test for distinguishing between forward contracts and futures contracts. A forward contract has all of the following indicia:

- unique terms for place of delivery, quantity and other terms such that the contract is not fungible with other contracts for the sale of the referenced commodities. (This indicia is not present when one party agrees to enter into an opposite, offsetting transaction if requested.)

- contract is between industry participants, and not arbitrageurs or speculators that are primarily interested in the value of the contract and not the delivery of the underlying commodity.

- delivery of the reference commodity cannot be deferred indefinitely.

The Commissions should provide guidance that physical delivery forwards that come within this test are not Swaps.

Furthermore, the Commissions should define the Physical Delivery Exclusion as applying to any trading contract that meets the criteria for the CFTC's Energy Forward

---

8 *See* Letter from Sen. Dodd, Chairman, Committee on Banking, Housing, and Urban Affairs and Sen. Lincoln, Chairman, Committee on Agriculture, Nutrition, and Forestry to Rep. Frank, Chairman, Committee on Financial Services, and Rep. Peterson, Chairman, Committee on Agriculture (June 30, 2010).

9 *See* Statutory Interpretation Concerning Forward Transactions *supra* note 6, at 39,190.

10 217 F.3d 436, 441 (7th Cir. 2000).

Exemption. Prior to the Commodity Futures Modernization Act of 2000, the CFTC, pursuant to a 1993 order for exemptive relief, created a limited exemption from the CEA for certain forward contracts referencing energy commodities (the "Energy Forward Exemption").[11] The exemption applied to contracts for the purchase and sale of "crude oil, condensates, natural gas, natural gas liquids, or their derivatives which are used primarily as an energy source." In addition, eligible contracts must:

- be entered into by persons reasonably believed to be within a specified class of commercial entities that incur risks, in addition to price risk, related to the underlying commodity and have the capacity or ability to make or take delivery of the underlying commodity;[12]
- be bilateral contracts between parties acting as principals, the principal economic terms of which are subject to individual negotiation;[13] and
- impose binding obligations on the parties to make and receive delivery of the underlying commodity, with no right to effect a cash settlement of their obligations without the consent of the other party, except pursuant to a *bona fide* termination right (such as upon default).[14]

Parties that enter into such forward contracts may enter into subsequent cancellation or "book-out" agreements providing for settlement other than by physical delivery.[15]

The exclusion of forward contracts from the CEA is integral to the efficient operation of energy markets.[16] For example, physical delivery forward transactions in power markets,

---

[11] 58 Fed. Reg. 21,286 (Apr. 20, 1993).

[12] The CFTC recognized that contracts subject to the Energy Forward Exemption gave the counterparties the substantial economic risk of a commercial cash market transaction in which delivery of the product is required. 58 Fed. Reg. 21,286, 21,293.

[13] Such contracts would include the following types of standardized trading contracts: The Master Power Purchase and Sale Agreement (the EEI Master), the WSPP Agreement; the LEAP Master Agreement for Purchasing and Selling Refined Products and Crude Oil; the ISDA Oil Annex; the ISDA Power Annex and the ISDA Gas Annex; the Base Contract for Sale and Purchase of Natural Gas (the NAESB Agreement); the Base Contract for Short-Term Sale and Purchase of Natural Gas (the GISB Agreement); the Midcontinent Association Capacity and Energy Tariff; the ERCOT Electricity Enabling Agreement; the ACORE/ABA Master Renewable Energy Certificate Purchase and Sale Agreement; and any other master agreement or transaction entered into under any market-based rate tariff or cost-based tariff.

[14] 58 Fed. Reg. 21,286, 21,294.

[15] *Id.*

[16] The CFTC, in creating the Energy Forward Exemption, found the exemption to be in the public interest as reducing legal uncertainty and allowing market participants to negotiate and structure contracts for energy commodities in ways that most effectively meet their economic needs, and thereby enhancing the global competitiveness of U.S. businesses. 58 Fed. Reg. 21,286, 21,292.

including those that are "booked out," are essential to cost-effective delivery scheduling, and their regulation as futures or Swaps would substantially limit their utility. A power producer may enter into a year-long contract with a counterparty to provide a certain amount of power over the duration of the contract. However, demand variability may lead the producer to purchase power from that counterparty during the term of their contract. Instead of the inefficient outcome of both parties delivering power, the two transactions are netted, yielding one transaction and one delivery of power. If there are price differences between the two trades, then they are settled in a manner similar to the financial settlement of the first transaction.

The regulation of physical delivery forwards that financially settle as Swaps would impose a regulatory burden on the efficient operation of energy markets comparable to the burden imposed by the regulation of such transactions as futures. Such regulation may also lead to inefficiencies in energy markets as commercial energy firms engage in duplicative transactions with redundant delivery obligations in order to avoid transactions being regulated as Swaps.

In accordance with the Congressional intent regarding the exclusion of transactions "intended to be physically settled" from the definition of Swap and the Congressional intent and policy rationale underlying the CEA's current forward contract exclusion, the Commissions should clearly define the Physical Delivery Exclusion to include, among other things, all contracts currently covered by the CEA's forward contract exclusion and the Energy Forward Exemption.

C. <u>Physical Delivery Options for Energy Commodities</u>.

The Commissions should exclude from the definition of Swap all option contracts that contain an obligation for the physical delivery of a commodity. Like physical delivery forwards, parties entering into physical delivery options have the requisite intent for the Physical Delivery Exclusion as the parties intend that such option contracts will physically settle.

Physical delivery options and physical delivery forwards, for purposes of the Physical Delivery Exclusion, are analogous. They are both entered into to mitigate the price and supply risks associated with a core business in nonfinancial commodities. The material difference between a forward and an option is that, in an option contract, one party (the option holder) is not obligated to exercise its right. This difference is not sufficient to distinguish such options from forwards for purposes of the Physical Delivery Exclusion. At their core, physical delivery forwards and physical delivery options involve the sale of a physical commodity. Moreover, as each transaction relates to, and is bounded by, the physical markets for energy commodities, they pose no systemic risk.

Physical delivery options are commonly used in the energy market to mitigate price and volume risks. For example, participants in natural gas markets enter into puts and calls

on the price of natural gas to ensure a degree of price stability or to ensure the availability of energy commodities to address variable demand.

Exclusion of physical delivery options through the Physical Delivery Exclusion would be "consistent" with the current forward contract exclusion and, thus, Congressional intent to exclude physically settled transactions from the definition of Swap. As noted above, physical delivery options and physical delivery forwards are both used to mitigate underlying risks and allow delivery of nonfinancial commodities to occur in a cost-efficient manner. In addition, like physical delivery forwards, physical delivery options between commercial entities generally are not regulated as futures under the CEA.[17] Therefore, to ensure the continuing efficient operation of markets in nonfinancial commodities, such as energy markets, the Working Group respectfully requests that the Commissions clearly exclude physical delivery options from the definition of Swap in new CEA Section 1a(47), as transactions in nonfinancial commodities that are "intended to be physically settled."

The CFTC has long recognized the value and unique nature of physical delivery options in commodity markets. When the trading of options on commodities was banned in the 1970s, Congress and the CFTC provided the "trade option exemption" found in CFTC Regulation 32.4. CFTC Regulation 32.4 exempts off-exchange options on commodities (other than certain enumerated agricultural commodities) that are "offered by a person which has a reasonable basis to believe that the option is offered to a producer, processor or commercial user of . . . the commodity . . . and such [person] is offered or enters into the commodity option transactions solely for purposes related to its business as such." This description of an option transaction generally describes physical delivery options as used in the energy markets. In creating the trade option exemption for certain commodities, the CFTC recognized the value of such options in the operation of cash markets. As there was no need to regulate physical delivery options as futures prior to the passage of the Act, there exists no policy reason to regulate such options as Swaps.

D. EMBEDDED OPTIONS IN PHYSICAL DELIVERY FORWARDS.

Many physical delivery forwards contain elements of options or actual options within the contract, including options on the quantity to be delivered, price or delivery point. The Commissions should treat such physical delivery forwards as single contracts that are physical delivery forwards and not as separate contracts or options.

Market participants, such as commercial energy firms, frequently enter into physical delivery forwards that contain elements of options or options. For example, in a day-ahead shapeable call option, an electricity provider will enter into a contract for a specific amount of energy with an embedded option to purchase additional energy in the event that demand

[17] Privately negotiated physical delivery options on nonfinancial commodities between Eligible Contract Participants are exempt from most provisions of the CEA under Sections 2(g) and 2(h)(1) of the CEA.

outstrips expectations. Such contracts are essential to the efficient delivery of energy. Contracts with embedded options, such as day-ahead shapeable call options should be considered single contracts by the Commissions. This treatment is consistent with both Supreme Court precedent treating "contract[s] as a whole, not individual portions piece-by-piece"[18] and CFTC precedent "evaluating the complete transaction when considering forward contracts that contain elements of options."[19] Another example is that commercial energy firms sometimes include a "trigger price" option in physical delivery natural gas contracts, whereby a counterparty may elect to exercise a "trigger price" option to purchase natural gas under the contract at a fixed price as opposed to an index price.

When assessing the character of a physical delivery forward with an embedded option, the Commissions should again evaluate the complete transaction.[20] The primary purpose of the parties to such a contract is to enter into a transaction that creates an enforceable delivery obligation for power on a certain date. The inclusion of the option to purchase additional energy adds an additional risk mitigation tool to the transaction. It does not change the characterization of the contract from a physical delivery forward to an option. Accordingly, like other physical delivery forwards, a physical delivery forward with embedded options should be covered by the Physical Delivery Exclusion.

E. TRANSACTIONS IN CERTAIN REGULATED MARKETS.

The CFTC should clarify that the definition of Swap excludes any transactions in organized markets regulated by FERC or state regulatory agencies, such as the PUCT.

These transactions are not associated with systemic risk. There is comprehensive regulation and oversight of all transactions taking place in organized wholesale energy markets administered by regional transmission organizations or independent system operators pursuant to the terms and conditions of tariffs, market rules, or other rate schedules approved by, and on file with the FERC or state regulatory agencies, such as the PUCT. Pursuant to the terms and credit provisions in their respective tariffs or market rules, regional transmission

---

[18] *See In re Cargill, Inc.*, Comm. Fut. L. Rep. (CCH) ¶ 28,425, n.47, *citing Mastrobuono v. Shearson Lehman Hutton, Inc.*, 514 U.S. 52, 59 (1995) (quoting Restatement (Second) of Contracts § 202(2) (1979)).

[19] *See 1985 Interpretative Statement*, ¶ 22,718 at 31,029-31 (the Commission's General Counsel finds minimum price contacts to be forward and spot contracts even though they each contained the element of a "cash settled put option"); *CFTC Interpretative Letter No. 96-23*, [1994-1996 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 26,646 at 43,697-98 (CFTC Mar. 14, 1996) (Commission's Division of Economic Analysis considering contract "in its entirety," regarded "producer option contract" as a forward contract, although it contained provisions whereby the elevator buys an exchange-traded call option for the benefit of the producer); *CFTC Interpretative Letter No. 98-13*, [1996-1998 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 27,264 at 46,152-53 (CFTC Dec. 3, 1997) (Division of Economic Analysis viewed contract that establishes a minimum and maximum price and "includes characteristics of an option" to be a forward contract "based upon the nature of the instrument as a whole.")

[20] *See In re Cargill, Inc.*, n.47, citing *1985 Interpretative Statement*, at 31,029-31.

organizations and independent system operators currently function as clearinghouses governing the operation of wholesale markets subject to their respective jurisdictions.

The CFTC should afford the same degree of deference to transactions in FERC or other organized markets, such as the PUCT, as is afforded securities and certain other derivatives in the definition of Swap. Although the definition of Swap is wide in scope, the definition excludes certain instruments that are already regulated. For example, the exclusions from the definition of Swap includes securities and derivatives regulated under the Securities Act of 1933 and the Securities Exchange Act of 1934, as well as certain foreign exchange transactions executed on regulated exchanges. Section 722 of the Act clarifies that both FERC and state regulatory agencies, such as the PUCT, maintain jurisdiction over their organized markets and transactions in those markets. Thus, the CFTC would be acting consistently with the intent of Congress in excluding transactions in FERC or other organized markets, such as the PUCT, from the definition of Swap as instruments already subject to pervasive regulation.

In addition, Congress gave the CFTC the authority to work with FERC in addressing the regulation of transactions in FERC-organized markets. Addressing the status of such transactions could be part of the memorandum of understanding between the CFTC and FERC required by Section 720 of the Act. Moreover, Section 722 of the Act explicitly provides the CFTC with statutory authority to exempt such transactions from the definition of Swap.

F. CONTRACTS FOR ENVIRONMENTAL COMMODITIES.

The CFTC should clarify that forward contracts and options for environmental commodities such as compliance and voluntary greenhouse gas emission allowances and offset credits and renewable energy certificates are not Swaps. The efficient trading of such "environmental commodities" is important for national and state policy objectives. For example, these transactions are inextricably intertwined with well functioning markets in renewable energy. The transfer of emission allowances and offset credits and other "environmental commodities" is of critical importance to energy companies as they meet environmental compliance and other regulatory requirements. In each case, the settlement of such contracts is accomplished by physical delivery as title to a commodity is passed from one counterparty to the other.

However, for purposes of the Physical Delivery Exclusion, the Commissions should issue regulations that afford physical delivery forwards and physical delivery options on such "environmental commodities" the same regulatory treatment as contracts referencing excluded commodities, such as energy commodities.

G. INTERPRETATIONAL CONCERNS WITH "INTENDED TO BE PHYSICALLY SETTLED."

In establishing what constitutes intent under the Physical Delivery Exclusion, the Commissions should consider the totality of the circumstances that are commonly analyzed with respect to the forward contract exclusion. A narrower analysis focused only on the specific intent of the parties raises numerous issues in practical application. For example:

(1) Which party must hold the requisite intent? Is it the intent of both parties, or is the intent of one party sufficient? What if one party is indifferent and does not have an intent as to the type of settlement (or will decide the settlement method closer to the delivery date)? Is the requisite intent present if a party enters into an onward sale to a third party?

(2) At what point does the intent have to be present? Must the intent be present at the beginning of the contract term, or must the intent be maintained throughout the term of the contract?

(3) How do parties memorialize and establish the intent to physically settle? How does a party assure itself of its counterparty's intent?

(4) How do the parties account for change in circumstances that may change their intent during the contract term?

Legal uncertainty will exist in the energy and other nonfinancial commodity markets without guidance from the Commissions on how parties can establish the existence of the requisite intent for the Physical Delivery Exclusion. Transacting parties, based on the language of the Act alone, have no criteria on which to determine whether the requisite intent necessary to qualify under the Physical Delivery Exclusion has been established. This legal uncertainty will be a hindrance to the otherwise efficient markets for energy and other nonfinancial commodities.

The Commissions can promote legal certainty with respect to the Physical Delivery Exclusion by creating a presumption that such intent is present for certain contracts. A presumption, though not conclusive, will provide enough legal certainty for parties to continue to engage in such transactions efficiently and with certainty. The current treatment of the forward contract exclusion has worked well for commercial energy markets and has provided the CFTC with the appropriate level of flexibility and authority to prohibit transactions structured to avoid regulation as futures through abuse of the forward contract exclusion.[21]

---

[21] *See In re MG Refining & Marketing, Inc.*, 1995 CFTC LEXIS 190, CFTC Docket no. 95-14, 1995 WL 447455*2, *6 (July 27, 1995).

The Working Group respectfully suggests that there should be a rebuttable presumption that parties entering into contracts that contain an enforceable obligation (contingent or otherwise) of one party to physically deliver a commodity have the necessary intent for the Physical Delivery Exclusion to apply to such contracts. An enforceable contractual provision is a legal obligation of a party to settle a transaction with physical delivery, which is strong evidence that the parties both contemplated, were capable of, and intended physical delivery. The act of providing for the enforceable right of physical delivery within the contract is a clear indication of the intent of the parties.

The presumption that contracts that contain a physical delivery obligation come within the Physical Delivery Exclusion should remain even if a contract contains an option for the parties to financially settle. This is consistent with the CFTC's current treatment of physical delivery forwards, which allows the application of the CEA's forward contract exclusion to transactions that permit cash settlement.[22] As discussed above, the nature of a contract should not be altered by terms providing optionality to a party, such as delivery place, delivery method, price or quantity.

H. DOCUMENTATION STANDARDS.

Swaps are commonly documented on standardized master agreements and confirmations. Traditionally, each transaction is considered to be documented under one contract, even though that contract may be represented by several writings. Congress recognized this in the definition of Swap. New CEA Section 1a(47)(C) states:

> "(i) IN GENERAL.—Except as provided in clause (ii), the term 'swap' includes a master agreement that provides for an agreement . . . that is a swap . . . together with each supplement to any master agreement . . .
>
> "(ii) EXCEPTION.—For purposes of clause (i), the master agreement shall be considered to be a swap only with respect to each agreement…covered by the master agreement that is a Swap."

The Working Group requests the Commissions, in further defining the term Swap, clarify that the phrase "supplement to" refers to documents such as schedules to master agreements, credit support annexes, and physical annexes that are understood by the markets to be part of a Swap contract. Certain documents that are not considered by the market as part of such contract should be excluded from the definition of Swap. Such documents include, but are not limited to, credit support agreements (to be distinguished from credit support annexes as they are provided by third parties) and master netting agreements. Although instrumental to the trading relationship between two parties, these are not integral to the core economic terms of any particular transaction and should be considered separate agreements.

---

[22] *See* Statutory Interpretation Concerning Forward Transactions at 39,191.

IV. CONCLUSION.

The Working Group appreciates this opportunity to comment, and requests that the Commissions consider these comments as it develops proposed rules or regulations further defining the term Swap. The Working Group looks forward to offering its views in response to the notice of proposed rulemaking addressing this definition.

Respectfully submitted,

/s/ R. Michael Sweeney, Jr.

R. Michael Sweeney, Jr.
David T. McIndoe
Mark W. Menezes

Counsel for the
Working Group of Commercial Energy Firms

Sweeney, R. Michael

Name:	R. Michael Sweeney
Full Name:	Sweeney, R. Michael
Organization:	Hunton & Williams LLP;Regulated Industries & Government Relations
Title:	Partner
Telephone Number (Work Voice):	21944
Address (Work):	Washington
Delivery Label (Work):	Washington
Electronic Mail Address (Preferred Internet):	rsweeney@hunton.com

vCard Version: 2.1 | Revision: 20070723T205001Z