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

**VIA ELECTRONIC SUBMISSION**

RE: *Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement;" Mixed Swaps; Security-Based Swap Agreement Recordkeeping*, RIN 3038-AD46

Dear Secretary Stawick:

## I. INTRODUCTION.

On behalf of the Working Group of Commercial Energy Firms (the "Working Group"), Hunton & Williams LLP hereby submits these comments in response to the request for public comment set forth in the Commodity Futures Trading Commission (the "CFTC" or "Commission") and the Securities and Exchange Commission's (the "SEC") (collectively, the "Commissions") Joint Proposed Rule, *Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement"; Mixed Swaps; Security-Based Swap Agreement Recordkeeping* (the "Proposed Rule"), which was published in the *Federal Register* on May 23, 2011,[1] and seeks to further define, among other things, the term "Swap," pursuant to new Section 1a(47)(A) of the Commodity Exchange Act ("CEA"), as adopted in Title VII, Subtitle A of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Act").[2]

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 regulatory and legislative developments with respect to

[1] *Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement"; Mixed Swaps; Security-Based Swap Agreement Recordkeeping*, Joint Proposed Rules, 76 Fed. Reg. 29,818 (May 23, 2011), as corrected, 76 Fed. Reg. 32,880 (June 7, 2011) ("Proposed Rule").

[2] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, 124 Stat. 1376 (2010).

the trading of energy commodities, including derivatives and other contracts that reference energy commodities.

## II. COMMENTS OF THE WORKING GROUP OF COMMERCIAL ENERGY FIRMS.

As a general matter, the Working Group supports the Commission's adoption of the Forward Contract Exclusion. The comments set forth herein specifically respond to the Commission's request for comments regarding: (i) the proposed extension of existing Commission guidance and precedent implementing the forward contract exclusion to non-financial commodities, including environmental commodities; (ii) agreements, contracts, and transactions entered into pursuant to tariffs or rate schedules approved by the Federal Energy Regulatory Commission ("FERC") and state regulators, such as the Public Utility Commission of Texas ("PUCT"), (iii) commodity options and commodity options embedded in forward contracts; and (iv) the Commission's proposed anti-evasion rules.

The Working Group appreciates the opportunity to provide these comments and respectfully requests the Commission's consideration of such in adopting any final rule in this proceeding.

### A. PROPOSED EXTENSION OF THE FORWARD CONTRACT EXCLUSION TO SWAP MARKETS.

#### 1. Any Agreement—Oral, Written, or Otherwise—to "Book-Out" Physical Transactions in Energy Markets Should Be Acceptable Under the Forward Contract Exclusion.

Because physical delivery forward transactions in energy markets, including those that are subsequently "booked-out," are essential to cost-effective scheduling and the delivery of physical energy commodities to consumers, the Working Group generally supports the Commission's proposal to adopt the Brent Interpretation for "book-outs" of non-financial commodity transactions and permit such transactions to qualify for the forward contract exclusion from the definition of Swap.[3] Further, the Working Group supports the Commission's interpretive guidance stating that the Brent Interpretation with respect to the application of the forward contract exclusion from the term "future delivery" in the context of book-outs applies to ***all*** non-financial commodities.

Notwithstanding the Working Group's support of the Commission's proposal to apply broadly the Brent Interpretation to all non-financial commodities, the Working Group requests that the Commission clarify that the form of agreement (oral, written, or otherwise) entered into to book-out a transaction in which there is an obligation to make or take physical delivery of an underlying commodity is not relevant with respect to the requirement in the Proposed Rule that parties enter into a subsequent, separately negotiated agreement when effectuating a book-out.[4] This clarification is particularly important to participants in wholesale electricity, natural gas, oil

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[3] Proposed Rule at 29,828-29.

[4] Proposed Rule at 29,829.

and refined products markets. Specifically, given the pace at which these markets transact and the frequency that book-outs may sometimes occur for operational and other reasons, formal written documentation of each and every book-out in these energy markets is impracticable. The use of oral agreements to book-out transactions in energy markets is a standard practice and has been critical to maintaining the efficient operation of such markets.[5]

The Working Group believes that the critical distinction for purposes of the forward contract exclusion should be the existence of a subsequent, separately negotiated agreement to effectuate a book-out, not the means chosen by the applicable parties to memorialize such agreement. In this light, the Working Group respectfully requests that the Commission permit the continuation of prevailing industry practice, which allows subsequent agreements to book-out certain physical transactions to be made orally, in writing, or through other operationally convenient means.

### 2. <u>Environmental Commodities Are Non-Financial Commodities</u>.

The Working Group respectfully requests that the Commission clarify that transactions involving environmental commodities, such as greenhouse gas emission allowances, offset credits, and renewable energy certificates ("RECs") that are created pursuant to federal, state, or other applicable law transacted in primary and secondary markets are physical (i) spot market transactions, or (ii) forward contracts for non-financial commodities that are subject to the forward contract exclusion. Although environmental commodities may be traded as the underlying commodity component of certain derivatives transactions (*i.e.*, futures and options on emission allowances and offset credits), environmental commodities are, at their very essence, simple purchase and sale transactions that transfer title and all other incidents of ownership, including rights and liabilities involving certain regulatory compliance obligations, from a seller to a buyer. Thus, given transactions involving environmental commodities actually transfer title to, and ownership of, the environmental commodities, these transactions are physically-settling spot or forward contracts for non-financial commodities that are exempt from the definition of Swap under the forward contract exclusion.

The Interagency Working Group for the Study on Oversight of Carbon Markets, *Report on the Oversight of Existing and Prospective Carbon Markets*, published pursuant to Section 750 of the Act, clearly identifies and distinguishes the existence of three distinct markets for emission allowances and offset credits: (i) primary markets, (ii) secondary markets, and (iii) derivatives markets.[6] Specifically, the *Interagency Report* distinguishes between primary markets, wherein emission allowances and offset credits are "introduced into circulation . . . via direct distribution via allocation by regulators or action to market participants," and secondary markets, wherein "allowances and offsets are actually bought and sold following their initial entry into commerce in the primary market."[7] Further, the *Interagency Report* contrasts derivatives markets from

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[5] Additionally, market participants often enter into agreements to book-out transactions through other means such as e-mail, instant messenger, and facsimile.

[6] Interagency Working Group for the Study on Oversight of Carbon Markets, *Report on the Oversight of Existing and Prospective Carbon Markets*, at 12 (Jan. 18, 2011) ("*Interagency Report*").

[7] *Interagency Report* at 39, 42.

primary and secondary markets by describing derivatives markets as risk management and price discovery markets wherein transactions are tied to the price of an underlying emission allowance and actual transfer of the allowance may not occur."[8] While the Working Group notes that some environmental commodity markets, such as markets for RECs, operate differently than those described in the *Interagency Report* and are not limited by a finite amount of the commodity distributed in the market by regulators, the same analysis and findings apply to them.

When addressing secondary markets for emission allowances and offset credits, the *Interagency Report* states:

> There are two types of secondary cash market transactions, spot transactions and forward contracts. In a spot transaction, one party sells an allowance to another party for immediate delivery of the allowance. In a forward transaction, the parties agree to a price or a method to fix a price with delivery of the allowance to take place at a later date.[9]

The Working Group supports the view expressed in the *Interagency Report* that secondary markets for emission allowances and offset credits operate through the execution of spot transactions or forward contracts. This characterization is appropriately extended to state-regulated markets for RECs and other environmental commodities.

As noted above, the Working Group acknowledges that derivatives markets for environmental commodities currently exist and will likely continue to evolve. Such markets, whether for futures, options on futures, or Swaps, are clearly within the Commission's jurisdiction under the CEA. However, a forward contract for the purchase and sale of environmental commodities are not derived from, or otherwise based upon, the price of an underlying environmental commodity, and transfer of the allowance from the seller to buyer actually occurs. Further, the element of physical delivery takes place the moment that title and ownership in the environmental commodity itself is transferred from the seller to the buyer whether through the execution of a legally binding contract or attestation, or submission of records to a centralized data base, such as a registry.[10] Indeed, the *Interagency Report* clearly acknowledges that emission allowances and offset credits can be transferred among parties, resulting in physical delivery that satisfies the forward contract exclusion.

The following are indicia that environmental commodities are non-financial commodities. First, as discussed above, the purchase and sale of environmental commodities are accomplished by physical delivery, wherein title to a commodity is passed from one counterparty to the other. Second, environmental commodities are "consumed," whether for compliance with state-mandated renewable portfolio standards or laws limiting the emissions of greenhouse

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8 *Id.* at 42.

9 *Id.*

10 For RECs, the Generation Information System's electronic registry records a change of owners. For greenhouse gas emissions and offset credits, physical transfer of title is documented in a contract or via attestation or, in some cases, electronic transfer of ownership is effectuated through a registry, such as those maintained by the Climate Action Reserve, the Verified Carbon Standard, and the American Carbon Registry.

gases.[11] Third, the transfer of emission allowances, offset credits, and other environmental commodities is critical to energy companies seeking to meet state and federal environmental regulatory compliance requirements. Thus, forward contract sales on environmental commodities should not be regulated as Swaps. Indeed, (i) the efficient trading of such environmental commodities is important to well-established federal and state energy and environmental policy objectives; and (ii) duplicative regulation of these commodities by the Commission is not in the public interest as it would unnecessarily impair the pursuit of important environmental and energy policies and impose unnecessary costs on energy markets and, ultimately, consumers.[12]

Accordingly, the Commissions should recognize that transactions involving the actual transfer of title to, and ownership of, environmental commodities are physically-settling spot transactions or forward contracts for non-financial commodities that are exempt from the definition of Swap under the forward contract exclusion.

### B. AGREEMENTS, CONTRACTS AND TRANSACTIONS ENTERED INTO PURSUANT TO TARIFFS AND RATE SCHEDULES APPROVED BY OTHER FEDERAL AND STATE REGULATORS SHOULD NOT BE REGULATED AS SWAPS.

Sections 722(f) of the Act provides the Commission with the authority to act on its own initiative and exempt all agreements, contracts, or transactions entered into pursuant to tariffs or rate schedules approved or permitted by FERC or state regulatory agencies, such as the PUCT in the case of ERCOT, if it finds that granting such exemption is consistent with the public interest. Specifically, Section 722(f) states, in relevant part:

> (f) PUBLIC INTEREST WAIVER.—Section 4(c) of the Commodity Exchange Act (7 U.S.C. 6(c)) (as amended by Section 721(d)) is amended by adding at the end the following:
>
> "(6) If the Commission determines that the exemption would be consistent with the public interest and the purposes of this Act, the Commission ***shall***, in accordance with paragraphs (1) and (2), exempt from the requirements of this Act an agreement, contract, or transaction that is entered into—
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> "(A) pursuant to a tariff or rate schedule approved or permitted to take effect by the Federal Energy Regulatory Commission;
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> "(B) pursuant to a tariff or rate schedule establishing rates or charges for, or protocols governing, the sale of electric energy approved or permitted to

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[11] For example, emission allowances for regulated pollutants represent a regulatory authorization to emit a specific quantity of pollutant. RECs represent proof that one megawatt-hour (MWh) of electricity was generated from an eligible renewable energy resource.

[12] *See* Comments of the Working Group of Commercial Energy Firms, *Commodity Options and Agricultural Swaps*, Advanced Notice of Proposed Rulemaking, *Definitions Contained in Title VII of Dodd-Frank Wall Street Reform and Consumer Protection act of 2010*, at Part III.F (Sept. 20, 2010) ("Working Group Definitions ANOPR Comments").

> take effect by the regulatory authority of the State or municipality having jurisdiction to regulate rates and charges for the sale of electric energy within the State or municipality . . . ."

(Emphasis added).

Significantly, Section 722(f) compels the CFTC to grant the waiver if it determines that such waiver is "consistent with the public interest." The Working Group believes that based on the following, the grant of such wavier by the CFTC is consistent with the public interest and necessary to provide certainty and preserve the efficiency of the well-functioning energy markets.

First, FERC and the PUCT have plenary authority to regulate the wholesale electricity markets subject to their respective jurisdictions.[13] Further, in addition to the authority FERC has to regulate the interstate transportation of natural gas,[14] state regulatory commissions and agencies akin to the PUCT have authority to regulate intrastate natural gas markets. Second, all FERC and PUCT-jurisdictional agreements, contracts, and transactions are subject to pervasive rate regulation and review by the FERC and PUCT. Similarly, in the case of natural gas markets, state-jurisdictional agreements, contracts, and transactions are subject to pervasive retail rate regulation and review by state regulatory commissions and agencies. Third, the transmission of electricity in FERC and PUCT-jurisdictional wholesale markets and the transportation of natural gas in FERC-jurisdictional markets are subject to well-established open access and non-discrimination rules. Fourth, market rules, protocols, and business practices developed and implemented by FERC and PUCT-jurisdictional RTO/ISOs are subject to prior review and approval by these regulatory bodies. Fifth, participants in FERC and PUCT-jurisdictional wholesale markets are (i) subject to vigorous enforcement rules and regulations, including broad anti-manipulation and anti-fraud authority, real-time monitoring by the respective regulatory

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[13] FERC has plenary authority under Part II of the Federal Power Act, 16 U.S.C. § 824, to regulate the sale and transmission of electric energy at wholesale in interstate commerce, including organized competitive wholesale markets operated by FERC-approved regional transmission organizations and independent system operators (collectively, "RTO/ISOs"). The PUCT has plenary authority under Chapter 39 of the Public Utility Regulatory Act, TEX. UTIL. CODE §§ 39.001-29.916 to regulate Texas wholesale electricity markets, including the organized wholesale electricity market operated by the Electric Reliability Council of Texas ("ERCOT"), and for enforcing statutes and ERCOT procedures relating to those wholesale electricity markets.

[14] Natural Gas Act, 15 U.S.C. § 717.

bodies' enforcement divisions, and (ii) certain transparency and reporting requirements.[15] Sixth, organized wholesale electricity markets operated by FERC or PUCT-approved RTO/ISOs are also subject to monitoring by appointed independent market monitors. Seventh, certain products transacted in FERC and PUCT-jurisdictional RTO/ISO markets, such as firm transmission rights ("FTRs"), are inextricably intertwined with these physical electricity markets and cannot be functionally unbundled from the prevailing market structure.

In short, it is consistent with the public interest to ensure that FERC or PUCT-jurisdicitonal agreements, contracts, or transactions are not regulated as Swaps. If agreements, contracts, and transactions entered into pursuant to FERC or PUCT-approved tariffs, rate schedules, or protocols are subject to regulation as "Swaps," (i) market participants would face significant uncertainty and costly, duplicative regulatory requirements, (ii) CFTC resources would be diverted away from primary areas of CFTC regulation, and (iii) FERC's and the PUCT's ability to execute their statutory duties to provide comprehensive oversight of such markets would be impaired.

Accordingly, to ensure continued regulatory certainty for participants in physical wholesale electricity and natural gas markets, the Working Group respectfully requests that the Commission act *sua sponte* and use the authority granted to it under Section 722(f) to exempt from the CEA as "consistent with the public interest" all agreements, contracts, and transactions entered into pursuant to a tariff or rate schedule permitted to take effect by FERC or the PUCT.

Separately, the Working Group respectfully requests that the CFTC and FERC continue to work together to execute the "Memorandum of Understanding" mandated by Section 720 of the Act within which the exemptive status of these tariff or rate schedule agreements, contracts, and transactions should be memorialized.

### C. <u>REGULATION OF PHYSICAL OPTIONS ON PHYSICAL COMMODITIES AS SWAPS</u>.

Options routinely executed in physical energy markets are generally viewed in two distinct contexts: (i) a financial option on a physical commodity ("Financial Option");[16] and (ii)

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[15] For example, FERC's Division of Energy Market Oversight ("Market Oversight") is responsible for performing daily oversight of the wholesale natural gas and electric power markets and related energy and financial markets, identifying market events and trends, reporting them to FERC and, as appropriate, the public, and proposing policy options and regulatory strategies for addressing issues identified. Market Oversight (i) refers issues of potential market manipulation or rule violations for investigation and possible enforcement; (ii) assesses factors that relate to the competitiveness, fairness and efficiency of wholesale energy markets; (iii) develops and applies quantitative analysis to screen markets for anomalous behavior; (iv) advises FERC on the efficacy of its current regulatory policies in light of evolving energy markets; and (v) ensures that FERC has the information needed to oversee the markets effectively. *See* http://www.ferc.gov/about/offices/oe/oe-doemo.asp. Market participants in PUCT-jurisdictional wholesale electricity markets are subject to real-time oversight by the PUCT's Oversight and Enforcement Division pursuant to TEX. UTIL. CODE § 39.157 and the PUCT's wholesale oversight rules 16 TEX. ADMIN. CODE §§ 25.502-25.504. In addition, the ERCOT wholesale electricity markets are subject to real-time oversight by the wholesale electric market monitor, which has independent authority and responsibility to detect and prevent market manipulation strategies and recommend measures to enhance the efficiency of the wholesale market pursuant to TEX. UTIL. CODE § 39.1515.

[16] Financial Options are based on the value of an underlying physical commodity and result in an exchange of cash flows between the counterparties upon exercise of the option.

an option to purchase or sell a physical commodity ("Physical Option"). A Physical Option is a contract that can only result in the physical delivery of a commodity upon exercise of the option. Physical Options, whether executed as a stand alone transaction or embedded in another agreement, are characterized by the right, but not the obligation, to make or take physical delivery of a commodity, and the corresponding and binding obligation to take or make delivery of such commodity when exercised.

Unlike Financial Options, Physical Options do not result in financial settlement based on a mutual exchange of cash flows between the parties. Indeed, the defining characteristic of a Physical Option is that it is entered into with the intent that the underlying commodity will be delivered. Accordingly, Physical Options, however transacted, fall within the statutory exclusion for deferred shipment or delivery, and thus are not Swaps as defined in the CEA, as amended by the Act. They are, therefore, outside the scope of these regulations.

Physical Options are an essential tool in markets for many physical energy commodities, including natural gas, power, crude oil, refined products and other energy and energy-related products, and are used in a variety of ways. They provide commercial energy firms with the flexibility necessary to reliably acquire and deliver physical commodities necessary to meet the specific requirements of buyers and sellers of the commodities.

It is well recognized that energy markets themselves are dynamic and that supply and demand are variable. Availability of production and requirements for consumption are often influenced by factors outside the control of the parties to an energy commodity transaction and can change on an hourly or daily basis. These factors, include, but are not limited to, customer manufacturing or product requirements, load growth, reserve margin requirements, weather, and certain operational considerations (*e.g.*, available transportation capacity to deliver physical natural gas purchased on the spot market). Contracts transacted in energy commodity markets reflect these dynamics.

Given that Physical Options settle by physical delivery and are used to meet varying customer demand for a commodity, the optionality associated with Physical Options is best characterized as "volumetric optionality." The Working Group respectfully submits that "volumetric optionality" is separate and distinct concept from "deliverability optionality." That is, the question is not how the option will settle (*i.e.,* financially or physically), but rather what volume of the underlying physical commodity will be delivered if and when the customer exercises the option.[17]

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[17] In energy markets, a customer's requirements for an energy commodity underlying a Physical Option can swing anywhere from zero to 100 percent of the total volume provided under the option. For example, in wholesale electricity markets, a municipal utility with multiple industrial businesses with unusually dynamic load profiles located in its service territory (*i.e.,* aluminum smelter, steel mills) could enter into a Physical Option with a commercial energy firm. The purpose for entering into the Physical Option is to provide the municipal utility, which may be energy resource constrained, with the flexibility to meet customer demand, which varies widely depending on whether the industrial businesses are (i) not operating, (ii) operating at partial capacity, or (iii) operating at full capacity.

### 1. <u>The Commission Should Exercise its Plenary Authority Under CEA Section 4c(b) to Regulate Physical Options in a Manner Distinct from Swaps</u>.

To the extent the Commission concludes that Physical Options do not meet the requirements of the physical delivery exclusion and are therefore Swaps, it still retains the authority to regulate these contracts under a separate regulatory regime. Specifically, Congress vested the Commission with the statutory authority to regulate options, including Physical Options, in a manner different than Swaps under CEA Section 4c(b). In light of the foregoing, the Commission should use its exemptive authority under CEA Section 4c(b) and not regulate Physical Options in the same manner as other transactions falling within the definition of "Swap." Section 4c(b) of the CEA states:

> No person shall offer to enter into, enter into or confirm the execution of, any transaction involving any commodity regulated under this Act which is of the character of, or is commonly known to the trade as, an "option", "privilege", "indemnity", "bid", "offer", "put", "call", "advance guaranty", or "decline guaranty", contrary to any rule, regulation, or order of the Commission prohibiting any such transaction **or allowing any such transaction under such terms and conditions as the Commission shall prescribe**. Any such order, rule, or regulation may be made only after notice and opportunity for hearing, **and the Commission may set different terms and conditions for different markets**.

(Emphasis added).

Based on the foregoing, the Commission has clear authority to promulgate an appropriate regulatory structure for each Physical Option market. As it did in its comments on the Commodity Options Proposed Rule, the Working Group urges the Commission to use its authority under CEA Section 4c(b) to adopt a modified "trade option exemption" substantially similar to that set forth in existing CFTC Rule 32.4.[18] In its initial adoption of the current trade option exemption, the Commission recognized that allowing commercial entities to use options on physical commodities in the normal course of their business does not create the opportunity for wide-spread fraud and allows such commercial entities to conduct their business operations in an efficient and cost effective manner.[19] Because that underlying rationale remains just as valid today, the Working Group submits that the Commission should continue to treat Physical

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If the industrial businesses are not operating, the municipal utility may not exercise the option as aggregate customer demand is not sufficient to call on this resource. If these businesses are operating at partial capacity, it may exercise the option but elect to take physical delivery of a percentage of the volume available under the option (assuming the terms of the option permit this). Finally, if the economy is strong and the industrial businesses are operating at full capacity (*e.g.*, three shifts a day, seven days a week), the municipal utility will exercise the option and take physical delivery of the full amount of electricity provided under the option.

[18] 17 C.F.R. § 32.4 (2011). *See also* Comments of the Working Group of Commercial Energy Firms, *Commodity Options and Agricultural Swaps* (Apr. 4, 2011) ("Working Group Commodity Options Comments").

[19] *See Regulation and Fraud in Connection with Commodity and Commodity Option Transactions*, 41 Fed. Reg. 51,808, at 51,815 (Nov. 24, 1976); *Report of the Advisory Committee on Definition and Regulation of Market Instruments*, 41 Fed. Reg. 44,563, *Appendix A-4*, (Jan. 22, 1976).

Options entered into by a commercial entity as commercial transactions exempt from the provisions of the CEA.[20]

### 2. **<u>The Significant Operational and Practical Burdens Associated with Regulating Physical Options as Swaps Must Be Considered by the Commission</u>.**

In its comments filed in the Proposed Commodity Option Rule, the Working Group highlighted the following list of operational concerns associated with regulating Physical Options as Swaps.[21] In particular, the list focuses on daily call and put options transacted in physical energy markets.

- How will such daily call or put options be treated by the Commission? Will they be treated as (i) swaps prior to the first exercise, and (ii) physical forwards after the first option is exercised?
- If a contract calls for a series of daily call or put options, will each option be considered a separate swap or will the whole series of options set out under the contract be considered a swap?
- If daily call or put options are deemed to be swaps, will standardized options be subject to the mandatory clearing requirement and will they be required to be traded on a swap execution facility or designated contract market (collectively, an "Exchange")?
- Once a daily call or put option is exercised and becomes a forward contract, how does the Commission propose to handle the resulting physical delivery of energy? Can an Exchange accommodate physical delivery of energy? Or, upon the exercise of the option will the transaction be treated as a bilateral physical deal for regulatory purposes?
- If a counterparty to the daily call or put option was registered with the Commission as a swap dealer or major swap participant, how would capital and margin be applied to these transactions? Would any applicable margin requirements be (i) limited to the Commission-jurisdictional "option" aspect of the transaction, or (ii) bifurcated between the swap and physical forward aspects of the transaction?
- How would other federal or state regulators, such as the FERC or, for the Electric Reliability Council of Texas ("ERCOT"), the PUCT, be affected if a daily call or put option is deemed to be a swap? How would it affect the ability of FERC and PUCT to perform their statutory obligations to provide regulatory oversight of the physical delivery of electricity in their respective jurisdictional electricity markets when the option

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[20] The Working Group requests that, if the Commission does not use its authority under Section 4c(b) of the CEA to exempt Physical Options from the definition of "Swap," it use its authority under Section 4(c) of the CEA to do so. *See* Comments of the Working Group of Commercial Energy Firms, *Commodity Options and Agricultural Swaps*, at 12 (Apr. 4, 2011) ("Working Group Commodity Options Comments").

[21] *See* Working Group Commodity Options Comments at 5-6.

is exercised? If the option is exercised within an organized, wholesale electricity market, how would the Proposed Rule affect the ability of the FERC or PUCT-approved market operator to administer such markets?

- How would the Commission's proposed rules for reporting swap transaction data apply to daily call and put options for physical energy? Would market participants engaging in such transactions be required to report the option sale and premium or each exercise of an option?

In light of the foregoing, Physical Options, whether executed as a stand alone transaction or embedded in a forward contract (i) fall within the statutory exclusion for deferred shipment or delivery, and thus are not Swaps as defined in the CEA, as amended by the Act, or (ii) alternatively, if deemed by the Commission to be Swaps, should be exempt from the definition of Swap pursuant to a modified trade exemption pursuant to CEA Section 4c(b).

### D. ANTI-EVASION.

Section 721(c) of the Act requires the Commission to adopt a rule to further define "swap," "swap dealer," "major swap participant," and "eligible contract participant" to "include transactions and entities that have been structured to evade" Title VII, Subtitle A of the Act. In accordance with Section 721(c), the Commission proposes to define as Swaps those transactions that are "willfully structured to evade" the provisions of Title VII of the Act and subject those transactions to the swap provisions of the CEA enacted pursuant to Title VII of the Act.

The Commission's interpretive guidance in the Proposed Rule states that, absent other indicia of evasion, it would not consider transactions, entities, or instruments structured in a manner solely motivated by a legitimate business purpose to constitute evasion. The "legitimate business purpose" standard set forth in the Proposed Rule is not the appropriate standard applying Section 721(c). Due to the lack of any discussion or guidance in the Proposed Rule, market participants are faced with uncertainty as to how the Commission will determine what constitutes a "legitimate business purpose."

The appropriate standard for applying Section 721(c) should be simply whether or not a transaction is lawful or not. Specifically, any transaction structured in manner that (i) does not violate the CEA and CFTC rules, regulations, or orders, and (ii) that is otherwise legal under applicable federal, state, or other laws cannot be viewed as being willfully structured to evade the provisions of Title VII of the Act.

The Working Group is concerned that the adoption of the "legitimate business purpose" standard will have a significant chilling effect on markets for energy commodities and the competitiveness of the U.S. economy. As a consequence, it is critical that the Commission not apply its proposed anti-evasion provisions in a manner that would preclude market participants from entering into creative, but legal, transaction structures that achieve bona fide commercial objectives while minimizing potential regulatory burdens, including those associated with being subject to regulation under Title VII.

Finally, the Working Group submits that the penalty for violating the anti-evasion rules is draconian as all transactions subject to the penalty will be deemed Swaps whether or not they meet other aspects of the statutory definition of "Swap." If a transaction that was not believed to be a Swap by the transacting parties subsequently is deemed to be a Swap pursuant to the anti-evasion rules, it will likely result in more violations of the CEA.

### E. THE COMMISSION SHOULD PERFORM A COST-BENEFIT ANALYSIS.

Section 15(a) of the CEA requires the CFTC, before promulgating a rule, to "consider the costs and benefits of the action of the Commission." As a general matter, the cost and benefit analysis specific to the regulations regarding Swaps does not appear to be based on any empirical data and does not appear to be consistent with the expected costs of compliance anticipated by market participants. In particular, the Commission should consider and evaluate the cost implications associated with removing the trade option exemption, which, as discussed above, the Commission has the authority to retain. Trade options are currently exempted from the CEA and are a critical risk management tool to market participants. In this light, the Working Group submits that there is no benefit to begin regulating such transactions under the CEA.

As set forth in President Obama's Executive Order 13563, "Improving Regulation and Regulatory Review," regulatory objectives should be achieved using the least burdensome regulatory tools.[22] President Obama, in his July 11, 2011 Executive Order, "Regulation and Independent Regulatory Agencies," requires federal agencies as well as independent agencies to promote the goals set forth in Executive Order 13564 and requires independent agencies to conduct reviews of their existing regulations with respect to their costs, benefits, and impacts on the industry and the economy.[23] Thus, in accordance with President Obama's Executive Orders, the Working Group requests that the Commissions (i) consider the costs and benefits associated with the Proposed Rule in the manner prescribed by CEA Section 15(a), (ii) issue a supplemental rule in this proceeding setting forth empirical data supporting its conclusions regarding the costs and benefits of the Proposed Rule, and (iii) notice the supplemental rule in the *Federal Register* for public comment. Indeed, the CFTC has stated that it intends to comply with the spirit of Executive Order 13563.[24]

## III. CONCLUSION.

The Working Group supports appropriate regulation that brings transparency and stability to the energy swap markets in the United States. The Working Group appreciates this opportunity to comment and respectfully requests that the Commission consider the comments set forth herein as it develops a final rule in this proceeding.

The Working Group expressly reserves the right to supplement these comments as deemed necessary and appropriate.

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[22] *See Improving Regulation and Regulatory Review*, Exec. Order No. 13,563 (Jan. 18, 2011).

[23] *See Regulation and Independent Regulatory Agencies*, Exec. Order (July 11, 2011).

[24] *See Reducing Regulatory Burden; Retrospective Review Under E.O. 13563*, Request for Information, 76 Fed. Reg. 38,328 (June 30, 2011).

If you have any questions, please contact the undersigned.

Respectfully submitted,

/s/ R. Michael Sweeney, Jr.

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