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June 26, 2012

Via Electronic Filing

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

Re: Interim Final Rule – Commodity Options, RIN No. 3038-AD62

Dear Secretary Stawick:

On April 27, 2012, the Commodity Futures Trading Commission's ("CFTC" or "the Commission") Final Rule and Interim Final Rule on Commodity Options ("the Commodity Options Rule") was published in the Federal Register.[1] In the Commodity Options Rule, the Commission, *inter alia,* implemented "the commodity option rules as proposed in the [Notice of Proposed Rulemaking], whereby commodity options are permitted subject to the same rules as all other swaps," together with "a new trade option exemption" which limits the scope of regulation for qualifying commodity options.[2]

In the Commodity Options Rule, the Commission also made clear that "[f]or the purposes of this release, the Commission uses the term 'commodity options' to apply solely to commodity options not excluded from the swap definition set forth in [Commodity Exchange Act ("CEA")] section 1a(47)(A),"[3] which is the subject of an ongoing rulemaking to further define the term "Swap."[4] The Commission stated in the Commodity Options Rule that it would accept comments on the trade option exemption which it has adopted as an interim final rule until June 26, 2012.

[1] 77 Fed. Reg. 25320 (April 27, 2012)

[2] *Id.* at 25325.

[3] Commodity Options Rule, 77 Fed. Reg. 25320 at 25321 fn 6.

[4] *See Further Definition of ''Swap,'' ''Security-Based Swap,'' and ''Security-Based Swap Agreement''; Mixed Swaps; Security-Based Swap Agreement Recordkeeping*, 76 FR 29818, (Notice of Proposed Rulemaking) (May 23, 2011) (the "Swap Definition Rulemaking").

By letter dated June 7, 2012, the Coalition of Physical Energy Companies ("COPE")[5] addressed the legal, propriety, and regulatory implications of defining commodity options that are intended to, and can only, settle physically as "swaps" (such letter, the "June 7 Letter"). In the June 7 Letter, COPE pointed out that there is a material statutory basis upon which to find that such physically-delivered products are not swaps and set forth concerns about the application of swap regulation to such products.[6] In the June 7 Letter, COPE also informed the Commission it would provide additional comment on the newly created trade option exemption.[7]

COPE members are physical energy companies in the business of producing, processing, and merchandizing energy commodities at retail and wholesale. COPE members utilize swaps to hedge the commercial risk of their physical businesses. COPE members also engage in transactions involving commodity options.

The Commission Should Not Define Physically-Settling Commodity Options As Swaps

COPE understands that the Commission may believe that, notwithstanding the physical nature of commodity options that are intended to and can only settle physically, it has limited legal freedom to avoid defining them as "swaps" under Dodd-Frank. COPE believes that not only does the statutory language support not defining physically-settling commodity options as "swap," but also that doing so would be unproductive in the overall cause of swap regulation and would be harmful to physical energy markets.

The Dodd-Frank Wall Street Reform and Consumer Protection Act[8] ("Dodd-Frank") is designed to regulate financially-settling products that can be cleared, exchange traded, used for speculation, or used as hedges (not for physical supply), and take the form of derivative products.[9] The physically-settling commodity options addressed in COPE's June 7 Letter have none of the characteristics of the products that Dodd-Frank was intended to regulate.

By contrast, commodity options that are intended to and can only settle physically have the following general characteristics:

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[5] The members of the Coalition of Physical Energy Companies are: Apache Corporation; EP Energy LLC; Enterprise Products Partners, L.P.; Iberdrola Renewables, Inc.; Kinder Morgan; MarkWest Energy Partners, L.P.; Noble Energy, Inc.; NRG Energy, Inc.; Shell Energy North America (US), L.P.; SouthStar Energy Services LLC; and Targa Resources.

[6] *See* June 7 Letter at pp. 2-4.

[7] *Id.* at p. 1, fn 5.

[8] Pub. L. 111-203, 124 Stat. 1376 (2010).

[9] *See* Commodity Options Rule at 25321.

- Cannot be Cleared: Such options must be physically delivered and are not financially settled. A clearinghouse cannot physically deliver these products.
- Cannot Be Exchange-Traded: As a practical matter, the parties to these options will evaluate their counterparties' ability to provide them physical products. Only a counterparty capable of physical delivery of the underlying product is even evaluated under other criteria such as creditworthiness. In short, these options are not the kind of fungible product that is susceptible to exchange trading.
- Cannot Be Used For Speculation: Speculators are not interested in physical supply; they are looking for financial settlement. These contracts do not fit the bill. If physical supply were a vehicle for speculation, forward contracts would also be used for that purpose.
- Not Used For Financial Hedging: These physical contracts are only associated with physical delivery. They are not financial risk management tools.
- Not Derivatives: These contracts are physical contracts by nature; unlike swaps, they are not derivatives of physical contracts.

The purpose of Dodd-Frank is to provide a regulatory scheme for the swaps/derivatives market akin to that which exists for the futures markets while also recognizing the continued role of over-the-counter swaps. It is not the purpose of Dodd-Frank to regulate End-Users and their physical transactions.[10] As set forth above and in the June 7 Letter, COPE can discern no regulatory purpose associated with the goals of Dodd-Frank that will be achieved by defining physically-settling commodity options as swaps. The Commission has material discretion in fashioning its rules implementing Dodd-Frank.[11] There are clear legal and

[10] *See, e.g.*, Letter from Senators Christopher Dodd and Blanche Lincoln to Representatives Barney Frank and Collin Peterson, June 30, 2010.

[11] *See Chevron U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837, 842-43 (1984) (holding that administrative agencies necessarily require discretion to formulate policy and make rules to fill in any gaps left by Congress and that a reviewing court must give deference to a Federal agency's construction of a statute that it administers); *Mayo Found. for Med. Educ. & Research v. United States*, 131 S. Ct. 704, 706, 711 (2011) (holding that Congress's silence on the issue grants to the Treasury Department authority and discretion to define the term "student" under the Federal Insurance Contributions Act and that the Department's full-time employee rule is a reasonable construction of the statute that merits *Chevron* deference); *Nat'l Cable & Telecomms. Ass'n v. Brand X Internet Servs.*, 545 U.S. 967, 973 (2006) (concluding that Congress has given the Federal Communications Commission (FCC) discretion to "execute and enforce" the Communications Act and holding that the FCC's ruling that "broadband cable modem companies are exempt from mandatory common-carrier regulation is a lawful construction of the Communications Act under *Chevron* . . . ."); *First Am. Discount Corp. v. CFTC*, 222 F.3d 1008, 1014 (D.C. Cir. 2000)

factual bases for the Commission to determine that commodity options that are intended to and can only settle physically are not swaps.[12]

Accordingly, COPE respectfully requests that the Commission find that commodity options that are intended to and can only settle physically are not swaps. The alternative offered to this approach in the Commodity Options Rule, the trade option exemption, appears designed to "turn off" Dodd-Frank regulation as much as possible for qualifying swaps. As shown below, the proposed trade option exemption retains regulatory components for qualifying trade options that are problematic for physical market participants and counterproductive for the Commission. If the Commission cannot exclude these physical products from the swap definition, it must undertake a thorough review of the regulatory elements of the exemption to make sure that inadvertent and unneeded regulation does not result.

It is COPE's view that the best solution is to not include physically-settling commodity options within the definition of "swap." If the Commission is compelled to include them within the swap definition, it must significantly reduce the scope of swap regulation accorded to these products.

As Proposed, The Trade Option Exemption Retains Excessive Regulatory Components

In the Commodity Options Rule, the Commission amended its approach to commodity options to include a trade option exemption. The exemption is subject to the following prerequisites:[13]

> (1) Such commodity option transaction must be offered by a person that has a reasonable basis to believe that the transaction is offered to

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(concluding that there is sufficient ambiguity in in the applicable section of the Commodity Exchange Act for the Commodity Futures Trading Commission (CFTC) to interpret at its discretion and upholding the CFTC's regulation as a permissible construction of the statute under the *Chevron* doctrine (quoting *Chevron*, 467 U.S. at 843-44)).

[12] In its implementation of Dodd-Frank, the Commission has often exercised appropriate discretion in interpreting the statute. For example, the Commission decided to exclude certain inter-affiliate swaps from real-time reporting requirements pursuant to 17 C.F.R. § 43.2, where the Dodd-Frank statutory provision, Section 727, requiring the Commission to "provide by rule for the public availability of swap transaction and pricing data" does not address or exclude such inter-affiliate transactions from the requirement. *See* Dodd-Frank § 727 (codified at 7 U.S.C. § 2(a)(13)); *Real-Time Public Reporting of Swap Transaction Data*, 77 Fed. Reg. 1182, 1244 (Final Rule) (January 9, 2012). The Commission can similarly do so here.

[13] 17 C.F.R. § 32.3(a) (Interim Final Rule).

> an offeree as described in paragraph (a)(2) of this section. In addition, the offeror must be either:
>
> > (i) An eligible contract participant, as defined in section 1a(18) of the Act, as further jointly defined or interpreted by the Commission and the Securities and Exchange Commission or expanded by the Commission pursuant to section 1a(18)(C) of the Act; or
> >
> > (ii) 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 such offeror is offering or entering into the commodity option transaction solely for purposes related to its business as such;
>
> (2) The offeree must be 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 such offeree is offered or entering into the commodity option transaction solely for purposes related to its business as such; and
>
> (3) The commodity option must be intended to be physically settled, so that, if exercised, the option would result in the sale of an exempt or agricultural commodity for immediate or deferred shipment or delivery.

If an option meets these criteria, is will be exempt from certain Dodd-Frank regulations, but will remain subject to others.[14] While COPE believes that many of the options that meet these criteria should be excluded from the definition of swap, COPE appreciates the Commission's efforts to limit the burdens placed on physical entities that transact in these options. As shown below, COPE believes that the regulatory elements reserved in the Commodity Options Rule are overbroad and should be further limited.

The provisions discussed below are provided based upon the scope of expectations for the definition of "swap," including the scope of options included therein. COPE reserves its rights to provide further comments in the event the final product definition triggers a need for further requested exemptions.

[14] *See id.* at § 32.3 (b)-(d).

Trade Options Should Not Be Subject To Position Limits.

As shown above and in the June 7 Letter, physical-settling commodity options are not the type of product that can be used by speculators. They are not financial price discovery products. As such, they are not the type of product for which the Commission expressed concern in the Position Limits Final Rule.[15] Nevertheless, they may include pricing that is "directly or indirectly linked" to a Core Reference Futures Contract or the delivery location thereof. Such a pricing term would render a trade option a "Reference Contract"[16] which would then be a component of a market participant's position under the Position Limits Final Rule.[17]

COPE requests that trade options be exempted from the scope of contracts counted towards the position limits. As set forth above, these contracts are not the type of contract that can be used for "excessive speculation." They were not contemplated or addressed in the Position Limits Final Rule. No factual predicate for their inclusion in position limits has been offered by the Commission in the Commodity Options Rule. There has been no basis in fact offered to include physical-settling commodity options in the position limits regime and, to COPE's knowledge, none exists.

In addition to the conceptual impropriety of subjecting trade options to position limits, their inclusion creates an additional burden on physical entities in the already arduous effort of complying with position limits. Since COPE can discern no connection of these contracts to speculation, there is an inherent cost/benefit mismatch to subjecting such contracts to costly position limits compliance.

Trade Options Should Not Be Subject To Documentation Requirements of Proposed Margin Rules

As COPE anticipates that certain physical energy firms and physical commodities businesses of financial firms will be designated as Swap Dealers, commodity options that qualify as trade options under the Commodity Options Rule will be subjected to Dodd-Frank margin requirements in keeping with Section 32.3(c)(5) of the Interim Final Rule, which requires qualifying trade options to comply with the Capital and Margin requirements of Dodd-Frank. The Commission has proposed regulations implementing those margin requirements that

[15] *Position Limits for Futures and Swaps*, 76 Fed. Reg. 71626 at 71627 (Final Rule), (Nov. 18, 2011) (discussing the Commission's perceived mandate under Dodd-Frank to establish position limits "to diminish, eliminate, or prevent excessive speculation and market manipulation").

[16] *See* 17 C.F.R. § 151.1 (definition of "Referenced Contract").

[17] *See id.* at § 151.4 (Position limits for Referenced Contracts).

would require the execution of "credit support arrangements" between swap dealers and their swaps counterparties that satisfy specific requirements.[18]

As noted in the June 7 Letter, trade options are often executed under industry standard documentation such as the EEI or NAESB agreements.[19] COPE believes it would be burdensome and create confusion if all physical agreements among Swap Dealers and their counterparties were required to be amended to satisfy documentation requirements designed for financial swaps and their agreements. COPE members already will be faced with amending their financial agreements. COPE cannot imagine any benefit to be gained by forcing amendments to physical agreements that do not currently contain credit support arrangements that would satisfy the Commission's proposed margin rules or any other documentation requirements required by the Commission for financial swaps.

The Commission has provided no basis in the proposed margin rules or the Commodity Options Rule to support subjecting trade options to swap documentation regulation .

Trade Options Should Be Subject To Internal Business Conduct Rules Only to the Extent They Clearly and Specifically Apply To Physical Contracts

The Commodity Option Rule does not exempt trade options from the internal business conduct standards for Swap Dealers and Major Swap Participants set forth in subpart J of part 23 of the Commission's regulations.[20] This rule contemplates highly structured internal risk management requirements for Swap Dealers that would apply under the Interim Final Rule to any qualifying trade option executed with a Swap Dealer.[21]

Since trade options are intended for physical delivery, there appears to be a significant mismatch between the internal risk management rules that are designed for financial contracts and trade options that are physical contracts. COPE members do not object to their Swap Dealer counterparties being required to undertake prudent risk management. However, COPE is concerned that the broad application of these financially-oriented rules to physical contracts could create additional expenses for Swap Dealers which would necessarily be passed along to their physical counterparties. As a result, COPE requests that the Commission make clear that these requirements apply to physical contracts, such as trade

[18] *See Margin Requirements for Uncleared Swaps for Swap Dealers and Major Swap Participants*, 76 Fed. Reg. 23732 at 23744 (proposed § 23.151), (Notice of Proposed Rulemaking) (April 28, 2011).

[19] June 7 Letter at pp. 2-3.

[20] *See* 17 C.F.R. § 32.3(c)(3) (Interim Final Rule); *id*. at §§ 23.600-23.607.

[21] *Id.* at § 23.600.

options, only to the degree they are applicable on the face of the regulations. No significant additional requirements should be required of physical contracts merely because the Commission has decided to apply these rules to trade options.

Once Exercised, Trade Options Should Either Not Be Swaps, or Should Be Exempted From Swaps Regulation

Unlike the options typically covered by the Commission's regulation which are not subject to multiple exercises, trade options will be susceptible to physical delivery and continued optionality simultaneously. As stated in the June 7 Letter:

> "[S]ince an option may cover a considerable period (a winter heating season of 5 months) and also be subject to a shorter exercise period (day, week, month, on peak, off peak or around-the-clock), these transactions will become some sort of hybrid with the exercised deliveries not considered a Swap and the unexercised remaining portion of the term considered a Swap. This will cause needless regulatory confusion with regulated and unregulated elements of the same transaction and regulatory ambiguity between the Commission and other regulators."[22]

Given the foregoing, the Commission should make clear that physically-delivered and exercised trade options are not swaps, or are exempted from swap regulation under the rule. The Commission should also address the hybrid nature of trade options and how the duplicative regulation will be avoided. For example, what regulator will have jurisdiction over common terms and conditions for the "option" portion and the "delivered commodity" portion of the contract?

The Commission has not addressed this unique feature of trade options in any manner in the Commodity Options Rule.

There Are Likely Additional Overbroad Aspects of Swap Regulation For Physical Commodity Options That COPE Has Not Identified

The foregoing are only the items COPE was able to identify from a review of the structure of the trade option exemption proposed by the Commission and the elements of its Dodd-Frank regulation. There are likely other aspects of swap regulation contemplated for trade options that are equally problematic that COPE or the Commission have not yet contemplated. In recognition of the forgoing, it appears to COPE that the Commission's anti-fraud regulations

[22] *Id.* at p. 4.

(for the unexercised aspect of the option) and reporting requirements at a more reasonable level than that proposed by the Commission (addressed below) should be the extent of "swap regulation" of trade options.

The Reporting Trigger for Form TO Should Be Modified

The Commission has proposed a "Form TO" to limit the reporting burden for physical firms with respect to transactions that qualify as trade options under the Commodity Options Rule.[23] Form TO is only available to entities that have not reported any swaps during the prior twelve months.[24]

COPE appreciates the Commissions attempt to limit the reporting requirements of physical firms that are not otherwise subject to swap reporting obligations pursuant to the Commission's regulations implementing Dodd-Frank. However, COPE believes that the Commission has set the threshold for the ability to use Form TO too high. This is particularly true since the Commission has required the reporting of inter-affiliate swaps pursuant to Part 45 of its regulations.[25]

For many COPE members, swap reporting under Part 45 is most likely to be triggered by the need to report inter-affiliate swaps, since no dealer or exchange will be present in these transactions to pick up the reporting burden. This, in turn, would eliminate the ability of such entities to reply on Form TO as set forth in the Interim Final Rule.[26] While COPE continues to believe that inter-affiliate swaps should not be subject to mandatory reporting, such reporting is less burdensome as there is no need to negotiate with a counterparty as to which entity will be the reporting entity or address any third party concerns. However, as proposed by the Commission, the mere reporting of a single inter-affiliate swap triggers additional reporting burdens for any physically-settling trade option. COPE believes that the existence of such swaps or other limited reporting activity should not trigger a new reporting burden when Form TO is available.

COPE recommends that the Commission permit all non-Swap Dealer/Major Swap Participants to use Form TO regardless of other reporting they may undertake. The fact that the Commission has determined to include these physical contracts as swaps should not generate new burdens. If the Commission determines that it will not permit the use of Form

[23] *See* § 32.3(b)(2) (Interim Final Rule).

[24] *Id.*

[25] 17 C.F.R. Part 45.

[26] COPE has filed a letter with the Commission seeking to limit or remove inter-affiliate swap regulation. *See* COPE Letter Re: Inter-Affiliate Swaps, May 24, 2012.

TO across the non-Swap Dealer/Major Swap Participant class of market participants, COPE requests that it expand the eligibility for the filing of Form TO such that inter-affiliate swap reporting during the prior twelve months by a given entity would not negate that entity's Form TO eligibility. Further, a firm should be permitted to enter into a specific number of qualifying trade options before it would lose its eligibility to utilize Form TO in lieu of reporting. COPE recommends that as long as a firm does not enter into more than twenty-five unreported trade options in the calendar year, it would be permitted to utilize Form TO. Conversely, if a firm entered into twenty-six trade options in a calendar year, it would be required to report all twenty-six trade options, and each additional trade option when entered into.

Conclusion

For the reasons set forth above and in the June 7 Letter, COPE requests that the Commission: (1) not define physically-settling commodity options as swaps; (2) in the event it defines physically-settling commodity options as swaps, expand the scope of exemptions associated with trade options; and (3) expand the eligibility for the use of Form TO.

Very truly yours,

/s/ *David M. Perlman*
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Counsel to
Coalition of Physical Energy Companies

CC:
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