ISDA® Safe, Efficient Markets

October 12, 2012

Ms. Sauntia S. Warfield, Assistant Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, Northwest
Washington, D.C. 20581

COMMENT

Office of the Secretariat
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Received CFTC

Re:RIN 3038-AD46 – Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement"; Mixed Swaps; Security-Based Swap Agreement Recordkeeping (77 Fed. Reg. 48207)

Dear Ms. Warfield:

The International Swaps and Derivatives Association, Inc. ("ISDA") is writing in response to the rules and interpretations (the "Product Release")[1] issued by the Commodity Futures Trading Commission ("CFTC") and Securities and Exchange Commission ("SEC" and, collectively, the "Commissions") regarding the product definitions contained in Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").

Since 1985, ISDA has worked to make the global over-the-counter ("OTC") derivatives markets safer and more efficient. Today, ISDA is one of the world's largest global financial trade associations, with over 800 member institutions from 56 countries on six continents. These members include a broad range of OTC derivatives market participants: global, international and regional banks, asset managers, energy and commodities firms, government and supranational entities, insurers and diversified financial institutions, corporations, law firms, exchanges, clearinghouses and other service providers.[2]

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1 CFTC and SEC, *Further Definition of "Swap", "Security-Based Swap" and "Security-Based Swap Agreement", Mixed Swaps, Security-Based Swap Agreement Recordkeeping*, 77 Fed. Reg. 48207 (August 13, 2012).

2 Information about ISDA and its activities is available on the Association's web site: www.isda.org.

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As set forth below, ISDA is concerned with two aspects of the Product Release, namely the CFTC's interpretation concerning forward contracts with embedded optionality and the CFTC's interpretation concerning usage contracts.[3] Without clarification, as discussed below, the regulatory structure meant to apply to the OTC derivatives market will instead also regulate legitimate commercial, non-derivative activities. ISDA does not believe this was the intention of Congress when enacting the Dodd-Frank Act and ISDA does not believe the Product Release should include within the definition of swap standard commercial contracts.

Volumetric Optionality

In the Product Release, the CFTC excluded from the definition of swap certain agreements, contracts and transactions[4] that qualify as forward contracts. Pursuant to this interpretation, the CFTC excluded from the definition of swap any contract that is on a non-financial commodity under the terms of which physical delivery is intended (the "Forward Contract Exclusion"). As part of this interpretation, the CFTC addressed certain forward contracts on non-financial commodities that contain embedded volumetric optionality and specifically requested comments on its interpretation.[5] In setting forth its interpretation, the CFTC stated that, when determining whether a forward contract with embedded optionality will qualify for the Forward Contract Exclusion, "the CFTC will look to the relevant facts and circumstances of the transaction as a whole to evaluate whether the transaction qualifies for the forward exclusions from the definitions of the terms 'swap' and 'future delivery.'"[6] Notwithstanding its establishing a general "facts and circumstances" standard, the CFTC confused the analysis by setting forth a more rigid separate standard in a seven part test (the "Seven Part Test") to be applied in determining whether a forward contract with embedded volumetric optionality is excluded from the definition of swap. While ISDA understands and accepts the rationale for the first six parts of the Seven Part Test, it is very concerned with the seventh part.[7]

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3 We note that the two highlighted sections are interpretations provided by the CFTC in the jointly adopted Product Release.

4 For purposes of this letter, "agreements, contract and transactions" will be referred to as "contracts".

5 *See* 77 Fed. Reg. at 48208 ("The CFTC requests comment on its interpretation concerning forwards with embedded volumetric optionality, contained in Section II.B.2.(b)(ii) of this release.").

6 77 Fed. Reg. at 48239.

7 The first six parts of the six part test require that:

1. the embedded optionality does not undermine the overall nature of the agreement, contract, or transaction as a forward contract;
2. the predominant feature of the agreement, contract, or transaction is actual delivery;
3. the embedded optionality cannot be severed and marketed separately from the overall agreement, contract, or transaction in which it is embedded;
4. the seller of a nonfinancial commodity underlying the agreement, contract, or transaction with embedded volumetric optionality intends, at the time it enters into the agreement, contract, or transaction to deliver the underlying nonfinancial commodity if the optionality is exercised;
5. the buyer of a nonfinancial commodity underlying the agreement, contract or transaction with embedded volumetric optionality intends, at the time it enters into the agreement,

Part seven of the Seven Part Test ("Part Seven") provides that a contract with embedded volumetric optionality will not be a forward contract unless "[t]he exercise or non-exercise of the embedded volumetric optionality is based primarily on physical factors, or regulatory requirements, that are outside the control of the parties and are influencing demand for, or supply of, the nonfinancial commodity."[8] The CFTC further explained that the exercise of the embedded optionality would be based primarily on physical factors if

> the predominant basis for failing to exercise the option would be that the demand or supply (as applicable) that the optionality was intended to satisfy, if needed, never materialized, materialized at a level below that for which the parties contracted or changed due to physical factors or regulatory requirements outside the parties' control.... The [CFTC] does not interpret this to mean that absolutely all factors involved in the decision to exercise an option must be beyond the parties' control, but rather the decision must be predominantly driven by factors affecting supply and demand that are beyond a parties control.[9]

ISDA believes that the standard set forth in Part Seven (namely, the use of the terms "primarily" and "predominantly" based on physical factors) creates an absolute standard that often will not be met, undermines the "facts and circumstances" guidance and is inconsistent with the goals of the Forward Contract Exclusion. Based on this standard, in order to qualify for the Forward Contract Exclusion, the optionality cannot be exercised for discretionary reasons. That is, if a factor outside the control of the entity causes a change in demand or affects the price, the optionality cannot be exercised based on any discretion. Thus, the contract may not qualify as a forward contract under Part Seven where the optionality can be exercised for any discretionary reason (*e.g.*, good commercial practice).

We submit that the distinctions between forward contracts and commodity options should be based on the parties' intent to make or take delivery.[10] Part Seven appears to be an absolute requirement (*i.e.*, if the primary purpose for exercise of the optionality is not based on physical factors, the contract cannot be excluded from the definition of swap) and, as set forth, it undermines the Forward Contract Exclusion's purpose, which is to exclude contracts where the primary purpose is to make or take delivery. The Seven Part Test and the relevant interpretation should be modified to apply to the first six parts with the focus on the intent to make or take delivery.

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contract, or transaction, to take delivery of the underlying nonfinancial commodity if it exercises the embedded volumetric optionality; and

6. both parties are commercial parties.

See 77 Fed. Reg. at 48238.

[8] 77 Fed. Reg. at 48238 (emphasis added).

[9] 77 Fed. Reg. at 48238, n.341 (emphasis added).

[10] Section 1a(47)(B)(ii) of the Commodity Exchange Act [7 U.S.C. § 1a(47)(B)(ii)] ("The term 'swap' does not include ... any sale of a nonfinancial commodity or security for deferred shipment or delivery, so long as the transaction is intended to be physically settled") (emphasis added).

Furthermore, the Product Release contemplates, and many other regulations promulgated under Title VII of the Dodd-Frank Act implicitly require, that the determination as to whether a contract is a commodity option or is excluded from the definition of swap be made at the outset of the contract. Under Part Seven as currently written, the purchaser of the optionality will not and cannot know its future reason for exercising the optionality. Additionally, even if the determination was made at the time of the entry into the option, it would be impossible for the seller of the option to know the future intention of the counterparty in exercising the embedded optionality. In either case, it would be impossible for both parties to determine whether an instrument is a forward contract or a swap (or commodity option). Moreover, a purchasing counterparty would, for obvious reasons, not be in a position to provide the seller with the needed contractual representation at the outset of the contract.

In addition, it is not entirely clear how to count forward contracts with embedded volumetric optionality towards the *de minimis* threshold or towards the major swap participant threshold. In many of the forward contracts with embedded volumetric optionality entered into by commercial counterparties, it is not apparent how to calculate the premium or if there is even a premium. Oftentimes, the purchaser does not necessarily pay an upfront premium for the volumetric optionality.[11] Therefore, in many cases, it will be difficult to subject these forward contracts with embedded volumetric optionality to regulation as commodity options under Title VII of the Dodd-Frank Act for purposes of swap dealer or major swap participant analysis or position limits.

ISDA respectfully requests that the CFTC modify the Seven Part Test. Specifically, ISDA believes that the first six parts of the Seven Part Test establish the intent to deliver, as required for exclusion from the definition pursuant to the statute. In addition, forward contracts with embedded optionality that meet the first six parts of the Seven Part Test cannot be used to evade the provisions of Title VII of the Dodd-Frank Act.[12] Part Seven, therefore, should be eliminated so that the interpretation with respect to forward contracts with embedded optionality focuses only on the intent to deliver rather than the underlying reasons for exercising the optionality. ISDA does not believe that the reason for exercising the option to deliver more or less of the commodity at the time of exercise provides any additional insight into whether the parties intended to physically settle the contract at the outset. If Part Seven is kept in its current form, the definition of swap would include types of contracts that are employed frequently in a

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11 For example, in swing contracts, the purchaser will buy a baseload amount of 10,000 MMBtu of natural gas and a call option of 2,000 MMBtu and a put option of 2,000 MMBtu. The baseload is for $2 per MMBtu and the volumetric optionality will be to put back to the seller 2,000 MMBtu at $2 per MMBtu or call from the seller 2,000 MMBtu at $2 per MMBtu. In this situation, there is no distinct premium and it is not clear how to derive and/or calculate a premium.

12 Because the first six conditions of the Seven Part Test cannot be satisfied by contracts that share characteristics with swaps and are similarly structured, the contracts that fall in this category cannot be used to evade swap regulations promulgated under Title VII and should not be subject to Title VII of the Dodd-Frank Act. .

variety of commercial settings where physical delivery is actually intended. ISDA does not believe this was the intent of the Dodd-Frank Act or of Congress.[13]

Usage Contracts

In the Product Release, the CFTC also provided a problematic interpretation with respect to certain physical commercial contracts. In particular, the CFTC provided interpretative guidance for determining whether certain types of agreements for the supply and consumption of energy should be excluded from the definition of swap.[14] Generally, the CFTC stated that it will interpret a contract not to be a commodity option (and therefore not a swap) if (i) the subject of the contract is the usage of a specified facility, (ii) the contract grants the purchaser the exclusive right to use the facility (or part thereof) and (iii) the payment for the use of the facility is a payment for *actual* use of the specified facility rather than the option to use it.[15] In addition to this three-part standard, the Product Release also provides that

> in the alternative, if the right to use the specified facility is only obtained via the payment of a demand charge or reservation fee, and the exercise of the right (or use of the specified facility or part thereof) entails the further payment of actual storage fees, usage fees, rents, or other analogous service charges not included in the demand charge or reservation fee, such agreement, contract or transaction is a commodity option subject to the swap definition.[16]

ISDA notes, as a preliminary matter, that, while the CFTC did not invite additional comments on this issue (unlike volumetric optionality), this interpretation first appears in the Product Release without notice or an opportunity to comment. It is a very significant issue that deserves attention, and ISDA believes it will be the subject to substantial comment.

ISDA believes that the standard set forth in the Product Release for determining whether these contracts are swaps is too inclusive and that the interpretation highlighted above expands the scope of the CFTC's jurisdiction beyond the intention of the Dodd-Frank Act. If this interpretation is adopted without additional guidance, the

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13 While the Product Release is silent on whether forward contracts with volumetric optionality may qualify as trade options, we submit that they should not. These transactions as a whole are forward contracts for delivery (*i.e.*, the optionality is not severable (see the third part of the Seven Part Test)). They have none of the essential characteristics of trade options and should not be burdened with the regulatory obligations imposed on trade options. *See*, *infra*, n.26.

We note that a trade option will be subject to the following regulations of the CFTC that are applicable to swaps: (i) position limits; (ii) swap data reporting requirements; (iii) large trader reporting requirements; (iv) duties of swap dealers and major swap participants; (v) reporting and recordkeeping requirements for swap dealers and major swap participants (except for the daily transaction records requirements); and (vi) capital and margin requirements for swap dealers and major swap participants.

14 Part II.B.2(b)(iii) of the Product Release. 77 Fed. Reg. at 48242.

15 77 Fed. Reg. at 48242.

16 77 Fed. Reg. at 48242 (emphasis added).

contracts of many commercial entities could be subject to regulation as commodity options (and swaps). ISDA does not believe this was the intention of the Congress or the CFTC. Many commercial entities enter into contracts that involve paying an upfront reservation fee followed by further facility-usage payments or service charges. These types of agreements include:

1. tolling agreements for electricity generation;[17]
2. storage;[18]
3. re-gasification of imported LNG;[19]
4. marine vessel chartering;[20]
5. terminal arrangements;[21] and
6. take-or-pay contracts.[22]

The types of contracts are pervasive throughout the commercial energy industry. Almost any commercial entity that relies on infrastructure to carry out its commercial activities engages in these types of usage contracts. Commercial entities do not consider these types of contract to be derivatives. Furthermore, structuring the contract in this manner (with an upfront reservation payment following by a variable usage cost) is standard throughout the energy industry and in some cases is even required. For example, certain types of transportation contracts are required by federal regulation to be structured with an upfront reservation fee and then a payment for usage of the facility (see Federal Energy Regulatory Commission ("FERC") Order 636).[23] Pursuant to its regulations, the FERC requires that, when setting rates for a transportation service,

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17 A tolling agreement is an agreement whereby the owner of an electric generation facility agrees to convert fuel provided by its counterparty into electricity and deliver the electricity back to the counterparty. Often times pursuant to these agreements, the counterparty will pay a reservation fee to the facility owner and a price per use of the facility.

18 Pursuant to a storage agreement, a commercial counterparty may pay a reservation fee for the right to use a storage facility. In many storage agreements, the counterparty often will then pay the owner of the storage facility a price per usage of the storage facility. Alternatively, storage agreements may be structured so a party may inject or withdraw up to a certain amount of a commodity but, upon surpassing this threshold, the counterparty may be required to pay usage charges for any additional injections or withdrawals.

19 Pursuant to re-gasification agreements, a commercial counterparty may agree with the owner of a re-gasification facility to pay a reservation fee for the right to use the facility at a certain time. The counterparty often will then pay a price for actual usage of the re-gasification facility.

20 Pursuant to a marine vessel chartering agreement, a commercial entity may pay a ship owner a reservation fee to use the vessel at a certain time. Often times pursuant to these agreements, the commercial entity often will then pay an additional for the actual usage of the vessel.

21 Pursuant to a terminal agreement, a commercial entity may pay for the right to use the terminal. Often times pursuant to these agreements, the commercial entity often will then pay for the actual usage of the terminal.

22 Pursuant to a take-or-pay contract, the purchaser will pay for a set amount of a commodity in advance at a set price. If the purchaser does not take delivery of the full amount of the commodity, the purchaser often will pay a penalty that is not necessarily equal to the price to be paid if delivery actually were to occur.

23 *See* FERC, *Pipeline Service Obligations and Revisions to Regulations Governing Self-Implementing Transportation Regulation of Natural Gas Pipelines After Partial Wellhead Decontrol*, 57 Fed. Reg. 13267, at 13281 (April 16, 1992) ("[FERC]is adopting the straight fixed variable method for rate design, unless [FERC] provides otherwise.").

a provider must charge fixed capacity costs allocated to capacity reservations to compute the reservation fee. The remaining fixed costs and all variable costs must be used to determine the volumetric rate.[24] Thus, a usage contract on firm pipeline transportation must be structured with both a fixed cost portion and a variable cost portion. Because both a fixed component and variable component is not only industry practice but sometimes required by regulation, these types of agreements should not be considered options and should not be included in the rules and calculations applicable to swaps.

Moreover, these usage contracts, especially storage, vessel chartering and LNG regasification contracts are very similar in nature to lease agreements. The CFTC expressly excluded commercial leases from the definition of swap.[25] The CFTC should also exclude these usage contracts because these usage contracts are commercial arrangements with rights more similar to leases than to swaps.

Separately, but for similar reasons, ISDA does not believe that these usage contracts should be treated as trade options. These usage contracts are not trade options because they do not share common characteristics with trade options and should not be regulated as trade options. These contracts are not options on the price of a physical commodity.[26] Usage contracts, to the extent that they have optionality, are options on storage, transportation and other similar services; not the price of the storage, transport or service. Furthermore, contracts on storage, transportation and similar services are individual commercial agreements that have never been subject to and do not fit within CFTC jurisdiction. Indeed, it is difficult to even imagine how these commercial agreements can be traded on a central order book or cleared. Commercial entities, in comment letters, have already recognized that considering these contracts to be options (either commodity options or trade options) would have a very negative effect on commercial activities and is a mistake.[27]

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24 *See* 12 C.F.R. § 284.10(c)(2).

25 See 77 Fed. Reg. 48247 ("The types of commercial agreements, contracts, or transactions that involve customary business arrangements (whether or not involving a for-profit entity) and will not be considered swaps or security-based swaps under this interpretation include: ... The purchase, sale, lease, or transfer of real property, intellectual property, equipment, or inventory").

26 Historically, "'trade options' generally are off-exchange options on a physical commodity entered into in normal commercial channels for the commodity or its byproducts." 50 Fed. Reg. 39659 (September 30, 1985). The CFTC cited three characteristics of a commodity option "[(1)] An option gives the purchaser the right to make or take delivery of the commodity option. [(2)] The initial charge for an option is normally a nonrefundable premium covering the grantor's commissions, costs and profits. [(3)] The purchaser's losses on the option are normally limited to the premium." 50 Fed. Reg. 39658–59.

27 *See* Letter, from Ms. Janet Kelly, General Counsel at ConocoPhillips Company, to Mr. David Stawick, Secretary of the CFTC, dated August 23, 2012, *Public Comments on the Commission's Interpretation Regarding Forwards with Embedded Volumetric Optionality* (arguing that these contracts should not be deemed as commodity options or trade options). *See also* Letter, from Ms. Mary Anne Mason, Messrs. Jeremy Weinstein and Vincent Bartolomucci to Mr. David Stawick, Secretary of the CFTC, dated July 22, 2011, *Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement"; Mixed Swaps; Security-Based Swap Agreement Recordkeeping; Proposed Rule 76 Fed. Reg. 29,818 (May 23, 2011)* (arguing that tolling agreements for electricity generation should not be treated as swaps (*i.e.*, commodity options)).

ISDA also notes that in adopting the Dodd-Frank Act, Congress expressed a clear intention not to affect the businesses of commercial end-users through over-regulation.[28] By including contracts containing volumetric optionality and usage contracts as commodity options (swaps) or trade options will subject these contracts commonly employed by commercial end-users in their commercial operations to regulation contrary to Congressional intent. Congress did not intend this level of regulation for these types of commercial contracts nor did it intend the commercial entities who enter into these contracts to be subject to this level of regulation. In particular, Congress did not intend the provision of Title VII of Dodd-Frank to limit the ability of commercial entities to engage in standard commercial practices. By subjecting these usage contract as well as certain forward contracts containing volumetric optionality to swap regulation, the CFTC will chill the market for these contracts. These regulatory requirements will directly impose additional costs on commercial end-users – a result that Congress did not intend.

ISDA respectfully requests that the CFTC amend its interpretations to clarify that the above described contracts are not to be included in the definition of swap or trade option. ISDA appreciates the opportunity to comment on the Product Release. Please feel free to contact me or my staff should you have any questions or require additional information.

Respectfully submitted,

Robert Pickel
Chief Executive Officer

cc: The Hon. Gary Gensler, Chairman
The Hon. Jill E. Sommers, Commissioner
The Hon. Bart Chilton, Commissioner
The Hon. Scott D. O'Malia, Commissioner
The Hon. Mark P. Wetjen, Commissioner

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28 *See, e.g.*, Letter from Sen. Dodd to Reps. Peterson and Frank (June 30, 2010) 156 Cong. Rec. S6192 (Daily Ed. July 22, 2010) ("The legislation does not authorize the regulators to impose margin on end users, those exempt entities that use swaps to hedge or mitigate commercial risk. If regulators raise the costs of end user transactions, they may create more risk. It is imperative that the regulators do not unnecessarily divert working capital form our economy into margin accounts, in a way that would discourage hedging by end users or impair economic growth.").