SUTHERLAND

THE COMMERCIAL ENERGY WORKING GROUP

REPORTING TRADE OPTIONS–FEBRUARY 6, 2013

The Commercial Energy Working Group ("Working Group") supports tailored regulation that brings transparency and efficiency to the swaps markets. Yet, for the reasons discussed below, the Working Group believes that the regulations, including regulatory reporting and position limits, applicable to trade options are unnecessarily burdensome and unworkable in many cases.

FIRST RECOMMENDATION

The Commission should permit ***all*** trade options to be reported annually pursuant to a Form TO. If the Commission determines it needs more data than what is requested in the Form TO, it should address any requirements applicable to trade options in a new rulemaking.

I. REPORTING PRIMARY ECONOMIC TERMS ("PET") AND CONTINUATION DATA UNDER PART 45 IS UNWORKABLE.

Reporting PET data for trade options under Part 45 is impractical given trade options may be exercised on a very frequent or near real-time basis (*i.e.*, daily or hourly). Exhibit A provides an example of a trade option and the difficulty in reporting PET data fields under Part 45. As discussed in Section II, below, and in Exhibit A, PET data required by Part 45 does not contemplate physical deals.

II. TRADE OPTION DATA IS CAPTURED IN SEPARATE SYSTEMS FOR PHYSICAL DEALS, WHICH DO NOT CAPTURE THE PET DATA REQUIRED UNDER PART 45.

Unlike systems designed to capture and report data for financial transactions, physical systems are primarily designed to manage logistics related to deliveries and inventory quantities at trade locations. Some physical systems of record do not contain market price information, execution venues, or other option characteristics, such as premiums and strike prices, which make reporting under Part 45 additionally challenging. Requiring market participants to extrapolate such information manually for Part 45 reporting purposes is unduly burdensome and should not be mandated. As demonstrated in the Working Group's trade option example set forth in Exhibit A, PET data fields for options cover terms only associated with financially-settled options.

III. FORM TO SUFFICIENTLY ACHIEVES THE CFTC'S TRANSPARENCY OBJECTIVES BUT IN A LESS BURDENSOME MANNER THAN PART 45.

The Working Group supports transparency in the markets, but submits price discovery and transparency are diminished with respect to trade options due to their bespoke nature. Thus, besides the impracticality of reporting PET data for trade options, the data will prove to be of little value and may give the CFTC a distorted view of the market. Additionally, because market participants in the energy industry transact a very large number of trade options (physically-settled deals), reporting under Part 45 will be extremely burdensome and costly. Form TO will provide the same level of transparency that would be achieved under Part 45 but in a less burdensome manner. Should the CFTC require additional information not provided in the Form TO, it could use its special call authority.

IV. DETERMINING AT EXECUTION WHETHER A COUNTERPARTY HAS BEEN A REPORTING COUNTERPARTY IN THE PREVIOUS 12 MONTHS IS IMPRACTICABLE.

All trade options should be permitted to be reported pursuant to Form TO even if one counterparty has been a reporting counterparty in the twelve months preceding the trade option execution date. In addition to the reasons described above regarding the sufficiency of the Form TO, requiring counterparties to determine at the time of execution whether either has been a reporting counterparty in the preceding twelve months is impracticable as employees who execute transactions likely would not have this information. Further, this condition would require a unique set of representations each time a trade option is entered into, which would be burdensome, difficult to obtain, and unnecessarily increase transaction costs.

V. COMPLIANCE WITH TRADE OPTION REPORTING REQUIRES ADDITIONAL TIME.

> **SECOND RECOMMENDATION**
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> If the CFTC determines to require trade options to be reported pursuant to Part 45, market participants will need additional time to come into compliance with the reporting requirements related to trade options. CFTC staff should provide no-action relief for reporting trade options until April 10, 2014, one year following the Part 45 compliance date.[1]

The Commission has not yet indicated whether it will take further action on its interim final rule on the trade option exemption. Consequently, market participants face much uncertainty on whether they should begin implementing the IT systems and business processes required for reporting trade options under Part 45 even though they may be required to come into compliance in the very near future. As described above, the manner in which information related to trade options is captured and maintained makes reporting economic and operational data under Part 45 more difficult and will therefore require additional time. Market participants should be given time to focus on implementing necessary IT systems and business processes to report traditional swaps before they must begin reporting physical transactions.

VI. LARGE TRADER REPORTING.

> **THIRD RECOMMENDATION**
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> The Commission should exempt trade options from large trader reporting.

The Working Group supports the CFTC's goal in providing oversight to the derivatives markets and believes the Commission's Large Trader Reporting regulations under Part 20 will permit the CFTC to monitor concentration in the derivatives markets. But, because trade options are physical, not financial, contracts, the Working Group submits that the rationale for reporting trade options under Part 20 does not exist. Additionally, because market participants in the energy industry transact such a large number of

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[1] If the Part 45 compliance date is modified for any reason, the Working Group would request that the one-year no-action relief period extend from the modified compliance date.

trade options, reporting them as principal and for counterparties will be extremely burdensome and costly, especially given the data fields required under Part 20 are not easily reportable for trade options. Finally, as stated above, the CFTC can use its special call authority to get more information from market participants.

VII. POSITION LIMITS SHOULD EXCLUDE TRADE OPTIONS.

FOURTH RECOMMENDATION

If the Commission re-issues a new position limits rulemaking, it should exclude trade options from any federal position limits.

If the Commission re-issues a new rule that adopts a hedging exemption similar to that provided in vacated regulation 151.5, many physical trade option contracts for the sale and purchase of energy commodities that fall within the definition of Referenced Contract (as defined in vacated Part 151) may not receive a hedging exemption, as some trade options function as a pure physical purchase or sale contract and, therefore, do not hedge physical commodity risk. Further, even if a trade option otherwise qualified for a *bona fide* hedging exemption under vacated regulation 151.5, market participants would not be permitted to carry it into the spot month as a *bona fide* hedging transaction. Adopting this restriction in a new proposed rule for federal position limits would be extremely disruptive to the physical markets as many trade options are priced based on Referenced Contracts and contemplate physical delivery during or after the spot month (a concept relevant only to physical futures). Accordingly, trade options should be excluded from any new rulemaking establishing federal position limits.

EXHIBIT A—TRADE OPTION REPORTING UNDER PART 45

The Working Group submits the following example of a trade option to demonstrate the difficulty and impracticality of reporting trade option data under Part 45 of the Commission's regulations.

Example. In the process of converting crude oil into refined products, a refinery may consume fuel in various forms (largely for the production of steam). While much of the fuel is produced internally as a by-product of the refining process itself, a refinery may also purchase natural gas to assure that fuel needs are balanced. The quantity of natural gas procured on any day varies (i) with the level of refining activity, and (ii) with the particular balance among the various activities within the refinery. All the available sources of fuel have value, so one business objective for the refinery is to minimize the total value of energy consumed to produce a given value of output.

During winter months, a refinery is typically able to condense propane and butane produced during the refining process into liquids, sell those liquids in the market, and purchase natural gas for fuel. This is economically attractive because the value received for the propane and butane typically exceeds the cost to procure the replacement natural gas.

On November 1, 2012, the refinery in question negotiates natural gas procurement contracts for the period December 1, 2012, to December 31, 2012, that give the refinery the right to procure volumes of natural gas on any day at GD Texas Gas, Zone 1 + $0.18. This contract allows the refinery to nominate volumes of natural gas each day of December in accordance with its operational variability in its natural gas requirements.

During the middle of December when the refinery would normally be selling liquid propane and butane and procuring substantial quantities of natural gas, the market value of propane and butane falls so that the value of the propane and butane is now less than the value of natural gas. In response to these market conditions, the refinery (i) elects to consume internally the propane and butane that it otherwise would have sold in the external market and (ii) reduces the quantity of natural gas to zero pursuant to its contract.

On November 3, 2012, the refinery, as an end-user reporting counterparty, attempts to submit to an SDR its trade data related to this contract. It addresses the following issues.

1. Strike price for options. At time of execution of this transaction, there is only a formula representing the strike price when the refinery exercises the call—GD Texas Gas, Zone 1 + $0.18.

- Does the refinery report the formula?
- Upon any exercise of the option, must the refinery report the exercise prices as continuation data?
    - Because the refinery exercises the option every day of December, this will be burdensome and costly. Further, reporting the exercise price within the continuation data reporting deadlines will not be possible at times because the actual price of exercising the option may not be known until a later time.

2. Quantity. When the contract is executed, there is no firm quantity agreed to by the parties. Quantity is unknown unless and until the option is exercised, which could be on a daily basis.

- What should the refinery report for quantity?

- Many trade options provide a firm quantity and then an option to increase or reduce the firm quantity. In this case, should the firm quantity or the swing be reported?

- Upon any exercise of the option, must the refinery report all nominations as continuation data?

    - Because the refinery exercises the option every day of December, this will be burdensome and costly with no discernible benefit given it, like most trade options, is bespoke in nature.

3. Contract Type. The description for this PET data field requires that one of the following be selected: "swap, swaption, option, basis swap, index swap." Importantly, there is no distinction between financially-settled and physically-settled options. The Working Group believes this data field description indicates that Part 45 reporting does not contemplate trade options.

- Should the refinery simply select "option" for this data field? Because this trade option (like all trade options) contemplates physical delivery and is significantly different from an option that financially settles, the CFTC would receive value in the distinction as it would indicate the type of data to expect in the rest of the PET data fields.

4. Execution Timestamp. Like all other physical deals, no execution timestamp for this transaction was captured. Given the bespoke nature of many trade options, these deals often result after back-and-forth negotiation over time, making a precise execution timestamp difficult to pin down and largely meaningless.

5. Buyer Pay Index/Seller Pay Index (published price paid by buyer/seller). For trade options, there would be delivery points, not indices.

6. Option premium. Like many trade options, this deal did not have a discreet premium. For embedded options, the premium is often implied or embedded in the commodity price and even when there is an explicit reservation charge or other premium-like charge, the fee might be intended to cover operational aspects of the contract beyond the volumetric optionality.

7. Any other terms of the swap. There could be any number of trade option provisions matched and affirmed by the counterparties that are not provided in this example and are completely unrelated to the optionality (e.g., losses, form of transportation, ratable delivery rates, spill fees, timing limitations, and special damages for failure to deliver).

8. Unique Swap Identifier ("USI"). Because market participants did not contemplate physically settled options being regulated as swaps, more USIs would be needed than previously contemplated.

9. Unique Product Identifier ("UPI"). Given the bespoke nature of many trade options, especially embedded options, there would be a need for many more types of UPIs than previously contemplated unless the Commission simply designates a generic UPI for "Trade Option."