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April 17, 2014

Ms. Melissa Jurgens, Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, D.C. 20581
Telefacsimile: (202) 418-5521
Email to secretary@cftc.gov and electronically to http://comments.cftc.gov

Re: Comments of the International Energy Credit Association on CFTC Staff Public Roundtable to Discuss Dodd-Frank End-User Issues Held on April 3, 2014

Dear Ms. Jurgens:

I. Introduction.

The International Energy Credit Association ("IECA") is an association of several hundred energy company credit management professionals, which has been grappling with credit-related issues in the energy industry for over ninety years. Our members' concerns regarding the relevant rulemakings that followed the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("DFA") have led us to submit to the Commodity Futures Trading Commission ("CFTC" or "Commission") numerous comments on various proposed rulemakings, as well as requests for no action relief and petitions in support of relief requests sought by other energy companies and trade groups, many of which have yet to be addressed by the Commission Staff.

The IECA seeks to protect the rights and advance the interests of the commercial end-user community that makes up the majority of its membership. IECA membership includes representatives of many small and large energy companies all of whom have a fundamental mission of providing safe, reliable, and reasonably priced energy commodities that American businesses and consumers require for our economy and our livelihood. Most of the IECA's members are representatives of commercial end-users, which rely on swaps to help them mitigate and manage (i.e., hedge) the risks of energy commodity price volatility to their physical energy businesses.

Correspondence with respect to these comments should be directed to the following individuals:

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II. Comments on the Roundtable Panels.

The IECA commends the Commissioners and the Commission Staff for holding the Public Roundtable on April 3, 2014 ("Roundtable"), to provide a forum for commercial end-users to present their concerns regarding the significant impacts on commercial end-users that were discussed during each of the three panels that were convened during the Roundtable. One or more members of the IECA participated on each of the three panels. The IECA hereby provides these additional comments in response to various comments and questions raised by the Commissioners and the Commission Staff during each panel's discussion of its respective topics.

II. Comments on the Roundtable Panels.

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- vi. **Commodity Options for Physical Delivery of a Nonfinancial Commodity Between Commercial Market Participants, which are not Investment Vehicles, Should Not be Treated as Swaps**
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III. Conclusion.

A. Panel One: Regulation 1.35 Discussion

Commercial end-users are customers which are allowed to have direct access to trading privileges on swap execution facilities ("SEFs"). SEFs are a new type of regulated entity created under the DFA, which adds a new Section 5h to the Commodity Exchange Act ("CEA") regarding the registration and operation of SEFs. The DFA also adds a new Section 2(h)(8) of the CEA, which requires the execution of certain swaps on SEFs. Pursuant to the rulebooks of certain SEFs, a commercial end-user seeking direct access to trading privileges on such SEFs may be required to become a **member** of such SEFs in order to have direct access to trading on such SEFs, which in turn will allow such a commercial end-user to fulfill the mandate of Section 2(h)(8) of the CEA.

The Commission has said that one of the key goals of the DFA was bringing greater pre-trade and post-trade transparency to the swaps market, which the Commission intends to accomplish by "requiring the trading of swaps on SEFs and designated contract markets ("DCMs").[1] In fact, Section 721 of the DFA amended the CEA to define a SEF as "a trading platform where multiple participants have the ability to execute swaps by accepting bids and offers made by multiple participants in the platform."[2] Finally, Section 723 of the DFA established "a trade execution requirement, which states that swap transactions subject to the clearing requirement must be executed on a DCM or SEF, unless [i] no DCM or SEF makes the swap available to trade or [ii] for swap transactions subject to the clearing exception under CEA section 2(h)(7)."[3]

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[1] See *Core Principles and Other Requirements for Swap Execution Facilities*, 78 Fed. Reg. 33476, at 33477 (June 4, 2013) ("SEF Final Rule").

[2] Id. at 33477.

[3] Id. at 33477.

i. Current Interpretation of CFTC Regulation 1.35

In its final rule entitled *Adaptation of Regulations To Incorporate Swaps – Records of Transactions* ("Regulations Adaptation Rule"),[4] the Commission made certain conforming amendments to the recordkeeping provisions of Section 1.35(a) of its regulations that were intended to incorporate into those recordkeeping provisions the new swap regulation framework under the DFA. The Commission chose to accomplish this goal in the Regulations Adaptation Rule by expanding the application of Regulation 1.35(a), which previously applied explicitly to each "member of a DCM," to now apply explicitly to each "member of a DCM or SEF," together with other explicitly enumerated registered entities. Specifically, CFTC Regulation 1.35(a)(1) now requires in part that:

> "(1) Each futures commission merchant, retail foreign exchange dealer, introducing broker, and **member of a designated contract market or swap execution facility** shall keep full, complete, and systematic records, which include all pertinent data and memoranda, **of all transactions relating to its business of dealing in commodity interests and related cash or forward transactions**." (Emphasis added.)

Subject to certain exclusions[5], the general categories of the types of records that are to be maintained under CFTC Regulation 1.35(a)(1) include:

> "[A]ll orders (filled, unfilled, or canceled), trading cards, signature cards, street books, journals, ledgers, canceled checks, copies of confirmations, copies of statements of purchase and sale, and all other records, which have been prepared in the course of its business of dealing in commodity interests and related cash or forward transactions. Among such records each **member of a designated contract market or swap execution facility** must retain and produce for inspection are all documents on which trade information is originally recorded, whether or not such documents must be prepared pursuant to the rules or regulations of either the Commission, the designated contract market or the swap execution facility. For purposes of this section, such documents are referred to as 'original source documents.' **Such records shall be kept in a form and manner**

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[4] 77 Fed. Reg. 75523 (December 21, 2012).

[5] Including, but not limited to, "Oral communications that lead solely to the execution of a related cash or forward transaction."

identifiable and searchable by transaction. Also included among the records required to be kept by this paragraph are all oral and written communications provided or received concerning quotes, solicitations, bids, offers, instructions, trading, and prices that **lead to the execution of a transaction in a commodity interest and related cash or forward transactions**, whether communicated by telephone, voicemail, facsimile, instant messaging, chat rooms, electronic mail, mobile device, or other digital or electronic media;…"[6] (Emphasis added.)

We note also that Section 1.35(a)(2) of the CFTC Regulations provides the following significant definition related to the foregoing recordkeeping provision:

"(2) For purposes of paragraph (a)(1) of this section, "related cash or forward transaction" means a purchase or sale for immediate or deferred physical shipment or delivery of an asset related to a commodity interest transaction where the commodity interest transaction and the related cash or forward transaction are used to hedge, mitigate the risk of, or offset one another."

ii. Commercial End-User Concerns with CFTC Regulation 1.35

The IECA submits that historically the **members** of a DCM have generally been intermediaries, i.e., intermediaries which had access to trading privileges on DCMs in order to enter trades on behalf of such members' customers. In fact, the typical customers of a member of a DCM would have included commercial end-users. As a result, the IECA believes that simply expanding the recordkeeping requirements of Regulation 1.35 from covering "members of DCMs" to include "members of SEFs" results in an inappropriate imposition of recordkeeping requirements on commercial end-users who would not otherwise be covered by Regulation 1.35.

Historically, a **member** of a DCM was a "floor trader" or a "floor broker," was trading futures transactions in the DCM on behalf of customers, and was obligated to register with the Commission. Commercial end-users, on the other hand, do not enter

[6] 17 C.F.R. 1.35(a)(1).

into trades on behalf of customers and are not generally required to register with the Commission in any capacity.

As such, onerous costly record keeping requirements under Regulation 1.35 will fall on those commercial end-users who might otherwise find economic benefit by participating in the **membership** of a DCM or SEF. For example, keeping records under Regulation 1.35 relating to commodity interests and related cash or forward transactions for a floor trader or floor broker entering into transactions involving commodity interests when and as requested by a customer and keeping records relating to any related cash or forward transactions for that customer should be a straightforward exercise. In fact, historically, the IECA submits most floor traders and floor brokers acting as intermediaries for a customer to trade futures transactions were not also trading related physical cash or forward transactions for that customer, so complying with this requirement was capable of being a straightforward exercise.

For a commercial end-user entering into commodity interests transactions on a SEF for its own behalf, and not at the request of a customer, it may enter into swaps and futures on a portfolio basis and, as such, will be required by Regulation 1.35 to keep records "identifiable and searchable by transaction" with respect to its entire physical business portfolio. Moreover, as was discussed during the Roundtable, it is not physically possible to assign a unique transaction identifier to each and every email, instant message, or other electronic communication that a commercial end-user has with every financial or physical commodity counterparty until sometime later when it becomes clear that a transaction is likely to be entered into with such counterparty. Therefore keeping electronic records under Regulation 1.35 and ensuring that such electronic

records are identifiable and searchable by transaction could be extremely onerous, if not impossible, for such commercial end-users.

Therefore, as currently written, Regulation 1.35 creates a disincentive for a commercial end-user to become a member of a DCM or SEF, encourages commercial end-user participants to avoid trading on SEFs which were created to enhance market transparency, limits the ability of commercial end-users to utilize the most modern and efficient means of communication, and leads to legal uncertainly for farmers, ranchers, and other commercial end-users and customers. These negative consequences have very real and substantial costs to customers and commercial end-users.

The IECA submits that the Commission's requirement under Regulation 1.35 for any commercial end-user that is a "**member**" of a DCM or SEF to maintain the required "written records" and "electronic written communications" is misplaced and chills the interest for many commercial end-users that might seek to become "**members**" of a DCM or SEF for execution cost savings reasons as well as interests in providing liquidity for the yet-to-develop centralized swap trading entities via SEFs. Simply stated, the costs associated with record creation, maintenance, organization and retrieval will vastly out-weigh the benefits that many commercial end-users may receive from becoming a "**member**" of a DCM or SEF. We submit that this result is directly contrary to the Commission's goal of encouraging participation on SEFs.

Instead, the Commission should modify Regulation 1.35 in order to help stimulate interest in DCM and SEF membership rather than shrinking the pool of commercial end-users who can afford to actively participate in DCMs or SEFs.

Making regulatory changes to alleviate these burdens on commercial end-users and customers will not impede the Commission's mission to promote market integrity and protect customers in the derivatives markets which it regulates. Therefore, we urge the Commission to address this issue quickly.

iii. Commission's Recent Treatment of Commercial End-User Concerns with CFTC Regulation 1.35

In adapting CFTC Regulation 1.35(a) to incorporate the regulation of swaps under the DFA, as set forth in the Regulations Adaptation Rule, the Commission considered (and rejected) the following comments by interested participants (including various commercial end-users) that:

> "The requirement to keep "electronic communications" **should not extend to members of a DCM or SEF that do not handle customer orders**; **regulation 1.35(a) has never required DCM members to keep records of their electronic communications relating to their cash commodity transactions**; and storing records of electronic communications would be **overly burdensome for these members**."[7]

In rejecting these comments, the Commission offered the following analysis in support of its decision in the Regulations Adaptation Rule:

> "In response, the Commission notes that the record retention requirements of existing regulation 1.35, as confirmed by the Commission's Division of Market Oversight in 2009, include all electronic forms of communication (emails, instant messages, and any other form of communication created or transmitted electronically). [footnote 36] Thus, contrary to commenter assertions, the recordkeeping obligations of regulation 1.35 currently require that all DCM members keep electronic communications. Therefore, the relevant portion of the proposed new language (now being adopted by the Commission) "all *** written communications *** whether communicated by *** instant messaging, chat rooms, electronic email, mobile device, or other digital or electronic media" does not impose any new requirements on DCM members."[8]

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[7] See Regulations Adaptation Rule, 77 Fed. Reg. at 75530 (December 21, 2012).

[8] Id. at 75530.

In footnote 36 cited in support of the above analysis in the Regulations Adaptation Rule, which included the parenthetical "(footnotes omitted)," the Commission quoted from an advisory letter dated February 5, 2009, from the CFTC's Division of Market Oversight, entitled *Advisory for Futures Commission Merchants, Introducing Brokers, and Members of a Contract Market over Compliance with Recordkeeping Requirements* ("2009 DMO Advisory Letter") as supporting the Commission's rejection of the comments provided by various participants, including commercial end-users, opposing the imposition of the recordkeeping requirements of Regulation 1.35 on members of DCMs and SEFs which did not "handle customer orders."

Footnote 36 included the following quoted passage from the 2009 DMO Advisory Letter:

> "The Division of Market Oversight (''Division'') has become aware that there is an industry misunderstanding of the record retention requirements of Regulations 1.35 and 1.31 as it relates to electronically conveyed records. The Division is issuing this Advisory to address any industry misunderstanding of the Commission's recordkeeping requirements applicable to futures commission merchants (''FCMs''), introducing brokers (''IBs''), and **members of a designated contract market (''members'')**. With the increased reliance in the futures industry on electronic media and the use of personal electronic devices and communications technology to facilitate the execution of transactions for both open outcry and electronic trading, the Division is issuing this Advisory to correct any misunderstandings and to make certain that the individuals and entities subject to the Commission's recordkeeping requirements maintain all electronic forms of communications, including email, instant messages, and any other form of communication created or transmitted electronically for all trading." (Emphasis added.) [9]

As further support for the Commission's rejection of comments from various participants, including commercial end-users, that "regulation 1.35(a) has never required DCM members to keep records of their electronic communications relating to their cash

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[9] See Regulations Adaptation Rule, 77 Fed. Reg. at 75530.

commodity transactions," the Commission provided footnote 39 to the Regulations Adaptation Rule, which said:

> "[39] 17 CFR 1.35(a). Regulation 1.35(a) has included transactions in "cash commodities" since as early as 1964: "Each futures commission merchant and each member of a contract market shall keep full, complete, and systematic records, together with all pertinent data and memoranda, of all transactions relating to his **business of dealing in commodity futures and cash commodities** *** 17 CFR 1.35(a) (1964)."" (Emphasis added.)[10]

iv. Errors in the Commission's Analysis of Commercial End-User Concerns with CFTC Regulation 1.35

The IECA submits that the Commission's interpretation of its precedent is misguided.

The opening paragraph of the 2009 DMO Advisory Letter was quoted "(without footnotes)" in the Commission's Regulations Adaptation Rule as supporting the Commission's rejection of comments by various commercial end-users and other participants that "The requirement to keep "electronic communications" should not extend to members of a DCM or SEF that do not handle customer orders."

The paragraph immediately following the above-quoted opening paragraph of the 2009 DMO Advisory Letter includes the following statement, which is quoted "with the applicable footnotes" as follows:

> "The Commodity Exchange Act ("ACT") and Commission regulations pertaining to recordkeeping impose requirements for recording information and maintaining records relating to the business of all FCMs, IBs and members.[iv]" (Footnote included.)

[10] See Regulations Adaptation Rule, 77 Fed. Reg. at 75531.

The text of footnote (iv) to the foregoing statement in the 2009 DMO Advisory Letter stated as follows:

> "[iv]Section 4(g)(a) of the Act, 7 U.S.C. §6g(a) (2002), provides generally that **FCMs, IBs, floor brokers, and floor traders** shall make, keep, and hold open for inspection "…**such reports as are required by the Commission regarding the transactions and positions of such person, and the transactions and positions of the customer thereof**, in commodities for future delivery on any board of trade in the United States or elsewhere."
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> Sections 4g(b) through (d) of the Act, 7 U.S.C. §§6g(b)-(d) (2002), further provide that: registered entities, including designated contract markets, are required to "maintain daily records"; floor brokers, IBs, and FCMs are required to "**maintain daily records for each customer in such manner and form as to be identifiable with the trades referred to in subsection (b)**…"; and "daily trading records shall be maintained in a form suitable to the Commission for such period as may be required by the Commission." (Emphasis added.)

As shown by the quote above, when the Division of Market Oversight ("DMO") referred to "members" in its 2009 DMO Advisory Letter, the DMO was substituting "members" for the statutory terms "floor brokers and floor traders" under Section 4g(a) of the CEA and the recordkeeping requirement of "members" in the 2009 DMO Advisory Letter had everything to do with records for "the transactions and positions of the customer thereof."

We also note for your consideration footnote (iii) to the 2009 DMO Advisory Letter, which stated:

"[iii] The original NYMEX rule addressing this issue was Rule 450, which read as follows: "Members must keep full, complete and systematic records, together with all pertinent data and memoranda, of **all transactions relating to its business of dealing in commodity futures, options and cash transactions** in accordance with CFTC Regulation 1.35."" (Emphasis added.)

Thus footnote (iii) to the 2009 DMO Advisory Letter made clear that "members" of a DCM were required by CFTC Regulation 1.35 to keep full, complete and systematic records of all transactions relating to its business of "dealing" in commodity futures, options and cash transactions.

It is probably not an accident that CFTC Regulation 1.35 has consistently through the years referred to a requirement to keep records of all transactions relating to the "business of **dealing in** commodity futures" as noted in footnote (iii) of the 2009 DMO Advisory Letter. In fact, the Commission's most recent pronouncement of CFTC Regulation 1.35 in the Regulations Adaptation Rule refers to "full, complete, and systematic records, which include all pertinent data and memoranda, of all transactions relating to its **business of dealing in** commodity interests and related cash or forward transactions." (Emphasis added.)

In addition, in footnote 39 to the Regulations Adaptation Rule, the Commission noted that "since as early as 1964," Regulation 1.35 required "full, complete, and systematic records, together with all pertinent data and memoranda, of all transactions relating to his business of **dealing in** commodity futures and cash commodities." (Emphasis added.)

The IECA submits that the reference to "dealing" should not now be ignored by the Commission as it expands the application of Regulation 1.35 to include "members of SEFs." Accordingly, the IECA believes that Regulation 1.35 should only apply to records of transactions of commercial end-users enacted on a SEF *if and to the extent* that such "transactions [are] related to its business of **dealing in** commodity interests and related cash and forward transactions."

The IECA submits that such a fair reading of the language of Regulation 1.35 would include under Regulation 1.35 all transactions in which a commercial end-user is handling customer orders and would exclude from Regulation 1.35 all transactions in which a commercial end-user is not handling customer orders.

Simply put, applying the Commission's Regulation 1.35 to impose recordkeeping requirements on commercial end-user participants as "members" of SEFs, when that commercial end-user is trading for its own account and not for any customer, was never intended by the 2009 DMO Advisory Letter and would be inconsistent with the explicit wording of Regulation 1.35 as enacted on December 21, 2012 in the Regulations Adaptation Rule and as far back as the explicit wording of Regulation 1.35 in 1964 (as quoted by the Commission in the Regulations Adaptation Rule).

We note that although Regulation 1.35 has included the term "member" since quite possibly the 1930's, the changes in derivatives markets and technological advances (such as moving from pit trading to electronic execution) have drastically changed the meaning of the term "member," which traditionally referred to a market participant acting as an intermediary on behalf of customers. As such, the reach of Regulation 1.35 has dramatically expanded beyond what was intended by the statutory requirement in Section

4g(a) of the CEA and the Commission ought to update Regulation 1.35 to reflect the reach originally intended.

v. <u>Suggested Amendment or Clarification of CFTC Regulation 1.35</u>

Absent a completely new and reworked Regulation 1.35, one way the Commission could address customer and end-user issues would be to simply remove the term "member" in the regulation, and insert the statutory definition provided in CEA Section 4g(a), which strictly applies the record-keeping regulations to "FCMs, IBs, floor brokers, and floor traders" in accordance with footnote (iv) the 2009 DMO Advisory Letter. For all of the above reasons, we believe that such a revision would be entirely consistent with previous CFTC statements on this topic.

Alternatively, the Commission could clarify the definition of "member" as applicable to Regulation 1.35 in a manner consistent with congressional intent and prior CFTC staff precedent. Prior to the December 2012 amendments to Regulation 1.35 the Commission has always applied the recordkeeping requirements to those that execute customer orders and perform an intermediary role for customers. Amendments to Regulation 1.35 in December 1948, June 1963, September 1971 and the 2009 DMO Advisory Letter (see attached) all place the record keeping burden strictly on those handling (or on the opposing side of) customer order executions. The recordkeeping burden was never inclusive of the customer and should not now be expanded simply because the rule text has not kept pace with the evolution of the derivatives markets. Revising or clarifying this definition would ensure that the Congressional historic intent of Regulation 1.35 would be rightly placed on intermediaries without unduly burdening

commercial end-users and customers by forcing them to record all written or electronic communications that "lead to the execution of a transaction in a commodity interest and related cash or forward transactions."

Such a revision could be accomplished by explicitly stating in the applicable Commission regulations that:

> "A member of a DCM or a SEF that is not registered with the Commission and not required to be registered with the Commission in any capacity shall satisfy the recordkeeping requirements of the CEA and recordkeeping rule, order or regulation under the CEA by maintaining a written record of each transaction in a contract for future delivery, option on a future, swap, swaption, trade option, or related cash or forward transactions. The written record shall be sufficient if it includes the final agreement between the parties and the material economic terms of the transaction and is identifiable and searchable by transaction."[11]

[11] See Section 353 of H.R. 4413 approved by the House Agriculture Committee on April 9, 2014.

B. Panel Two: Embedded Volumetric Optionality Discussion

The members of the International Energy Credit Association (IECA) have concerns with several factors of the 7-Factor Test applicable to "forward contracts with embedded volumetric optionality" as set forth in the CFTC's interpretation of Commodity Options Embedded in Forward Contracts, which is contained in the *Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement"; Mixed Swaps; Security-Based Swap Agreement Recordkeeping*, 77 Fed. Reg. 48,208 at 48,237 (August 13, 2012) ("Swap Definition Final Rule").

i. 7-Factor Test for Embedded Volumetric Optionality

In the Swap Definition Final Rule, the CFTC set forth the following 7-Factor test for assessing whether a forward contract with embedded volumetric optionality continues to satisfy the terms of the forward contract exclusion from the swap and future delivery definitions, or should be considered a swap. Therein the Commission provided the following interpretive guidance (footnotes omitted):

> "The CFTC also is providing an interpretation, in response to commenters, with respect to forwards with embedded volumetric optionality. Several commenters asserted that agreements, contracts, and transactions that contain embedded ''volumetric options,'' and that otherwise satisfy the terms of the forward exclusions, should qualify as excluded forwards, notwithstanding their embedded optionality. The CFTC believes that agreements, contracts, and transactions with embedded volumetric optionality may satisfy the forward exclusions from the swap and future delivery definitions under certain circumstances. Accordingly, the CFTC is providing an interpretation that an agreement, contract, or transaction falls within the forward exclusion from the swap and future delivery definitions, notwithstanding that it contains embedded volumetric optionality, when:
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> 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, contract, or transaction, to take delivery of the underlying nonfinancial commodity if it exercises the embedded volumetric optionality;

6. Both parties are commercial parties; and

7. The 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."

ii. <u>Concerns with Factors 1 and 2 of the 7-Factor Test</u>

The first two factors of the 7-Factor Test state that "1. The embedded optionality does not undermine the overall nature of the agreement … as a forward contract; and 2. The predominant feature of the agreement … is actual delivery." (77 Fed. Reg. 48238) With that part of its guidance, we agree with the CFTC.

CFTC interprets Factors 1 and 2 as requiring a "binding, albeit deferred, delivery obligation." (77 Fed. Reg. at 48238). With that part of its guidance, we also agree with the CFTC.

We have been advised that the Staff of the CFTC has taken the position in various meetings with market participants that the "delivery of a *non-nominal* volume of a nonfinancial commodity" is required for a transaction to be a "forward contract" and

without such an obligation, one does not even get to apply the 7-Factor Test for volumetric optionality with respect to "commodity options embedded in a forward contract," because such a transaction does not involve a forward contract, but is simply a commodity option, and is therefore a swap.

The IECA objects to the mischaracterization of such commercial transactions entered into between commercial parties in order to achieve actual delivery of the nonfinancial commodity, which includes a non-nominal or zero volume at different times during the term of that transaction, as something other than a forward contract with embedded optionality.

We suggest that application of the Commission's various tests for forwards with embedded optionality can achieve the Commission's objectives with respect to speculative transactions, while simultaneously acknowledging that various commercial participants use forward contracts that include non-nominal or zero delivery obligations at various times during the terms of those forward contracts, to meet their physical requirements for nonfinancial commodities.

Doing so will require clarification of some portions of the Commission's interpretative guidance in the Swap Definition Final Rule. As one example, the following text regarding the 7-Factor Test would likely require some further explanation (77 Fed. Reg. 48239): "Where an agreement, contract, or transaction requires delivery of a non-nominal volume of a nonfinancial commodity, even if an embedded volumetric option is exercised, the CFTC believes that the predominant feature of the contract, notwithstanding the embedded volumetric optionality, is actual delivery. This is the case in many forward contracts that have an embedded option that allows a party to buy or sell

an additional amount of a commodity beyond the fixed amount called for in the underlying forward contract." (Emphasis added.)

We note that the CFTC's interpretative guidance does allow a "nominal or zero delivery" to be part of a forward contract in a "full requirements contract" (and perhaps also in the context of a contract for "reserves" procured to meet a "regulatory requirement" or to address "physical factors beyond the control of the parties" as described in Footnote 340). In the further interpretations to explain how the CFTC would treat a full requirements contract, the CFTC said (77 Fed. Reg. at 48239): "Based upon this description, the CFTC believes that a going commercial concern with an exclusive supply contract has no option but to get its supply requirements met through that exclusive supplier consistent with the terms of the contract. Any instance where nominal or zero delivery occurred would have to be because the commercial requirements changed or did not materialize. Furthermore, any variability in delivery amounts under the contract appears to be driven directly by the buyer's commercial requirements and is not dependent upon the exercise of any commodity option by the contracting parties." (Emphasis added.)

The position requiring "delivery of a non-nominal volume" that we understand is being expressed by the Staff of the CFTC (as discussed in the two preceding paragraphs) is also inconsistent with the way electric utilities purchase electricity (as described more fully herein), because utilities enter into multiple contracts with different companies owning electric generating facilities, instead of one full requirements contract, and the contracts with many of those generating companies will allow "nominal or zero delivery" in order to meet the electric utilities' commercial needs.

Consider, for example, an electric utility (Utility X) serving thousands of customers with an aggregate load (combined requirement) on an average day of 5,000 Megawatts (MW) that can rise up to 10,000 MW on an extremely hot day (due to increased air conditioning load, etc.).

Under the CFTC's interpretative guidance, if Utility X had one contract with one supplier (Supplier W) capable of delivering up to 10,000 MWs in any hour, and if that one contract obligated Supplier Y to meet the "full requirements" of Utility X, then that contract would not be a swap, but would likely qualify for the forward exclusion from swap regulation, even if the volume during any hour fell to a nominal volume or zero.

Similarly, under the CFTC's interpretative guidance, if Utility X had two contracts, one contract with Supplier Y for a "fixed amount" of 3,000 MW, plus an option to purchase an additional 2,000 MW, and a second contract with Supplier Z for a fixed quantity of 2,000 MW, plus an option to purchase an additional 3,000 MW, then, assuming the CFTC would agree that both contracts "require delivery of a non-nominal volume," then those two contracts would not be swaps under the CFTC's interpretation and would likely qualify for the forward exclusion from swap regulation.

Unfortunately, our exemplary Utility X does not fare as well under the interpretative position being taken by members of the Staff of the CFTC requiring "delivery of a non-nominal volume," when it procures the 10,000 MW of electricity its customers require by entering into as many as 100 separate power purchase agreements (PPAs) with each of 100 different generating companies, each owning a power generating facility. In a typical electric utility's portfolio of supply contracts, some of suppliers own and operate large generating facilities capable of generating several

hundred MWs of power, while many other suppliers own and operate much smaller generating facilities capable of generating no more than 15 or 20 MW.

Several of those generating companies will be called upon by Utility X under their respective contracts to generate electricity during every hour of every day to produce the “fixed volume” of 5,000 MW that the customers of Utility X require every hour of every day.

Several of the other generating companies will not be called upon by Utility X under their contracts to generate electricity until the temperature rises (or falls) during certain hours of any day and the requirements of the customers of Utility X exceed the fixed 5,000 MW level.

To Utility X, those generating companies called upon to deliver a “fixed volume” of electricity every hour of every day are forward contracts, because “the predominant feature of [all of such] contracts is actual delivery.”

To Utility X, those generating companies who generate zero electricity during many hours of many days during the term of their contracts, i.e., a “nominal or zero delivery,” are nevertheless subject to “a binding, albeit deferred, delivery obligation” on any day when the customers of Utility X require more than 5,000 MW of electricity and Utility X calls upon one or more of those generating companies to deliver electricity to Utility X to meet the commercial needs of Utility X and its customers. From the perspective of Utility X, all of such contracts should be forward contracts, because “the predominant feature of [all of such] contracts is actual delivery” and both the buyer (Utility X) and each seller under those contracts intend to take and make delivery of that nonfinancial commodity (electricity) when called upon by Utility X.

And yet, under the position being taken by members of the Staff of the CFTC, for those contracts under which a "nominal or zero delivery" WILL occur on many days of any year, such contracts cannot be forward contracts, because they do not always require "delivery of a non-nominal volume" or a "fixed amount" and so they must be swaps.

The IECA objects to this position being taken by members of the Staff of the CFTC, whether based on an interpretation of the Commodity Option Final Rule[12] or Factors 1 and 2 of the 7-Factor test for volumetric optionality, because that Staff position is directly contrary to the Commission's own words in the Swap Definition Final Rule, as well as the commercial purchasing practices of an entire industry. The CFTC Staff's interpretation simply does not work for the typical electric utility in the US, which is concerned with assuring it can deliver power to its customers and which has contracts with a hundred or more suppliers of many different sizes, some of whom will deliver "nominal or zero" volumes at various times during the course of each year.

iii. Suggested Resolution of Concerns Regarding the First Two Factors of the 7-Factor Test

The IECA would support deleting that portion of the CFTC's interpretation of Factors 1 and 2 that appears to the Staff of the CFTC to "require delivery of a non-nominal volume" or requires delivery of a "fixed amount" and clarifying that a forward contract between commercial participants, the predominant feature of which is actual delivery of a nonfinancial commodity, can provide for a nominal or zero volume at various times during the term of that forward contract. Alternatively, having the CFTC provide additional interpretative guidance indicating that zero delivery or nominal delivery under one or more supply contracts will not cause such contracts to fail to satisfy

[12] Commodity Options, 77 Fed. Reg. 25310 (April 27, 2012) ("Commodity Options Final Rule").

Factors 1 and 2 so long as the underlying contracts do impose a binding, albeit deferred, delivery obligation on the supplier of the nonfinancial commodity so that if the purchaser of that commodity calls upon the supplier to deliver the nonfinancial commodity, then that contract will result in physical delivery of the nonfinancial commodity.

iv. Concerns with Factor 7 of the 7-Factor Test

Factor 7 of the 7-Factor Test requires that "exercise or non-exercise of the embedded volumetric optionality is based primarily on physical factors or regulatory requirements outside the control of the parties, which are influencing demand for, or supply of, the nonfinancial commodity." This Factor 7 of the 7-Factor test also fails to address adequately the commercial needs of the electric industry.

In our hypothetical example shown above, when the requirements of Utility X's customers rises from 5,000 MW to 5,500 MW, it is true that the increase in quantity of electricity to be purchased by Utility X will require the exercise of the embedded optionality based "primarily on physical factors or regulatory requirements outside the control" of Utility X, but the decision of which of its multiple suppliers to call upon (in the absence of any transmission or system reliability constraints) will be purely economic.

Utility X will look at the stack of contracts capable of supplying up to 5,000 MW, which are available to supply the additional 500 MW of electricity required by its customers, and Utility X will select the cheapest contract (subject to credit risk/exposure considerations). If additional electricity in excess of the electricity available under the cheapest contract is required to meet the requirements of Utility X's customers, then Utility X will call on the seller under the next cheapest contract and will continue to work

its way, on a purely economic basis, through the remaining contracts in its stack of suppliers until all the electricity required by the customers of Utility X has been delivered.

Notably, regarding the "non-exercise" requirement in Factor 7, one of the sellers ("Seller 17") who included volumetric optionality in its contract with Utility X may not know that Utility X purchased electricity from one or more other suppliers on a day when Utility X did not exercise the optionality under its contract with Seller 17, rather than exercising the optionality under Utility X's contract with Seller 17, much less know the reason that Utility X chose the "non-exercise" of the optionality under its contract with Seller 17.

It is equally unclear what regulatory consequences result for a party, for example a supplier we will call Seller 17, it that party believes (whether such belief arises as a result of a contractual representation, due diligence, historical course of dealing, or some other factor) that, at the time its transaction is entered into with Utility X, that the transaction satisfies Factor 7 of the 7-Factor Test, which belief turns out to be incorrect based on the reason that Utility X elects the "exercise or non-exercise" of its transaction with Seller 17 on some future date.

v. Suggested Resolutions of Concerns Regarding Factor 7 of the 7-Factor Test

The IECA supports deleting Factor 7 of the 7-Factor Test. From the IECA's perspective, this Factor 7 creates substantial uncertainty and ambiguity with respect to whether any transaction can satisfy the requirements of Factor 7. First, and foremost, the test for whether a transaction is a forward contract should be ascertained at the time the transaction is entered into, not at some distant date when the commercial end-user who

requested the optionality in its transaction elects to exercise or not exercise that optionality.

Alternatively, the IECA would support a clarification of Factor 7 of the 7-Factor Test that says: "The volumetric optionality is included in a forward contract, at the time of execution of such contract, in order to meet the commercial needs of one of the parties to that forward contract and not for any speculative or investment purpose of that party."[13]

As a further alternative, the IECA would support a replacement of the 7-Factor Test with the following test:

> "Any purchase or sale of a non-financial commodity or security for deferred shipment or delivery, so long as the transaction is intended to be physically settled, including any stand-alone or embedded option for which –
>
> (I) exercise results in a physical delivery obligation;
>
> (II) cannot be severed or marketed separately from the overall transaction for the purpose of financial settlement; and
>
> (III) both parties are commercial participants.[14]

vi. <u>Commodity Options for Physical Delivery of a Nonfinancial Commodity Between Commercial Market Participants, which are not Investment Vehicles, Should Not be Treated as Swaps</u>

[13] In the interpretative guidance included in the Swap Definition Final Rule, the Commission elected not to regulate as swaps certain commercial transactions even if such transactions have attributes that could be viewed as falling within the swap definition. Because such transactions are used to meet the commercial parties' needs, such forward contracts are similar to the Commission's category of excluded commercial transactions. The IECA's proposed clarification of Factor 7 of the 7-Factor Test borrows from the enumerated attributes the Commission considered common to excluded commercial agreements. See Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement"; Mixed Swaps; Security-Based Swap Agreement Recordkeeping, 77 Fed. Reg. 48,208 at 48,247 (August 13, 2012).

[14] See Section 354 of H.R. 4413 approved by the House Agriculture Committee on April 9, 2014.

The IECA supports an additional finding that should be added to the Commission's interpretative guidance in the Swap Definition Final Rule, namely that Commodity Options, which provide for physical delivery of a nonfinancial commodity between commercial market participants as the parties to such Commodity Option, will not be treated as swaps.

The IECA submits that commodity options that qualify for the trade option exemption under Section 32.3 of the Commission's regulations ("Trade Options"), just like forward contracts, are not intended to transfer price risk from one party to another, but are simply commercial transactions intended to transfer physical delivery and ownership of a physical commodity from one party to another.

Commercial market participants utilize Trade Options, i.e., forward contracts with embedded volumetric or price optionality, no differently than any other physical forward contract to procure or sell quantities of a nonfinancial commodity that is needed for its commercial business and not as a means of mitigating volatility or other financial risks or for speculative investment purposes. As such, Trade Options should not be treated as swaps.

vii. Other Reasons Why It Matters that Commodity Options for Physical Delivery of a Nonfinancial Commodity Between Commercial Market Participants Not be Treated as Swaps

The plain language of the definition of "Trade Option" also provides a basis for the categorical exclusion of Trade Options from position limits. By its terms, Trade Options are commercial transactions, because at least one of the counterparties must be a commercial participant (a producer, processor, commercial user of, or merchant handling, the underlying physical commodity or a product or byproduct of such physical commodity), and such commercial participant is offering or entering into the commodity

option transaction solely for purposes related to its business as such. Since Trade Options are commercial and not speculative, it is unclear how subjecting Trade Options to position limits would further the Commission's efforts to "diminish, eliminate, or prevent excessive speculation."

In fact, the Commission should exclude Trade Options from position limits to avoid imposing regulations that are designed to deter excessive speculation on transactions that are fundamentally commercial.

Moreover, including Trade Options within the position limits regime subjects them to a form of analysis that they simply do not fit. The CFTC's proposed Position Limits rule defines a significant exemption from such limits on positions, arising from the statutory text, for "bona fide hedges." Although Trade Options are, by definition, commercial transactions, they may not meet the requirements for a bona fide hedging exemption to the CFTC's proposed Position Limits. As was noted at the Roundtable, commercial parties to a Trade Option will not be using Trade Options to hedge the risk of a physical forward transaction, because the commercial parties to the Trade Option view the Trade Option itself as the physical forward transaction.

Since the primary exclusion allowing a party to a swap to exceed a Position Limit is the bona fide hedging exemption, and since Trade Options by their very definition are used to provide physical delivery, not a hedge of a financial risk related to a physical delivery, there is a substantial likelihood that the bona fide hedging exemption will not be available to allow a commercial participant to enter into Trade Options that exceed a Position Limit applicable to the positions underlying its Trade Options. As a result, a commercial participant using one or more Trade Options to meet its physical

requirements for a nonfinancial commodity may find itself in violation of that Position Limit with no available exemption for securing the quantity of a nonfinancial commodity required for its commercial business.

For the foregoing reasons, the IECA submits that a commercial participant's position in any Trade Option should not be subject to Position Limits. Similarly, just as confirmation by a commercial participant that it is entering into a swap for purposes of hedging and not speculation can confer pass-through swap status for the benefit of its counterparty, so too should qualification of a transaction as a Trade Option, by virtue of its definitional requirement that at least one counterparty is a commercial participant entering into a Trade Option solely for purposes related to its business, definitively exclude such Trade Option from position limits for the other counterparty. Context matters, and the Commission should take the fundamental commercial nature of Trade Options into account in its deliberations on position limits.

In addition, there is significant uncertainty as to what is or is not a Trade Option based on the lack of clarity in the CFTC's guidance for distinguishing physical forward transactions from commodity option swaps, and especially the ambiguity of applying the 7-Factor Test. Similarly, there is inconsistency in Form TO reporting of transactions when one party to a trade applies the Commission's test and concludes it is an excluded physical forward and the other party to the same trade applies the Commission's test and concludes it is a Trade Option. These inconsistencies are not surprising when comparing the CFTC's interpretive guidance to the requirements of Section 1a(47)(B)(ii), which says 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." "Settled" does not mean "delivered." A physically settled contract is settled by an exchange of money for the commodity if the commodity is delivered, or not delivered, as provided in the contract.[15] This is in contrast to a swap, which is "financially" settled by an exchange of cash flows, such as an exchange of a fixed price for a floating price.

Commission rules or staff positions casually including within its regulatory purview transactions that were in fact excluded from that purview by Congress has a substantial potential cost on business, none of which was addressed in the Commission's cost benefit analysis of the Swap Definition Final Rule or its Commodity Option Rule.

We are concerned that a representation believed to be true by a party submitting Form TO may form the basis for prosecution of well-meaning and law-abiding business persons. Section 3 of Form TO contains an Authentication and Consent, whereby an individual represents that "that the information and representations [in Form TO] are true and correct." This is certainly not a casual certification exercise given the provisions of the CEA stated below.

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[15] In its Commodity Option Rule, the Commission took the CEA's exclusion from all of DFA of transactions that are intended to be physically settled and made it an element of being subject to some of DFA. Under Commission Regulation 32.3(a)(3), something is a Commodity Option that can be more lightly regulated as a "Trade Option" subject to Commission regulation if "(3) The commodity option must be intended to be physically settled," However, under CEA §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". Yet, the Commission in this instance defines "physically settled" as "if exercised, the option would result in the sale of an exempt or agricultural commodity (i.e. non-financial) commodity for immediate (spot) or deferred (forward) shipment or delivery," and adds an element requiring intent of "both parties." Yet "settled" does not mean "purchased" or "sold" or "delivered," and the above phrase added by the Commission to §1a(47)(B)(ii) at 77 F.R. 25326 col. 3 is not in the statute at all. Something that can only be physically settled must be intended to be physically settled, whether or not one or both parties "intend" to "purchase" or "sell" or "deliver." The Commission has added two new elements - "dual intent" to "actually deliver" that are not in the statute. The statute clearly provides that if the parties to a deferred shipment or delivery transaction for a nonfinancial commodity intend to physically "settle" (not "deliver"), then CEA section §1a(47)(B)(ii) trumps CEA §1a(47)(A)(i) and the Commission was not given jurisdiction over such commodity options as "swaps." The Commission has plenary jurisdiction over such commodity options pursuant to CEA §4c and provisions of the CEA pre-dating DFA, but not as "swaps" pursuant to DFA.

Section 6(c)(2) of CEA makes it unlawful to make any false or misleading statement of a material fact to the Commission, including in any … report filed with the Commission under the CEA, or any other information relating to a swap, or a contract of sale of a commodity, in interstate commerce, … or to omit to state in any such statement any material fact that is necessary to make any statement of a material fact made not misleading in any material respect, if the person knew, or reasonably should have known, the statement to be false or misleading.

Section 9(a)(3) of CEA makes it a felony punishable by a fine of not more than $1,000,000 or imprisonment for not more than 10 years, or both, together with the costs of prosecution, for any person knowingly to make, or cause to be made, any statement in any application, report, or document required to be filed under this Act or any rule or regulation thereunder … which statement was false or misleading with respect to any material fact, or knowingly to omit any material fact required to be stated herein or necessary to make the statements therein not misleading.

By the above, the Commission and its Staff are proposing to send to federal prison business people for failing to tell the Commission that the companies they work for engaged in transactions that (a) Congress specifically excluded from being "swaps" under the DFA, and (b) must be deciphered pursuant to characterization rules that are incapable of being interpreted and applied, even by the Commission and its Staff, on a consistent basis.[16]

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[16] Due process of law is also implicated in another way. The Commission published its proposed Commodity Option rules on January 13, 2012 (77 F.R. 2136), before anyone could have known they needed to comment on the rules because the Commission would dramatically expand its jurisdiction to include forward, physically settled transactions with embedded physical optionality in its Swap Definition Final Rule published August 13, 2012. In Footnote 6 of its Commodity Options rule, the Commission says that it "uses the term 'commodity options' to apply solely to commodity options not excluded from the swap definition set forth in CEA section 1a(47)(A), 7 U.S.C. 1a(47)(A)." (77 F.R. 25321; note that the

Commission does not refer to CEA 1a(47)(B)(ii)) The Commission then describes the pending final rule defining a "swap," which is being developed jointly with the SEC, and says: "The final rule and interpretations that result from the Product Definitions NPRM will address the determination of whether a commodity option or a transaction with optionality is subject to the swap definition in the first instance. If a commodity option or a transaction with optionality is excluded from the scope of the swap definition, as further defined by the Commission and the SEC, the final rule and/or interim final rule adopted herein are not applicable." (See 77 Fed. Reg. 25321) This means that no one had the ability to comment on the Trade Option rule with any inkling that transactions that are intended to be physically settled would be regulated by the Commission as swaps under DFA and that the Commission would make them subject to its DFA rules by interpreting "physically settled", which is an exclusion from DFA under §1a47(B)(ii), as instead an element of a trade option that would require inclusion within DFA and some DFA compliance. Had the Commission allowed market participants to comment on its rules before promulgating them, it would have learned the difficulties of meeting Commission rules for Trade Options embedded in many types of forward contracts with volumetric optionality.

C. **Panel Three: "Special Entity" De minimis Threshold for Swap Dealing to Government-Owned Electric Utilities**

The IECA commends the Commission and its Division of Swap Dealer and Intermediary Oversight ("Division") for issuing No-Action relief with respect to "utility operations-related swaps" entered into with "utility special entities" in the Division's Letter No. 14-32.

The IECA fully supports the Commission's making the Division's No-Action Relief permanent pursuant to the proposed rulemaking which Acting Chairman Wetjen announced at the Roundtable.

Furthermore, the IECA requests that the CFTC amend its regulations to specify that the de minimis quantity of swap dealing that is currently set at a quantity of $8,000,000,000 shall only be amended or reduced through a new affirmative action of the Commission undertake by rule or regulation. By so doing, non-special entities will be able to consider entering into swap transactions with "utility special entities" with respect to "utility operations-related swaps" for a longer term than would otherwise be prudent in light of the risk of an automatic reduction of such de minimis threshold to $3,000,000,000 under the Commission's existing applicable regulations.

III. **Conclusion.**

The IECA appreciates the opportunity to provide the foregoing comments and information to the Commission. This letter represents a submission of the IECA, and does not necessarily represent the opinion of any particular member. If you would like for us to expand our discussion of any of the above-listed discussion points, please let us know.

Yours truly,

INTERNATIONAL ENERGY CREDIT ASSOCIATION

/s/	/s/
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