

April 17, 2014

VIA ONLINE SUBMISSION

Ms. Melissa Jurgens
Secretary of the Commission
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, NW
Washington, D.C. 20581

**Re: Comments Regarding Forward Contracts with Embedded Volumetric
Optionality in Response to the April 3, 2014, CFTC Staff Public Roundtable
on Dodd-Frank End-User Issues.**

Dear Secretary Jurgens:

On behalf of The Commercial Energy Working Group (the “**Working Group**”), Sutherland Asbill & Brennan LLP hereby submits these comments in response to the April 3, 2014, Public Roundtable on Dodd-Frank End-User Issues (“**Roundtable**”) held by the Commodity Futures Trading Commission (“**CFTC**” or “**Commission**”) staff.¹ As detailed further below, the seven-part analysis regarding the treatment of forward contracts with embedded volumetric optionality derived from the interpretive guidance set forth in the final rule further defining the term “swap” (the “**Final Swap Rule**”)² is largely unworkable. For this reason, the Working Group appreciates the opportunity to provide comments on this important issue and looks forward to working with the Commission to develop a solution.

The Working Group is a diverse group of commercial firms in the energy industry whose primary business activity is the physical delivery of one or more energy commodities to others, including industrial, commercial, and residential consumers. Members of the Working Group are energy producers, marketers, and utilities. The Working Group considers and responds to requests for comment regarding regulatory and legislative developments with respect to the trading of energy commodities, including derivatives and other contracts that reference energy commodities.

¹ April 3, 2014, CFTC, Public Roundtable to Discuss Dodd-Frank End-User Issues. Press release available at: <http://www.cftc.gov/PressRoom/PressReleases/pr6872-14>.

² See *Further Definition of “Swap,” “Security-Based Swap,” and “Security-Based Swap Agreement;” Mixed Swaps; Security-Based Swap Recordkeeping*, Joint Final Rule, Interpretations, and Request for Comment on an Interpretation, 77 Fed. Reg. 48,208 (Aug. 13, 2012).

I. INTRODUCTION.

In the Final Swap Rule, the CFTC created a test for physical forwards with embedded volumetric optionality that allows such a transaction to qualify for the forward contract exclusion from the definition of “swap” if it meets seven distinct requirements (the “**Seven-Part Test**”).³ However, there is much uncertainty surrounding the application of Prong 7 of the Seven-Part Test. As a result of this uncertainty, commercial market participants may be unable to determine definitively whether their physical forwards with embedded volumetric optionality are forwards or commodity options.

The Working Group previously submitted comments to the Commission regarding interpretational issues with the Seven-Part Test.⁴ About a year and a half has passed since the Commission received those comments. During that time frame, the Commission has received additional comments and suggestions from a wide range of market participants and effected parties most of which note how the Seven-Part Test is largely unworkable and problematic in application. Given the material issues associated with the Seven-Part Test and considering the length of time market participants have struggled with those issues, we strongly urge the Commission to give serious consideration to the comments it has received and will receive on this matter.

Much of the discussion about the Seven-Part Test has focused on the burden it creates on market participants. As discussed at the Roundtable, that burden is material and borne by many end-users. However, the Working Group respectfully suggests the question of burden is

³ The Seven-Part Test requires:

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

Final Swap Rule at 48,238.

⁴ See The Commercial Energy Working Group Letter to David A. Stawick, Secretary, Commodity Futures Trading Commission, in re: *Comments in Support of ConocoPhillips' Public Comments on the Commission's Interpretation Regarding Forwards with Embedded Volumetric Options*; RIN No. 3038-AD46 (Oct. 12, 2012).

misplaced. The true focus should be on whether the test is well designed, effective, and supported by, and is consistent with, the relevant statutory provisions.

On balance, the Commission could have used a principle-based approach and suggested that volumetric optionality only causes a forward-contract to become a swap when the option shifts the nature of the contract away from transferring the ownership of physical commodities towards the mere transfer of price risk. Under this approach, the CFTC could use its anti-evasion authority to police any potential abuses of the forward contract exclusion. The Commission has historically followed this path. However, as the Commission chose to depart from this precedent, the Working Group notes that further clarifying guidance from the Commission about the Seven-Part Test likely will be helpful for market participants. To this end, the Working Group proffers some recommendations on how the Commission's existing guidance can be improved. However, none of the Commission, Congress or the market should interpret such guidance as an adequate solution to the problems with the Seven-Part Test.

II. COMMENTS OF THE WORKING GROUP.

A. Problems with the Seven-Part Test Require Solutions Beyond Technical Guidance.

The Seven-Part Test is a flawed regulatory construct that has been disruptive to the physical commodities markets. The Commission should remove the Seven-Part Test entirely. Absent abandoning the Seven-Part Test, additional technical guidance on the application of the Seven-Part Test will likely help alleviate some of the difficulties with the test, and that guidance would be welcomed. Considering the first-hand knowledge the Working Group's members have with these issues, the Working Group offers the CFTC recommendations with respect to any future guidance the Commission may issue.

However, additional guidance cannot ultimately resolve the underlying flaws in the test. Thankfully, the Seven-Part Test is part of an interim final rule. As such, the Commission could – and should – complete such rulemaking and, in doing so, eliminate the Seven-Part Test entirely.⁵

Congress created a statutory exclusion from the definition of “swap” for forwards that are intended to physically settle. In short, to qualify for this exclusion, counterparties, at execution, must intend for the transaction to physically settle.

The Commission framed the Seven-Part Test as a construct for analyzing the availability of the forward contract exclusion for forward contracts with embedded volumetric optionality. However, the Seven-Part Test uses analytical criteria well beyond the presence of the intent to physically deliver. Specifically, the Seven-Part Test requires inquiry into the motivation of the exercising party and requires the examination of facts and circumstances well outside the four-corners of the agreement, such as supply and demand dynamics of the applicable markets. It is the nature of these other criteria that create a flawed construct, but they also cause the construct

⁵ We note also that Congress might assist the Commission by clarifying that physically-settling options, whether imbedded in physically-settling forward contracts or not, are not within the definition of “swap.”

to be disconnected from the statute on which it is based. Accordingly, further regulatory guidance on the Seven-Factor Test may ameliorate difficulties with the Seven-Part Test, but ultimately will not fix it.

B. Prong 7 Is Satisfied when the Optionality Is Intended to Meet the Commercial Needs of a Commercial Firm's Business.

Prong 7 of the Seven-Part Test requires the exercise or non-exercise of an embedded volumetric option to be “based primarily on physical factors . . . that are outside the control of the parties and are influencing demand for, or supply, of the nonfinancial commodity.”⁶ This standard is unworkably vague. The Commission does not provide the guidance necessary to allow market participants to adequately identify factors that are both (a) outside their control and (b) influence demand and supply.

Additionally, Prong 7 imposes a requirement to classify a transaction based on potential future actions and decisions. Specifically, to properly classify a transaction under Prong 7, a counterparty must know the true intentions of its counterparty at the time of execution and it must be able to predict what exogenous factors in the future will determine its or its counterparties' exercise or non-exercise of an embedded volumetric option. There are very few circumstances where a market participant can comfortably anticipate not only its own reasons for exercising volumetric optionality, but also the reasons of its counterparties. This inability to forecast prospective behavior in order to classify a transaction at the time of execution creates regulatory uncertainty that the Commission should remedy.

For these reasons, the Working Group supports the recommendation to interpret Prong 7 as satisfied whenever:

- *the optionality – whether a put or a call – is intended to meet the commercial production, consumption, or merchandizing requirements of the option owner's business, where these requirements can be reasonably affected by supply or demand conditions;*
- *regardless of whether the option owner arranges for multiple alternatives to address these requirements;*
- *including cases where business judgment is exercised in choosing among alternatives whose value is driven primarily by external factors, including qualitative factors.*

C. Prongs 4 and 5 Must be Corrected.

Prongs 4 and 5 of the Seven-Part Test respectively require that “[t]he seller . . . intends . . . to deliver . . . if the optionality is exercised,” and that “[t]he buyer . . . intends . . . to take

⁶ *Id.*

delivery . . . if it exercises the embedded volumetric optionality.”⁷ This language is drafted such that it is correct for call options, but not for put options. The Working Group respectfully requests that the Commission revise the wording in Prongs 4 and 5 to apply to both puts and calls. To correct this error, we would propose interpretative language along the following lines.

Recognizing that, upon exercise of an option that calls for physical delivery of a commodity, the owner of the option is obligated to make delivery if the option is a put, but to take delivery if the option is a call, with the seller of the option bearing the opposite obligation in each instance, Parts 4 and 5 of the Seven-Part Test shall be interpreted to be satisfied if:

- each party intends to satisfy its delivery obligations if the option is exercised;*
and
- the respective delivery obligations are consistent with the character of the embedded option as a put or a call.*

III. CONCLUSION.

The Working Group supports appropriate regulation that brings transparency and stability to the swap markets worldwide. The Working Group appreciates this opportunity to provide comments on the interpretive guidance set forth in the Final Swap Rule and respectfully requests that the Commission consider these comments as it develops its final interpretive guidance regarding these matters.

If you have any questions, please contact the undersigned.

Respectfully submitted,

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⁷ *See id.*