December 2014

Commissioners
Commodity Futures Trading Commission
Three Lafayette Centre, 1155 21st Street NW.
Washington, D.C. 20581

Re: RIN 3038-AE24, Forward Contracts with Embedded Volumetric Optionality

Dear Commissioners,

On behalf of Public Citizen's more than350,000 members and supporters, we are pleased to offer these comments on the Commodity Futures Trading Commission's (CFTC or Commission) proposed interpretation of "Forward Contracts with Embedded Volumetric Optionality."

In summary, because the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) requires the CFTC to regulate options, we oppose the proposed exclusion from CFTC oversight of contracts that provide for a volume option. Such forward contracts with volumetric optionality can be handled through the CFTC's trade option framework. By proposing an exclusion from regulation, the markets will be exposed to the opportunity for manipulation that inevitably will disserve the American consumer.

In a 2012 release titled "*Further Definition of 'Swap,' 'Security-Based Swap,' and 'Security-based Swap Agreement'; Mixed Swaps; Security-Based Swap Agreement Recordkeeping"* the CFTC provided an interpretation with respect to forward contracts that provide for variations in delivery amount. This is summarized as ''embedded volumetric optionality,'' or EVO.[1] Under the 2012 interpretation, the EVO contracts are excluded from CFTC oversight, as are forward contracts, provided they meet a seven-part test.

This seven-part test was constructed to guard against firms escaping important CFTC oversight in commodity markets. Whereas forward contracts relate to the future delivery of a fixed volume of a contract, option contracts provide for some form of option in the contract, such as the option to decline delivery if the purchaser decides the price isn't advantageous. Contracts that provide for optionality are

[1] *See* 77 FR 48207, 48238–42 (Aug. 13, 2012).

regulated by the CFTC because, among other reasons, they are subject to manipulation and market abuse.

Contracts with options invite speculators into the market who are neither producers nor users of a commodity. Speculators intend simply to profit, and if successful, they will extract a rent that must ultimately be paid by the consumer. While speculators can provide liquidity and price discovery, which are useful, these attributes come at a cost that the CFTC should work to minimize through oversight. (The last prong of the 2012 seven-part test includes language that certain market participants have complained is unclear. That provision states: "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." [2]

This specific prong was intended to prevent the contract purchaser from using the forward as an option, electing to decline delivery based on such factors as price.

To accommodate market critics of the 2012 language, the CFTC now proposes to replace this seventh prong with the following language: "The embedded volumetric optionality is primarily intended, at the time that the parties enter into the agreement, contract, or transaction, to address physical factors or regulatory requirements that reasonably influence demand for, or supply of, the nonfinancial commodity."

We believe both the 2012 interpretation and the current proposed language from the Commission fail to qualify these contracts as anything other than options. The effect of these interpretations is to accord the purchaser the option to refuse delivery. That would be a dangerous departure from the requirement set forth for the agency under Dodd-Frank to regulate options contracts.

Consider an EVO contract that allows the purchaser to buy between 50 and 100 units of a product for \$1/unit. Now, compare this with a scenario where this deal is broken into two contracts: One is a forward committing the purchaser to buy 50 units at \$1, and a second is an option, where the purchaser may exercise the option and buy another 50 units for \$1. If the CFTC understands that it must regulate the option in the two-part package, it should surely oversee the original EVO contract.

We believe the newly proposed interpretation further solidifies such EVO contracts as regulated options because it increases the discretion of the option purchaser. Whereas the former interpretation speaks clearly to "physical factors" that are "outside the control" of the contract parties, the second, more liberal interpretation, allows for reliance on "intentions" and makes no reference to factors beyond the control of contract parties.

We believe introducing an intangible, untestable concept such as "intention" unwisely means the CFTC must add to its responsibilities of counting quantifiable numbers the role of psychologist. Intentions are transitory. One party could intend to take delivery of the full amount at the onset of the contract, and then decide against full delivery as demand or even if prices change. While the CFTC says that price must

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[2] *See* 77 FR 48238, available at: http://www.cftc.gov/LawRegulation/FederalRegister/FinalRules/2012-18003

not be a reason that affects the exercise of the option, it would be difficult for the CFTC to challenge circumstances where it suspected that price figured in a decision. The purchaser can simply claim this wasn't the intention.

Even if the CFTC could show that price figured in the intention, the language seems to allow for price to be a secondary factor. It says that only the "primary intention" must involve physical factors. Moreover, the "intention" only applies to the onset of the contract. The contract purchaser could decide at the end that prices weren't favorable, and choose not to exercise the option. Finally, by excluding this market from supervision, the CFTC would be ill-positioned even to examine potential abuse of any reliance on a standard of original intention.

The CFTC already provides for a rubric for volume-based contracts through "trade options." Trade options are exempt from full regulation; market participants must simply report annually on the volume of a commodity purchased, and the names of the suppliers. [3] This is a simple alternative to accommodate commodity producers and users while protecting the CFTC's ability to guard against behaviors that could harm consumers. It should require little effort for compliance officers to report trade option data. Tailored contracts, not traded on exchanges, by their nature involve larger companies, and such firms already retain attorneys that routinely deal with the CFTC.

What is at stake if the CFTC excludes EVO from supervision? The history of commodities market manipulation provides an unfortunately robust list of rogue trading. The Enron loophole constructed by the 1993 CFTC serves as an especially chilling reminder of the dangers in excluding commodity trading from oversight. An unwatched sector not only poses an inherent danger, it can attract law breakers which are unfortunately common, as attested by the CFTC's own enforcement division.

The CFTC has now imposed penalties of more than $1.87 billion on banks and interdealer brokers for manipulative conduct with respect to LIBOR and other benchmark interest rates. The CFTC brought charges of "reckless use of a manipulative device" against the world's largest bank, namely JPMorgan Chase. The CFTC found that JPMorgan "recklessly disregarded" the precept that prices are to be established by supply and demand, and instead attempted to manipulate the market. The Commission continues to bring enforcement actions against market participants that hold positions in excess of CFTC-approved speculative position limits.[4]

Against this tapestry of law breaking, it seems unwise to allow an important market to go dark. Market participants bent on abusing this exclusion from the arena of CFTC surveillance aren't likely to reveal their plans for manipulation. Even when Enron's schemes led to black outs and price spikes it wasn't clear immediately how they abused the market; only subsequent investigations showed those schemes.

In promoting this proposed "reform," Chair Massad explains that one of his "priorities" is to "fine tune" the rules so they "do not impose undue burdens" for businesses. If the Chair promotes this new

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[3] See CFTC FAQs on Commodity Options, available at: https://forms.cftc.gov/_layouts/TradeOptions/Docs/TradeOptionsFAQ.pdf

[4] These descriptions are taken from the CFTC's own enforcement act yearly summary, available at: http://www.cftc.gov/PressRoom/PressReleases/pr7051-14

interpretation because of complaints from market participants, those same market participants should be required to show the true cost of the trade option burden and how that affects the real end user, namely the American consumer. We also believe that avoiding so-called "burdens" is an inappropriate place to begin any analysis. We believe promoting the integrity of markets and protecting consumers is the correct foundation for regulatory commission analysis.

Wey urge the CFTC to refrain from attempting to force a contract that contains an option into an exclusion that must only apply to contracts without options. Instead, the CFTC should perfect its use of the trade option form.

For questions, please contact Bartlett Naylor at bnaylor@citizen.org. Your consideration is appreciated.

Sincerely,

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