

December 22, 2014

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Office of Derivatives Policy  
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**Re: RIN 3038-AE24 and RIN 3235-AK65 – Proposed Interpretation; Forward Contracts with Embedded Volumetric Optionality (79 Fed. Reg. 69073)**

Ladies and Gentleman:

The International Swaps and Derivatives Association, Inc.<sup>1</sup> (“**ISDA**”) is writing in response to the proposed Interpretation issued by the Commodity Futures Trading Commission (“**CFTC**”) and Securities and Exchange Commission (“**SEC**” and, collectively, the “**Commissions**”) regarding forward contracts with embedded volumetric optionality (“**Proposed Interpretation**”).

As articulated in its October 2012 comments regarding the Commissions’ 2012 rule further defining “swap”<sup>2</sup> (the “**Product Rule**”), ISDA is concerned that the Commissions’ interpretation concerning forward contracts with embedded optionality will have the unintended consequence of covering legitimate, commercial, non-derivative activities. ISDA does not believe this was the intention of Congress when enacting the Dodd-Frank Act and ISDA is pleased to see that the Commissions have published a Proposed Interpretation that intends to resolve this result.

While we support the proposed changes, we remain concerned that the forward contract exclusion remains prescriptive in application and does not fully reflect the complexities of the commodity markets. As a result, we suggest that, consistent with accompanying language in the Product Rule, the Commissions clarify that participants may consider the totality of “facts and circumstances,” including the criteria contained in the Proposed Interpretation in determining whether a transaction falls under the forward contract exclusion. But at a minimum, we urge the

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<sup>1</sup> Since 1985, ISDA has worked to make the global over-the-counter (OTC) derivatives markets safer and more efficient. Today, ISDA has over 800 member institutions from 64 countries. These members include a broad range of OTC derivatives market participants including corporations, investment managers, government and supranational entities, insurance companies, energy and commodities firms, and international and regional banks. In addition to market participants, members also include key components of the derivatives market infrastructure including exchanges, clearinghouses and repositories, as well as law firms, accounting firms and other service providers. Information about ISDA and its activities is available on the Association's web site: [www.isda.org](http://www.isda.org)

<sup>2</sup> CFTC and SEC, *Further Definition of “Swap”, “Security-Based Swap” and “Security-Based Swap Agreement”, Mixed Swaps, Security-Based Swap Agreement Recordkeeping*, 77 Fed. Reg. 48207 (August 13, 2012).

Commissions to clarify that parts four and five of the forward contracts (with embedded volumetric optionality) exclusion test (the “**Seven Part Test**”) should not be solely contingent on whether the optionality is exercised and whether the delivery has taken place. We discuss these points in greater detail below.

In the Product Rule, the CFTC excluded from the definition of swap certain forward contracts on non-financial commodities that contain embedded volumetric optionality.<sup>3</sup> In doing so, the CFTC stated that it “will look to the relevant facts and circumstances of the transaction as a whole to evaluate whether the transaction qualifies for the forward exclusions from the definitions of the terms ‘swap’ and ‘future delivery.’”<sup>4</sup> ISDA supports this “facts and circumstances” standard as reflective of the nuances of the market.

The Commissions, however, have confused this standard with the imposition of a more prescriptive separate analysis in the form of a Seven Part Test to be applied in determining whether a forward contract with embedded volumetric optionality is excluded from the definition of swap.<sup>5</sup> The seventh part of this interpretation has raised serious concerns with the end-user community. Under this part, contracts with embedded volumetric optionality may qualify for the forward contract exclusion only if the exercise of the optionality is based on physical factors outside the control of the parties.

ISDA appreciates the Commissions’ efforts to address the end-users’ concerns regarding part seven of the Test. We support the proposed changes to remove reference to physical or regulatory factors “outside the control of the parties” and to clarify that “physical factors” should be construed more broadly to include any facts and circumstances that could reasonable influence the supply or demand for the underlying commodity. These proposed changes will eliminate much of the ambiguity and create a more workable interpretation.

While we support these modifications, as well as adjustments made to parts four and five of the Seven Part Test, we are concerned that it remains overly prescriptive. Thus we suggest that the Commissions treat this Interpretation as a non-exclusive list of factors to consider along with other guidance concerning the scope of the forward contract exclusion from the definitions of

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<sup>3</sup> See 77 Fed. Reg. at 48208 (“The CFTC requests comment on its interpretation (concerning forwards with embedded volumetric optionality, contained in Section II.B.2.(b)(ii) of this release.”).

<sup>4</sup> See 77 Fed. Reg. at 48239.

<sup>5</sup> The Seven Part Test requires that:

1. The embedded optionality does not undermine the overall nature of the agreement, contract, or transaction as a forward contract;
2. The predominant feature of the agreement, contract, or transaction is actual delivery;
3. The embedded optionality cannot be severed and marketed separately from the overall agreement, contract, or transaction in which it is embedded;
4. The seller of a nonfinancial commodity underlying the agreement, contract, or transaction with embedded volumetric optionality intends, at the time it enters into the agreement, contract, or transaction, to deliver the underlying nonfinancial commodity if the embedded volumetric 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 the embedded volumetric optionality is exercised;
6. Both parties are commercial parties; and
7. 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.

See 79 Fed. Reg. at 69074.

“future delivery” and “swap”. Specifically, we urge the Commissions to clarify that whether a transaction containing volumetric flexibility constitutes a forward contract does not depend on whether the transaction “passes” or “fails” the Seven Part Test. This clarification will allow market participants to rely on additional factors to determine whether the totality of the facts and circumstances triggers forward contract exclusion, even if the transaction does not specifically meet a particular component of the Seven Part Interpretation.

For example, the fourth and fifth parts of the test provide for delivery of the commodity if the optionality is exercised. Applying these two parts to many routine physical supply contracts in which delivery is a predominant feature could cause them to fall out of the exclusion. The CFTC minimizes the effect of this result by suggesting that “contracts that fail one or more of the seven elements of the...interpretation would fall within the exemption from most swaps regulation provided by the [Interim Final Rule for Commodity Options].”<sup>6,7</sup>

Even if the transaction meets the CTO exemption, it will still be subject to the CFTC’s reporting rules under Part 45 or Form TO reporting.<sup>8</sup> It may also be subject to large trader reporting, recordkeeping and other regulations, including any eventual position limits rules. The forgoing requirements will impose considerable compliance burdens upon commercial end-users.

The compliance costs are particularly heavy for non-U.S. persons who are not familiar with the U.S. rules and requirements. Many non-U.S. persons are reluctant to incur the expense of hiring U.S. counsel to review the CTO rules, review transactions and assist in compliance with related requirements. As a result, non-U.S. persons may instead transact with other non-US persons, thus reducing the liquidity of U.S. commodity markets and affecting the ability of U.S. persons to hedge and mitigate risk.

Should the Commissions determine not to apply a “facts and circumstances” standard, ISDA recommends that they clarify that the fourth and fifth elements of the Seven Part Test are not solely contingent on the “exercise” of the option and that optionality can take the form of increases or decreases in volume to the extent that physical delivery is intended. This is consistent with the Commissions’ position in the Proposed Interpretation that “[t]he embedded volumetric optionality therefore offers commercial parties the flexibility to vary the amount of the nonfinancial commodity delivered during the life of the contract in response to uncertainty in the demand for or supply of the nonfinancial commodity.”<sup>9</sup>

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To conclude, in adopting the Dodd-Frank Act, Congress expressed a clear intention not to affect the businesses of commercial end-users through over-regulation.<sup>10</sup> In particular, Congress did not

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<sup>6</sup> See 77 Fed. Reg. at 25320.

<sup>7</sup> See 79 Fed. Reg. at 69076.

<sup>8</sup> For example, Part 45 requires extensive investments in technology and infrastructure. Even if a Form TO filing is available in lieu of Part 45 reporting, the CFTC requires that each of the parties submit the Form. Parties must determine which transactions with optionality are CTOs and must track the aggregate notional value of any such transactions to ensure compliance with reporting obligations and meet internal certification processes.

<sup>9</sup> See 79 Fed. Reg. at 61075.

<sup>10</sup> See, e.g., Letter from Sen. Dodd to Reps. Peterson and Frank (June 30, 2010) 156 Cong. Rec. S6192 (Daily Ed. July 22, 2010) (“If regulators raise the costs of end user transactions, they may create more risk. It is imperative that the

intend Title VII of Dodd-Frank to limit the ability of commercial entities to engage in standard commercial practices. By subjecting certain forward contracts containing volumetric optionality to swap regulation, the Commissions will adversely affect the market for these contracts, directly imposing additional costs on commercial end-users – a result that Congress did not intend.

For these and the reasons stated above, while ISDA believes that the Proposed Interpretation is an improvement, we recommend that the Commissions further clarify that participants should apply a “facts and circumstances” analysis, rather than prescriptive reliance on the Seven Part Test.

ISDA appreciates the opportunity to comment on the Proposed Interpretation. Please feel free to contact me or my staff should you have any questions or require additional information.

Sincerely,



Stephen O'Connor  
Chairman  
ISDA