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4700 West Sam Houston Parkway North
Suite 250
Houston, Texas, TX 77041

T +1 281 781 0333
F +1 281 653 1454

December 22, 2014

Via Electronic Submission

To: Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, D.C. 20581

Attn: Mr. Christopher J. Kirkpatrick
Secretary of the Commission

Re: Proposed Interpretation – Forward Contracts with Embedded Volumetric Optionality (RIN 3235-AK65).

Dear Mr. Kirkpatrick:

I. Introduction

EDF Trading North America, LLC ("EDFTNA") submits these comments in response to the Forward Contracts with Embedded Volumetric Optionality (RIN 3235-AK65) proposed interpretation published by the Commodity Futures Trading Commission (the "CFTC" or the "Commission") in the November 20, 2014 edition of the Federal Register.[1]

EDFTNA is a wholly-owned indirect subsidiary of Eléctricité de France, S.A., a global leader in energy production and supply with over 140.4 Gigawatts of generation capacity and approximately 39 million customers world-wide. In addition to being the fifth largest marketer of natural gas in North America, EDFTNA is also a leading provider of energy management and risk management services and, through its affiliated companies, a provider of retail power and gas services to large-scale commercial and industrial customers.

In general, EDFTNA appreciates the Commission's efforts to clarify its interpretation of when a transaction with embedded volumetric optionality ("EVO") would be considered a forward contract. Consistent with the views expressed by other market participants, EDFTNA believes that the seven-part interpretation regarding forward contracts with EVO (the "current seven-part interpretation") introduced by the Commission in the Further Definition of "Swap," "Security-Based Swap Agreement,"; Mixed Swaps; Security-Based Swap Agreement Recordkeeping joint final rule[2] resulted in confusion with respect to the proper characterization of certain transactions. In EDFTNA's experience, various factors, including information asymmetries, differences

[1] 79 FR 69073 (November 20, 2014) (the "Proposed Interpretation").
[2] 77 FR 48208 (August 13, 2012) (the "Products Release").

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in regulatory risk tolerances and conflicting interpretations of the current seven-part interpretation, often led to transacting counterparties "agreeing to disagree" on the characterization of a transaction under consideration. For example, an entity with the ability to exercise the EVO under a transaction may, in reliance on its understanding of the reasons why it may exercise such EVO on a later date, determine that the transaction qualifies as an excluded forward contract while its counterparty in the transaction, unwilling to rely on representations regarding uncertain events that may transpire in the future, may determine that the transaction does not satisfy the current seven-part interpretation.

In light of the confusion introduced by the current seven-part interpretation and the resulting uncertainty regarding compliance with Commission regulations by affected market participants, EDFTNA believes that revisions to the current seven-part interpretation are necessary and appreciates the efforts taken by the Commission to address the concerns of market participants with respect to the current seven-part interpretation. EDFTNA questions, however, whether or not the revised seven-part interpretation introduced in the Proposed Interpretation (the "revised seven-part interpretation") and the associated guidance included in the Proposed Interpretation are adequate to address fully the challenges associated with the current seven-part interpretation. In particular, EDFTNA is concerned by the absence of any guidance from the Commission regarding how it expects market participants to manage, on a going forward basis, transactions executed under the umbrella of uncertainty associated with the current seven-part interpretation. Unless the Commission provides guidance that transacting counterparties can reasonably implement, the uncertainty and regulatory risk associated with the current seven-part interpretation – particularly with respect to the accuracy of Form TO submissions – will continue to plague market participants for as long as legacy transactions remain outstanding. In addition, EDFTNA believes that the Commission should provide guidance to participants in the physical energy markets with respect to transactions that do not fit exactly within the Commission's existing forward contract guidance. Without clarification from the Commission on energy related transactions that do not precisely fit within the Commission's forward contract guidance, market participants will continue to "agree to disagree" on the characterization of such transactions. The foregoing matters, in addition to other issues, are addressed in detail in the following comments.

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(a) **Because the reassessment of transaction characterization is impractical, the Commission should provide guidance explaining that (i) market participants are not required to undertake efforts to reevaluate the characterization of such transactions and (ii) the Commission will not pursue enforcement actions against a market participant for reporting errors that may have**

resulted from its good faith, but mistaken, characterization of transactions as excluded forwards or commodity trade options. 5

(b) **In order to resolve characterization challenges associated with the first two prongs of the current seven-part interpretation, the Commission should clarify the application of the Commission's existing guidance on the forward contract exclusion to the physical energy transactions such as FERC Order 712 asset management arrangements and reiterate that transactions that do not qualify as a forward contract may, under a separate analysis, be commercial business arrangements outside the scope of the term swap.** 8

(i) The first two prongs of the current seven-part interpretation present characterization challenges in the context of certain physical energy transactions not within the scope of the Commission's historical guidance regarding the forward contract exclusion. 8

(ii) Historical guidance issued by the Commission with respect to forward contracts and trade options is challenging to apply in the context of some energy transactions because it was developed in the context of non-energy related commodities. 10

(iii) The FERC Order 712 compliant asset management agreement is a transaction type that, while not considered a commodity option by market participants, is often subject to characterization disagreements under the current seven-part interpretation and the Commission's existing guidance regarding the forward contract exclusion. 11

(iv) To assist with the characterization of certain energy transactions, the Commission should clarify that optionality does not undermine the character of the transaction as a forward contract and that the predominant feature of a transaction is physical delivery when the transaction type otherwise satisfies the purpose of a forward contract and delivery, in fact, routinely occurs under comparable transactions. 12

(v) The Commission should also reiterate that commercial transactions that may not qualify as forward contracts may nevertheless qualify commercial transactions under section II.B.3 of the Products Release. 13

(c) **The Commission should further modify the fourth and fifth prongs of the revised seven-part interpretation in order to clarify that a transaction that allows the purchaser to take delivery of less than the full quantity or the**

seller to make delivery of less than the full quantity can, assuming the transaction otherwise is otherwise eligible, qualify as an excluded forward contract. 15

(d) **While the revised seventh prong proposed by the Commission is a substantial improvement to the current seven-part interpretation, the Commission should, as part of any final revised seven-part interpretation, implement small adjustments to promote enhanced understanding regarding when the seventh prong is satisfied and when market participants may rely on representations.** 18

(i) EDFTNA agrees with commenters regarding the challenges presented by the seventh prong of the current seven-part interpretation and appreciates the actions taken by the Commission to clarify the seventh prong. 18

(ii) The Commission should revise the seventh prong so that the question of intent focuses only on the party with the ability to exercise the EVO. 20

(iii) The Commission should clarify, as part of its guidance to market participants with respect to any final revised seven-part interpretation, that the fact that EVO may address price risks does not necessarily render EVO inconsistent with the seventh prong's intent requirement. 20

(iv) The Commission should not require market participants to conduct diligence regarding its counterparty's subjective intent in connection with reliance on representations that address the intent underlying the inclusion of EVO. 22

(e) **The Interim Final Rule for Commodity Options is not an acceptable substitute for clear guidance with respect to when a transaction with EVO, considered as a whole in light of its underlying purpose, is or is not an excluded forward contract.** 23

(f) **The costs to end-users resulting from lack of clarity concerning the seventh prong of the current seven-part interpretation are attributable to more factors than just compliance with the IFR.** 25

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II. Comments

(a) **Because the reassessment of transaction characterization is impractical, the Commission should provide guidance explaining that (i) market participants are not required to undertake efforts to reevaluate the characterization of such transactions and (ii) the Commission will not pursue enforcement actions against a market participant for reporting errors that may have resulted from its good faith, but mistaken, characterization of transactions as excluded forwards or commodity trade options.**

EDFTNA is particularly concerned by the lack of Commission guidance with respect to how transacting counterparties should manage legacy transactions affected by the uncertainty of the current seven-part interpretation. Without guidance, transacting counterparties cannot know the Commission's expectations regarding the management of transactions characterized by a party based on its understanding of the current seven-part interpretation. As a result, until all of the transactions executed and characterized based on the current seven-part interpretation mature and are no longer included in the annual Form TO submissions (or are omitted from the annual Form TO submissions), the uncertainty of the current seven-part interpretation will continue to affect the Form TO calculations of market participants.[3] For example, an entity that in good faith mistakenly characterized a transaction as a "trade option" under 17 C.F.R. section 32.3 (a "CTO") based on its belief that the transaction did not satisfy the seven-part interpretation will continue to account for the transaction in its Form TO calculations. Likewise, an entity that in good faith mistakenly characterized a transaction as an excluded forward based on its belief that the transaction satisfied the current seven-part interpretation will not include the transaction in its Form TO calculations. For entities provisionally registered with the Commission as a Swap Dealer or Major Swap Participant or that otherwise elect not to rely on the no-action relief[4] issued by the Division of Market Oversight, the visibility and associated risk of a mistaken characterization is greater: such an entity would not report to a Swap Data Repository a transaction mistakenly characterized as an excluded forward and would report to a Swap Data Repository a transaction mistakenly characterized as a CTO. Naturally, the reporting party repeats the original error every time that it reports continuation data (or fails to report continuation data) associated with the transaction.

To address the risk presented by legacy transactions entered into before the issuance of any final revised seven-part interpretation, EDFTNA believes that the Commission has two options. First, the Commission could direct market participants to reevaluate legacy transactions under the final version of the revised seven-part interpretation in order to determine whether the legacy transaction is (or was if no longer outstanding) an

[3] Concluding that a transaction that does not satisfy the current seven-part interpretation is a "trade option" assumes that the transacting parties and the transaction in question satisfy the three-part test promulgated by the Commission at 17 C.F.R. section 32.3 and is not otherwise excluded from the definition of the term "swap". Ignoring the possibility that a transaction may not be a swap, and therefore not a trade option, EDFTNA believes that the trade option assumption is accurate for most transactions impacted by the uncertainty associated with the current seven-part interpretation. Based on the Commission's first question included in the "Request for Comment" section of the Proposed Interpretation, EDFTNA's belief seems to be reflected in the Commission's own understanding of the assumption. *See generally*, Proposed Interpretation.

[4] CFTC Letter No. 13-08, Staff No-Action Relief from the Reporting Requirements of § 32.3(b)(1) of the Commission's Regulations, and Certain Recordkeeping Requirements of § 32.3(b), for End Users Eligible for the Trade Option Exemption (April 5, 2013).

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excluded forward or a CTO. Alternatively, the Commission could clarify that the reevaluation of legacy transactions is not necessary and that the Commission will, in light of the confusion associated with the current seven-part interpretation, not bring an enforcement action against a market participant that violates (or violated) the reporting rules under Part 32 or Part 45 of the Commission's regulations as a result of a good faith, but incorrect, characterization of a transaction as either an excluded forward or a CTO.

Although directing market participants to reevaluate the characterization of legacy transactions may provide greater certainty regarding the status of the transactions and, potentially, slightly improve the accuracy of information provided by market participants to the Commission, EDFTNA believes that the implementation of such a directive would be infeasible. Assuming that the majority of characterization errors relate to the ambiguity associated with the seventh prong of the current seven-part interpretation, to reevaluate affected legacy transactions in light of a final revised seven-part interpretation a transacting entity providing EVO would likely need to determine what its counterparty's intent was at the time that the parties executed the transaction. Although this may seem reasonably simple in theory, an ex-post analysis of intent would, in many situations, not be possible.[5] In particular, given issues such as turnover in traders, changes in portfolio composition, and legal risk, EDFTNA believes that many entities would be unwilling to provide representations regarding the intent it may have had at the time of execution. Furthermore, for a transaction in which the parties originally "agreed to disagree" on the characterization or under which the delivery period has expired, an entity attempting to reevaluate such transaction may be unable to secure the cooperation of its counterparty. If the parties to a transaction disagreed on the characterization, the party that characterized the transaction as an excluded forward may not respond to the inquiries of the party that characterized the transaction as a CTO. In such a scenario, the party that adopted the excluded forward characterization based on its control of the EVO may not believe that any reevaluation of the transaction is necessary and may therefore disregard what it considers an unnecessary inquiry made by its counterparty.

Notably, the foregoing analysis only identifies a subset of the challenges that market participants would encounter if required to reevaluate the characterization of its transactions. The analysis does not address other situations in which the counterparty may not be able to provide an explanation of its intent or situations in which the mistaken characterization is based on factors other than the seventh prong of the current seven-part interpretation. Likewise, the analysis does not address the additional challenges that would be encountered if the Commission directed market participants to, in essence, self-report violations of reporting rules by filing amended Form TO submissions or correcting reports submitted to Swap Data Repositories. Each additional challenge encountered would make the successful evaluation of the transaction less likely.

Even assuming that the reevaluation of legacy transactions is possible, the burdens associated with undertaking the reevaluation likely far outweigh the potential gains derived by the Commissions from the

[5] EDFTNA understands that certain industry groups may request that the Commission delay the submission of Form TO for the 2014 compliance year in order to permit market participants to finalize the characterization of transactions conducted prior to the issuance of any final revised seven-part interpretation. To the extent that such requests suggest that such a reassessment of legacy transactions can be conducted, EDFTNA respectfully disagrees for the reasons included in this section.

exercise. The successful completion of the reevaluation would, for each market participant, result in one of three possible outcomes: the market participant would determine that it either (1) generally characterized transactions properly, (2) over-characterized transactions as CTOs, or (3) over-characterized CTOs as excluded forwards or otherwise outside the definition of the term "swap". In the case of the first possible result, because of the accurate initial characterization the Commission would not derive any benefit from the reevaluation exercise. In the case of the second and third possible result (and excluding those transactions involving a market participant that reports CTOs to a Swap Data Repository), the Commission would only realize a benefit from improved reporting to the extent that any changes to characterization result in the total value of the commodities purchased and sold falling within a different Form TO reporting band than the entity would otherwise identify.

Offsetting the limited benefit potentially derived by the Commission through improvements in transaction reporting are the substantial burdens that market participants would incur in connection with any directed reevaluation. As an initial matter, part of any effort to reevaluate transactions would require market participants to review approximately two years' worth of transaction data in order to identify those transactions that the entity may have improperly characterized based on the current seven-part interpretation. For many entities involved in physical commodities markets, the review could encompass thousands of transactions and require the involvement of front-office traders, compliance managers, information technology personnel, and legal counsel. Furthermore, the entity would need to expend this time and expense up-front without any certainty that it will be able to secure the counterparty cooperation necessary to complete the reevaluation.

Based on the explanation provided above, EDFTNA believes that instead of directing market participants to reevaluate the characterization of legacy transactions, the Commission should instead provide certainty to market participants by clarifying that such reevaluation is not necessary. In addition, the Commission should state that it will not bring enforcement actions based on reporting errors associated with the good faith characterization of a transaction under the current seven-part interpretation. Implicitly, the adoption of this suggested course of action would acknowledge the possibility that limited data reporting errors may exist by permitting good faith characterization mistakes to persist uncorrected. Not directing market participants to reevaluate legacy transactions, however, would allow market participants to focus scarce compliance, legal and other resources on productive activities instead of a burdensome and likely futile reevaluation exercise.

(b) **In order to resolve characterization challenges associated with the first two prongs of the current seven-part interpretation, the Commission should clarify the application of the Commission's existing guidance on the forward contract exclusion to the physical energy transactions such as FERC Order 712 asset management arrangements and reiterate that transactions that do not qualify as a forward contract may, under a separate analysis, be commercial business arrangements outside the scope of the term swap.**

(i) The first two prongs of the current seven-part interpretation present characterization challenges in the context of certain physical energy transactions not within the scope of the Commission's historical guidance regarding the forward contract exclusion.

As part of the Proposed Interpretation, the commission is seeking comments regarding whether or not the proposed changes provide sufficient clarity on how transactions with EVO may satisfy all seven prongs of the interpretation, particularly the first and second prong.[6] EDFTNA understands this question to be directed at defining the line between when a transaction is, at its core, an excluded forward contract or outside the scope of the forward contract exclusion. While EDFTNA believes that the existing Commission guidance regarding the first two prongs of the current seven-part interpretation is instructive in connection with forwards and futures, such guidance was never intended to address whether or not a transaction is an excluded forward or a swap, as such term is defined in Commodity Exchange Act. As a result, the application of the first two prongs of the current seven-part interpretation, like the seventh prong, frequently results in counterparties "agreeing to disagree" on the characterization of certain transactions as excluded forwards or commodity options (and by extension, swaps).

In EDFTNA's experience, the risk of confusion concerning the first two prongs arises most often in connection with transactions that do not neatly fit within the Commission's historical guidance regarding trade options or the forward contract exclusion. In connection with the characterization, it is not uncommon for one counterparty (often the entity with the right to determine the delivery quantity in respect of any particular delivery date) to assert that the affected transaction may, under a facts and circumstances approach, nevertheless qualify as an excluded forward notwithstanding any potential inconsistency with Commission guidance. Some market participants, however, have declined to adopt an approach that concentrates on the underlying purpose of the forward contract exclusion and instead question whether or not the transaction should be considered a CTO in light of potential inconsistencies with Commission guidance regarding the forward contract exclusion.

Ultimately, the confusion with respect to the characterization of transactions that are not within the scope of the Commission's historical guidance creates conflict among market participants that have adopted reasonable alternative interpretations. The party adopting the position that the transaction can be an excluded forward bases its interpretation on the fact that the underlying purpose of the transaction, the nature of the counterparties, the use of the transaction by market participants, and the expectations of the parties with respect to delivery are all consistent with the Commission's guidance regarding forward contracts. The party that

[6] Proposed Interpretation at 69076.

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determines that the transaction may be a CTO, however, may focus its analysis less on the underlying purpose of the forward contract exclusion and more on Commission pronouncements regarding specific characteristics of forward contracts.

The challenges associated with the application of historical guidance regarding forward contracts and trade options within the new regime of swaps regulation cannot be addressed solely through the revised seven-part interpretation. The historical exclusions from the scope of the Commodity Exchange Act afforded to transactions between "eligible contract participants" and "appropriate persons" allowed energy markets and products to develop without significant guidance from the Commission.[7] Acting Chairman Albrecht's concurring statement to the 1993 Exemption for Certain Contracts Involving Energy Products final order reflects the Commission's historical approach to energy markets:

> This market for energy products has been in existence for many years and over those years it has grown in size, importance and complexity. The Commission has never regulated this market, nor has it sought to regulate it…. Absent [the *Transnor (Bermuda) v. BP North America Petroleum* decision and the Commission's new exemptive authority granted by Congress in the Futures Trading Practices Act of 1992] it is doubtful that the petitioners would have brought their request to us.[8]

Because of the various applicable exemptions to Commodity Exchange Act regulation, the Commission was rarely required to consider how its guidance regarding the forward contract exclusion and trade options may apply in the context of energy related bilateral transactions. In fact, ensuring the applicability of a particular exception from the Commodity Exchange Act effectively eliminated the need to label such transactions as "forwards" or "commodity options". As a result, Commission guidance does not take into consideration the unique aspects and concerns of energy market participants that give rise to the transactions common in today's energy markets. Unfortunately, with the advent of swaps regulation, energy market participants are expected to apply the Commission's historical guidance regarding forward contracts and trade options to energy transactions not contemplated in connection with the development of the guidance.

To address the continued uncertainty among participants in energy markets, EDFTNA believes that the Commission should, in connection with the final revised seven-part interpretation, address the rift between the Commission's historical guidance regarding the forward contract exclusion and the development of energy markets. In particular, EDFTNA believes that the Commission should clarify that transacting parties may conclude that optionality does not "undermine the overall nature of the … transaction as a forward contract" and that the "predominant feature of the … transaction is actual delivery" when the transaction is of a type that otherwise satisfies the purpose of the forward contract exclusion and "delivery, in fact, routinely occurs" under such transactions. In addition, EDFTNA believes that the Commission should reiterate that transactions that do

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[7] *See*, *e.g.*, Exemption for Certain Contracts Involving Energy Products, 58 FR 21286 (April 20, 1993) (the "Energy Exemption"); Exemption for Certain Swap Agreements, 58 FR 5587 (January 22, 1993).
[8] Energy Exemption at 21294.

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not qualify as forward contracts may, depending on the facts and circumstances, qualify as non-swap commercial transactions described in section II.B.3. of the Products Release.

(ii) Historical guidance issued by the Commission with respect to forward contracts and trade options is challenging to apply in the context of some energy transactions because it was developed in the context of non-energy related commodities.

With the notable exception of the Statuary Interpretation Concerning Forward Contracts, the Commission's historical guidance concerning forward contracts and trade options has generally not considered energy commodity related transactions. As explained in the Products Release, the "Characteristics Distinguishing Cash and Forward Contracts and "Trade" Options" interpretative statement issued by the Commission's Officer of the General Counsel in 1985[9] and the Commission's opinion in *In re Wright*[10] provide the foundation for the current seven-part interpretation.[11] In both of the cited documents, the Commission distinguished excluded forwards from options in the context of agricultural commodities based on the allocation of rights and obligations between the parties with respect to delivery.[12] The 1985 OGC Interpretation provided guidance regarding transactions that would not be permitted under the Commodity Exchange Act in the absence of a trade option exception applicable to agricultural commodities while *In re Wright* addressed certain hedge-to-arrive contracts entered into by corn farmers.

Because the Commission was primarily concerned with agricultural commodities in its guidance regarding forward contracts and trade options, the guidance does not account for the unique challenges encountered by participants in the physical energy markets. In particular, the Commission's guidance regarding forward contracts does not contemplate the situations faced by market participants in which a bilateral binding delivery obligations is not practical or possible under the transaction but in which "delivery, in fact, routinely occurs" by virtue of the commercial needs of the parties.[13] Likewise, the Commission's description of options as "limited risk investments" does not contemplate energy transactions under which the holder of the right to accept or make delivery is not insulated from the risk of adverse price movements.[14]

The differences between the Commission's guidance regarding forward contracts and its guidance regarding trade options causes many energy commodity transactions to fall in a classification gray area. For example, a transaction structure that is intended and conventionally used by commercial market participants to ensure the availability of the energy commodity in response to demand rather than price may defy characterization because it does not impose a binding delivery obligation on one party due to the nature of the physical energy transmission and distribution system. Notwithstanding that delivery may routinely occur under

[9] Characteristics Distinguishing Cash and Forward Contracts and "Trade" Options, interpretive statement of the office of the general counsel, 50 FR 39656 (Sep. 30, 1985) (the "1985 OGC Interpretation").
[10] *In re Roger J. Wright, et al*; CFTC Docket N. 97-02, Oct. 25, 2010 ("*In re Wright*").
[11] Products Release at 48237.
[12] 1985 OGC Interpretation at 39659; *In re Wright* at 12.
[13] *See*, 1985 OGC Interpretation at 39657-58.
[14] *See*, 1985 OGC Interpretation at 39658-59.

comparable transactions and that the transaction is otherwise consistent with the forward contract exclusion, it is difficult to characterize the transaction as a forward under Commission guidance. Because the transaction is fundamentally different from the limited risk investments described by the Commission as options, however, characterization of the transaction as a CTO also appears incorrect.

(iii) The FERC Order 712 compliant asset management agreement is a transaction type that, while not considered a commodity option by market participants, is often subject to characterization disagreements under the current seven-part interpretation and the Commission's existing guidance regarding the forward contract exclusion.

Natural gas asset management arrangements structured to comply with the requirements of Federal Energy Regulatory Commission ("FERC") Order 712 ("AMAs")[15] are a prime example of a transaction structure that evades characterization under the Commission's guidance regarding forward contracts and trade options. A FERC Order 712 AMA is fundamentally a services agreement that enables a holder of intrastate transportation capacity necessary for its own supply requirements to legally release the capacity to an asset manager better able to manage and optimize the capacity on behalf of the releasing shipper. Due to concerns that sham AMAs could be used to evade FERC capacity release rules, however, FERC determined that the releasing shipper in an AMA must have the right to direct the asset manager to deliver up to the released amount each day for at least five months out of each twelve month period of the release.[16] Therefore, in conjunction with the asset management services provided a FERC Order 712 compliant AMA must include an embedded commodity transaction under which the asset manager has an obligation to deliver natural gas at the direction of the releasing shipper.

The imposition of the delivery requirement is, at its core, necessary to reconcile the collision between FERC's shipper must have title rule and capacity release rules. By imposing on the asset manager an obligation to satisfy the releasing shipper's gas requirements during a material portion of the release, FERC sought to ensure that only bona fide AMAs would benefit from exemptions to the capacity release rules.[17] Because the shipper must have title to the transported gas, however, the asset manager cannot simply transport the releasing shipper's gas using the released capacity: the five-twelfths requirement of AMAs can only be satisfied through the sale of gas to the releasing shipper. Transportation of the releasing shipper's gas by the asset manager would, notwithstanding the AMA, violate the shipper must have title rule.

In the absence of clarifying guidance from the CFTC regarding the scope of the forward contract exclusion, it is probable that characterization disagreements with respect to AMAs will continue despite any

[15] Promotion of a More Efficient Capacity Release Market, 73 FR 37058 ("FERC Order 712").
[16] AMAs can be entered into by both consumers of natural gas and producers of natural gas. In the context of AMAs between producers and asset managers, so called "supply AMAs", the obligation of the asset manager to deliver and sell gas to the releasing shipper is instead an obligation to purchase and receive gas from the releasing shipper. *See* FERC Order 712 at 37083. The discussion of AMAs in this comment letter is equally applicable to supply AMAs.
[17] FERC Order 712 at 37081.

final revised seven-part interpretation. Because the objective of the AMA is to facilitate the use of the released capacity to satisfy the needs of the releasing shipper, delivery of natural gas is certainly intended and does routinely occur under AMAs. It is not practical, however, for both parties to have an obligation under the AMA to make or take delivery of natural gas. In the absence of the release, the releasing shipper is free to use the capacity to satisfy its requirements for natural gas at it sees fit, which may include not using the capacity at all on any particular day. As explained by FERC, "AMAs entail the releasing shipper transferring its capacity to a third party expert who will perform the functions the [FERC] expected the releasing shippers would do for themselves."[18] Including an obligation on the part of the releasing shipper to take delivery under an AMA would be inconsistent with the rights of the releasing shipper in the absence of the AMA and would undermine the purpose of the agreement. On the other hand, the same objective of the AMA indicates that the agreement is also not a limited risk instrument intended to insulate the releasing shipper from adverse movements in the price of natural gas and therefore not properly characterized as a commodity option or a swap.

(iv) To assist with the characterization of certain energy transactions, the Commission should clarify that optionality does not undermine the character of the transaction as a forward contract and that the predominant feature of a transaction is physical delivery when the transaction type otherwise satisfies the purpose of a forward contract and delivery, in fact, routinely occurs under comparable transactions.

To address the gaps in the Commission's historical guidance regarding forward contracts and trade options commonly encountered by participants in the physical energy markets, the Commission should clarify that the absence of a binding delivery obligation is not fatal to the characterization of the transaction as a forward when the transaction is otherwise consistent with the forward contract exclusion and delivery, in fact, routinely occurs under comparably structured transactions. In particular, the Commission should explain that if delivery commonly occurs under comparable transactions, the predominant feature of the transaction may be physical delivery notwithstanding any optionality in the volume and that such optionality does not undermine the character of the transaction as a forward contract.

EDFTNA believes that the requested clarification is consistent with the fundamental purpose of the forward contract exclusion and is not inconsistent with the Commission's existing guidance on the subject. As explained by the Commission in various interpretations, the original objective of the forward contract exclusion was to exclude from the definition of futures off exchange transactions between commercial market participants where delivery of the commodity was deferred for later shipment.[19] In this context, the presence of a binding delivery obligation was viewed by the Commission and courts as consistent with the objective of the forward

[18] FERC Order 712 at 37079. In fact, because of the exemptions from tying and the buy/sell prohibition afforded to AMAs, the asset manager may be required to take assignment of the releasing shipper's existing supply agreements and then resell the gas to the releasing shipper at the delivery point on the released capacity or, alternatively, purchase gas from the releasing shipper at an upstream point on the released capacity and then resell that gas to the releasing shipper at the delivery point on the released capacity.
[19] *See*, *e.g.*, 1985 OGC Interpretation at 39657; Statutory Interpretation Regarding Forward Contracts, 55 FR 39188, 39191 (September 25, 1990) (the "Brent Interpretation").

contract exclusion. As explained by the Commission in *In re Grain Land Cooperative*, however, "contract language must be considered in the context of the transaction as a whole."[20] Under this directive, the Commission explained that the "true significance" of contract terms allowing for cancellation in lieu of delivery "depends largely on how they were used."[21] The historical significance of including a binding delivery obligation in connection with forward contracts, however, was to help the Commission and courts distinguish legitimate forward contracts from off-exchange futures designed to shift price risk rather than transfer the actual commodity.[22]

As illustrated in the context of AMAs, the unique requirements of physical energy markets presents challenges for characterization not present in connection with agricultural and other commodities. In particular, competing regulatory requirements, reliability concerns, impracticably of storage, and other considerations often force commercial market participants to structure transactions in ways that deviate from the Commission's historical guidance regarding forward contracts. The inclusion of optionality in connection with such structures, however, should not be interpreted as being inconsistent with the fundamental purpose of the forward contract exclusion and should not automatically disqualify a transaction from characterization as an excluded forward. On the contrary, consistent with forward contracts, the affected transactions are entered into for a commercial purpose between commercial market participants that contemplate physical settlement in connection with the transaction. Consistent with the Commissions pronouncement in *In re Grain Land Cooperative*, the true significance of optionality terms included as a result of the unique attributes of physical energy markets depends on how commercial market participants entering into such transactions use such terms.[23] In this sense, when considering optionality in energy transactions such as AMAs, the fact that physical settlement regularly occurs in connection with comparable transactions should be viewed as strongly supporting the conclusion that the optionality does not undermine the character of the transaction as a forward contract or suggest that the predominant feature of the contract is not actual delivery.

(v) The Commission should also reiterate that commercial transactions that may not qualify as forward contracts may nevertheless qualify commercial transactions under section II.B.3 of the Products Release.

In addition to clarifying the scope of the forward contract exclusion in the context of energy transactions, the Commission should provide market participants with additional guidance explaining that transactions not otherwise eligible for the forward contract exclusion, whether under a final revised seven-part interpretation or under a facts and circumstances analysis, may still qualify as commercial transactions not within the scope of the definition of the term swap. Under the application of the current seven-part interpretation, many market participants have assumed that transactions not eligible for characterization as

[20] *In re Grain Land Cooperative*, CFTC Docket No. 97-01 at 29 (November 25, 2003) ("*In re Grain Land Cooperative*").
[21] *In re Grain Land Cooperative* at 29.
[22] *See*, *e.g.*, 1985 OGC Interpretation at 39657; Brent Interpretation at 39190-91.
[23] *See*, *In re Grain Land Cooperative* at 29.

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excluded forwards due to EVO considerations would instead be CTOs (a type of swap).[24] Unfortunately, assuming that excluded forward contract and swap are the only two characterization options overlooks the possibility that the transaction may not be a swap or a forward. As a result, market participants armed with the current seven-part interpretation and strained interpretations of Commission guidance regarding forward contracts and commodity options may disagree on characterization because they fail to contemplate the possibility that both characterizations are incorrect.

The Commission's discussion of commercial transactions in section II.B.3 of the Products Release provides a reasonable method for concluding that transactions that include attributes of, but are not readily characterized as, forward or options are nevertheless not swaps. In the Products Release, the Commission identified that certain transactions involving "customary business arrangements" may include swap-like attributes but are not properly considered or regulated as swaps.[25] To ensure that such arrangements were not within the scope of its definition of swap, the Commission provided a non-exclusive list of customary business arrangements not considered swaps and a description of characteristics and factors that it considered common to the identified commercial transactions. Specifically, the excluded commercial transactions: (1) "do not contain payment obligations, whether or not contingent, that are severable from the agreement, contract or transaction;" (2) "are not traded on an organized market or over-the-counter;" and (3) are entered into by commercial entities "to serve an independent commercial, business or non-profit purpose" and "other than for speculative, hedging, or investment purposes."[26] With respect to the second element, the Commission identified that the lack of "trading" ensures that the "agreement, contract or transaction does not involve risk-shifting arrangements with financial entities, as would be the case for swaps."[27]

With respect to many energy transactions, including AMAs, the common characteristics of non-swap customary business arrangements identified by the Commission in the Products Release all apply. The payment obligations under an AMA, although they may be complex,[28] are not severable from the AMA itself. Furthermore, AMAs are not traded by market participants or otherwise involve risk-shifting arrangements and are not entered into for speculative, hedging or investment purposes. On the contrary, because the primary purpose of an AMA is to secure the services of a particular asset manager, the assets under management are specific to the releasing shipper and the identity of the asset manager is an important consideration.[29]

Reiterating that transactions that do not qualify as forward contracts may qualify as customary business arrangement within the scope of section II.B.3 of the Products Release will provide much needed clarity with

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[24] Proposed Interpretation at 69076.
[25] Products Release at 48246.
[26] Products Release at 48247.
[27] Products Release at 48248.
[28] The payment structure of an AMA includes multiple components. In general, however, the parties to the AMA structure the payments in order to allocate fixed and variable costs charged by the pipeline taking into account the release of the capacity to the asset manager; compensate the asset manager, either on a fixed or success-based basis, for the performance of the services; and account for payments associated with natural gas delivered by the asset manager.
[29] FERC Order 712 at 37078.

respect to many energy transactions without offending the Commission's existing guidance regarding the forward contract exclusion. That is, because the exclusion of such transactions from the scope of the term swap would not depend on the character of the transaction as a forward contract, the Commission would not need to alter the guidance provided in the 1985 OGC Interpretation or in opinions such as *In re Wright* to account for features of such transactions that may be viewed as inconsistent with the objective of the forward contract exclusion. Likewise, the exclusion would ensure the preservation of the Commission's guidance regarding the limited risk instrument nature of commodity options.

(c) **The Commission should further modify the fourth and fifth prongs of the revised seven-part interpretation in order to clarify that a transaction that allows the purchaser to take delivery of less than the full quantity or the seller to make delivery of less than the full quantity can, assuming the transaction otherwise is otherwise eligible, qualify as an excluded forward contract.**

As explained by the Commission in the Proposed Interpretation, the identification of the party exercising the EVO as the seller in the fourth prong and the buyer in the fifth prong causes the current seven-part interpretation to apply to call-like EVO but, apparently, not to put-like EVO.[30] In the revised seven-part interpretation, the Commission proposes to correct this oversight by subtly modifying the phrasing of the fourth and fifth prongs so that the identity of the party exercising the EVO is irrelevant to the analysis. While the changes are a step in the correct direction, EDFTNA believes that the fourth and fifth prongs of the revised seven-part interpretation still unreasonably exclude certain types of transactions with EVO that should be eligible for characterization as an excluded forward contract. In particular, under the fourth and fifth prongs of the revised seven-part interpretation, transactions that permit the buyer to take delivery of less than the full contract quantity of the nonfinancial commodity or that permit the seller to make delivery of less than the full contract quantity of the nonfinancial commodity ("Negative EVO"), are apparently not eligible for characterization as an excluded forward contract.[31] EDFTNA believes that the Commission should further modify the fourth and fifth prongs to ensure that transactions with Negative EVO are within the scope of the final revised seven-part interpretation.

Based on the Commission's guidance regarding excluded forward contracts and options, EDFTNA understands that the scope of the delivery obligation undertaken by the parties is an important consideration in connection with the characterization of a transaction as a forward contract.[32] Furthermore, based on the

[30] Proposed Interpretation at 69075.

[31] Practically, Negative EVO is simply an alternative formulation of put-like and call-like optionality. A transaction that includes an obligation to make/take delivery of 10,000 MMBtu of gas per day but grants the buyer the option to take delivery of up to an additional 5,000 MMBtu each day is equivalent to a transaction that includes an obligation to make/take delivery of 15,000 MMBtus per day but grants the buyer the right to reduce the volume by up to 5,000 MMBtus per day.

[32] While not directly relevant to the Proposed Interpretation, it should be noted that the Commission's use of "physically settle" and "make or take delivery" is an additional source of confusion among market participants. As explained by the Commission in the Products Release at 48228, "the CFTC reads the 'intended to be physically settled' language in the swap definition with respect to nonfinancial commodities to reflect a directive that intent to deliver a physical commodity be part of the analysis." There is a concern among some market participants, however, that the term "delivery" may not encompass all forms of physical settlement used by

Commission's various interpretations concerning the forward contract exclusion, EDFTNA understands that "intent to deliver historically has been an element of the CFTC's analysis of whether a particular contract is a forward contract."[33] Combining the two principles, if the intent to physically settle is absent at the inception of the transaction with EVO and the transaction is structured in a way that permits financial settlement in lieu of physical settlement, the transaction would likely fail one of the necessary checks associated with forward contracts and the transacting parties could not properly characterize the transaction as an excluded forward.

Recognizing that intent to physically settle the transaction with EVO is essential to the characterization of a transaction as an excluded forward contract, the fourth and fifth prongs of the revised seven-part interpretation appear to focus solely on whether or not the same intent is present with respect to the quantity covered by the EVO. That is, the fourth and fifth prongs suggest that if the parties do not intend at the time the transaction is entered into to physically settle the EVO component of the transaction, the EVO would "undermine the overall nature of the agreement, contract, or transaction as a forward contract."[34] This analysis is supported by the Commission's use of the phrase "if the optionality is exercised" in both the fourth and fifth prongs. The buyer and seller must intend to physically settle any non-optional portion of the transaction regardless of whether or not the optionality is exercised – the "if" clause can only refer to the quantity within the scope of the EVO.

Limiting the scope of the fourth and fifth prongs of the revised seven-part interpretation to the quantity included within the scope of the EVO, however, inappropriately excludes transactions with Negative EVO from characterization as excluded forward contracts. In such transactions, the exercise of the Negative EVO reduces the quantity of the nonfinancial commodity that the buyer is required to purchase and the seller is required to sell. In other words, if the fourth and fifth prongs address the intended settlement of the EVO, the prongs are not satisfied by a transaction that includes Negative EVO: the parties cannot intend to make or take delivery of the quantity of nonfinancial commodity associated with the Negative EVO if the EVO is exercised because the exercise reduces the total quantity associated with the transaction. Consistent with the expectation that the transaction with Negative EVO is an excluded forward contract, however, the parties would intend to physically settle the transaction with respect to the full quantity if the Negative EVO is _not_ exercised.

Because transactions that include Negative EVO are not uncommon, the exclusion of such transactions from the scope of the forward contract exclusion is a real concern. Within the energy industry, market participants frequently combine Negative EVO with put/call-like EVO in "bandwidth"[35] transactions designed to address situations in which the actual quantity required by the party holding the optionality may be above or

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market participants. *See, e.g.*, Brent Interpretation at 39191. In order to avoid confusion and promote consistency, EDFTNA believes that the Commission should clarify that the scope of the "physical settled" and "delivery" expressions are synonymous and should be broadly interpreted.

[33] Products Release at 48228.

[34] Proposed Interpretation at 69074.

[35] The described transaction structure is also commonly identified by market participants as a "swing" or "operational swing" transaction.

below the volume specified in the contract. For example, a bandwidth transaction may specify a fixed daily quantity of natural gas for a particular month but then allow the buyer to adjust, within limits, the quantity up or down on any given day to reflect more precise expectations of its actual demand on that day. While the conventional EVO associated with the bandwidth transaction should satisfy the fourth and fifth prongs, the Negative EVO would not. The Commission should not, however, view the Negative EVO as a type of optionality that undermines the characterization of the transaction as an excluded forward.

To address the Negative EVO problem associated with the fourth and fifth prongs, the Commission should restructure the prongs to reflect alternatives that depend on the type of EVO under consideration. By separately addressing Negative EVO and other EVO in alternative prongs, the Commission would ensure that bandwidth and other transactions that include Negative EVO are not unreasonably excluded from characterization as excluded forward contracts under any final revised seven-part interpretation. EDFTNA believes that the Commission could achieve the desired clarification by consolidating the fourth and fifth prongs of the revised seven-part interpretation into a single prong and creating a new prong specific to Negative EVO. The following proposed revised fourth and fifth prongs illustrate how such consolidation could be accomplished by the Commission:

> 4. With respect to embedded volumetric optionality that allows the buyer or seller of the nonfinancial commodity underlying the agreement, contract or transaction to increase the volume of the underlying nonfinancial quantity, the buyer and seller intend, at the time they enter into the agreement, contract or transaction, to take delivery of the underlying nonfinancial commodity if the embedded volumetric optionality is exercised.
>
> 5. With respect to embedded volumetric optionality that allows the buyer or seller of the nonfinancial commodity underlying the agreement, contract or transaction to reduce the volume of the underlying nonfinancial commodity, the buyer and seller intend, at the time they enter into the agreement, contract or transaction, to take delivery of the underlying nonfinancial commodity if the embedded volumetric optionality is not exercised.

By implementing a revised fourth and fifth prong similar to the prongs suggested above, the Commission would clarify the application of the final revised seven-part interpretation to transactions with Negative EVO as well as transactions with conventional put/call-like EVO. Such clarification would in general be consistent with the expectations of the parties entering into these types of transactions, which are designed to better match delivered volumes with the requirements of the counterparty for the nonfinancial commodity, can be excluded forward contracts.

(d) **While the revised seventh prong proposed by the Commission is a substantial improvement to the current seven-part interpretation, the Commission should, as part of any final revised seven-part interpretation, implement small adjustments to promote enhanced understanding regarding when the seventh prong is satisfied and when market participants may rely on representations.**

(i) EDFTNA agrees with commenters regarding the challenges presented by the seventh prong of the current seven-part interpretation and appreciates the actions taken by the Commission to clarify the seventh prong.

EDFTNA commends the Commission for its decision to revise the seventh prong of the current seven-part interpretation and believes that the changes proposed by the Commission in the Proposed Interpretation will result in enhanced understanding and better application of the prong by market participants. The concerns raised by other market participants and trade groups with respect to the seventh prong under the current seven-part interpretation are shared by EDFTNA.[36] The inability of contracting parties to determine the situations in which the seventh-prong may be satisfied have resulted in frequent "agreements to disagree" regarding the characterization of transactions. From EDFTNA's perspective, these agreements to disagree often are based on two related concerns: inconsistent interpretations of the permissible reasons for the inclusion of EVO and the ex-post analysis required by the prong.

The phrase "based primarily on physical factors, or regulatory requirements, that are outside the control of the parties" is often not subject to consistent interpretation among market participants. Unfortunately, the differences in understanding of the language used by the Commission can result in disagreements between transacting parties. For example, a manufacturer's decision to decrease production at a facility in response to a decrease in the demand for its product would likely affect the manufacturer's need for a commodity like natural gas. The decision to decrease production, however, and therefore its demand for the commodity, is within the control of the manufacturer. This type of situation is not easily evaluated under the seventh prong of the current seven-part interpretation and, as a result, transacting counterparties applying their own understanding of the prong may reasonably reach opposing conclusions.

Perhaps more concerning is the Commission's focus on the exercise or non-exercise of the EVO rather than the rational for the inclusion of the EVO as a term of the transaction. The Commission's focus on exercise or non-exercise suggests that the characterization of the transaction made by a party at the time of execution could prove incorrect if the actual reasons for exercise or non-exercise of the EVO do not satisfy the seventh prong. While EDFTNA understands that intent may be ascertained based on facts and circumstances, including the parties' course of performance,[37] existing Commission guidance suggests that the ex-post facts and circumstances analysis is generally applied to classes of transactions rather than to individual transactions and that course of performance is relevant as evidence of the various parties' intent to physically settle the class of

[36] Proposed Interpretation at 69074.
[37] Proposed Interpretation at 69075.

transaction at execution.[38] That is, in determining whether or not an entity violated the Commodity Exchange Act by entering into off-exchange futures, the Commission has used an ex-post facts and circumstances analysis to evaluate the class of transactions as a whole rather than on a transaction by transaction basis and considers course of performance in order to support or refute an assertion that intent to physically settle was or was not present when the transactions were entered into.[39] By phrasing the seventh prong in terms of "exercise" and "non-exercise," however, EDFTNA believes that the Commission reversed the historical use of course of performance. Instead of serving as evidence of what the parties' intended at the time of execution, the seventh prong made course of performance of a single transaction dispositive regardless of intent at the time of execution of the transaction.

Although some entities entering into transactions with EVO are willing to provide representations that address the seventh prong, EDFTNA believes that the forgoing two concerns would preclude any form of reliance by the party without the ability to exercise the EVO. Typically, the representations proposed by a party at the time of execution assert that the basis for a decision to exercise or not exercise the EVO made at some point in the future will satisfy an ambiguous standard. In other words, some entities are willing to give, and expect their counterparties to rely on, representations regarding state of mind at a later point in time. Simply stated, however, from the perspective of the seller of the EVO, reliance on representations that attempt to predict the future is unreasonable.

Thankfully, the updated seventh-prong included in the Proposed Interpretation would, in most situations, not give rise to the same disagreements encountered under the existing seventh-prong. Nevertheless, EDFTNA believes that the Commission should make limited adjustments to the language of the seventh-prong and the associated guidance in order to ensure greater certainty among market participants. In particular, EDFTNA suggests that the Commission (i) adjust the seventh-prong so that the intent element focuses on the party with the ability to exercise the EVO, (ii) clarify that the fact that EVO may also address price risk concerns would not be inconsistent with the seventh prong so long as the EVO remains primarily intended to address to physical factors or regulatory requirements, and (iii) modify its statement regarding the ability of a party to rely on EVO related representations to reflect the qualifications imposed by the Commission in other contexts.

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[38] *See, e.g.*, *In re Grain Land Cooperative* (Vacating the administrative law judge's decision that hedge to arrive contracts offered by Grain Land were futures, the Commission considered the transactions in the aggregate and noted that "The record, however, does not reliable establish either the amount of grain actually covered by Grain Land [hedge-to-arrive] contracts or the amount of covered grain actually delivered to Grain Land.").

[39] *See, e.g.*, *In re Wright* ("The ALJ confronted conflicting testimony from a majority by not all of the substitute [hedge-to-arrive] producers, based on which (together with other evidence) he had to "affix a label to a *class* of contracts." We faced a similar situation in *Grain Land* … and held that the administrative law judge erred in making "broad findings about what producers as a class were told" or what they believed based on testimony from a limited number of nonrepresentative witnesses.")

(ii) The Commission should revise the seventh prong so that the question of intent focuses only on the party with the ability to exercise the EVO.

Although the version of the seventh-prong included in the Proposed Interpretation properly focuses the characterization inquiry on the intent associated with the EVO rather than the reasons why the EVO is or is not exercised, the question of intent is too broadly stated. Despite the flaws associated with the seventh-prong of the current seven-part interpretation, by basing the prong on the exercise or non-exercise of the EVO, the Commission correctly, although tacitly, focused the prong's inquiry on the party that controls the EVO. Under the version of the seventh prong included in the revised seven-part interpretation, however, the Commission seems to shift the inquiry from the party with the ability to exercise the EVO such that the intent of both parties is relevant to the satisfaction of the seventh prong.

EDFTNA believes that basing the satisfaction or non-satisfaction of the seventh prong on the intent of the party without the ability to exercise or not exercise the EVO is improper and, likely, not truly intended by the Commission. Unlike the physical settlement component of forwards transactions, the question of intent regarding why EVO is included is only relevant with respect to the party able to exercise the EVO. With respect to the "seller" of the EVO, the rational for the inclusion of the EVO is irrelevant but for the analysis of the transaction under the seventh prong. That is, as the party with the obligation rather than the right, the seller of the EVO is likely indifferent with respect to why its counterparty desires the EVO and, as a result, any intent regarding the basis for including EVO will only exist in order to ensure satisfaction of the seventh prong. On the other hand, the buyer of the EVO will have a reason for why it desires the EVO as part of the transaction and can therefore properly be the subject of the intent inquiry under the seventh prong.

Unless clarified by the Commission, market participants may believe that the seventh prong of any final revised seven-part interpretation can only be satisfied if both parties primarily intend that the EVO address physical factors or regulatory requirements as specified in the seventh prong. As a result, it is likely that transacting counterparties may insist on bilateral representations in connection with transactions that include EVO. Based on the explanation above, EDFTNA expects that sellers of EVO would either be reluctant to make such representations due to a lack of intent or would assume that their intent is always consistent with the requirements seventh prong. Therefore, to reduce the potential for conflict and to ensure a more meaningful analysis, EDFTNA encourages the Commission to revise the seventh prong by adding the phrase "by the party with the ability to exercise the embedded volumetric optionality" after the phrase "primarily intended" or otherwise explicitly clarify in the Commission's associated guidance that the seventh prong is only concerned with the intent of the party able to exercise the EVO.

(iii) The Commission should clarify, as part of its guidance to market participants with respect to any final revised seven-part interpretation, that the fact that EVO may address price risks does not necessarily render EVO inconsistent with the seventh prong's intent requirement.

The Commission explains in the Proposed Interpretation's discussion of revised seven-part interpretation that the modified seventh prong is intended to reflect the intent associated with the EVO at the

time the transaction is entered into rather than the rational for the actual exercise or non-exercise of the optionality. In footnote 18 of the Proposed Interpretation, the Commission clarifies that in deciding whether or not to exercise EVO, "commercial parties would be able to consider a variety of factors, including price, provided the intended purpose for including the embedded volumetric optionality in the contract at contract initiation was to address physical factors or regulatory requirements influencing the demand for or supply of the commodity."[40] Reflecting the opposite side of the issue, however, the Commission also explains that "concerns that are primarily about price risk … would not satisfy the seventh element absent an applicable regulatory requirement."

EDFNTA is concerned that the Commission's statements associated with price risk could be construed as expressing the Commission's belief that if considerations of price risk in any way affected the decision of the party to enter into the transaction with EVO, the transaction would not satisfy the requirements of the seventh prong. Such a limitation, however, is impractical in reality and would not be consistent with the use of the phrase "primarily intended" in the seventh prong. Inevitably, the decision to enter into any transaction that includes EVO will to some degree be influenced by price risk related considerations. In such a transaction, the EVO may simultaneously protect the party from adverse price changes and be intended to address physical supply or regulatory concerns associated with the entity's business.

The fact that market participants may consider price risk in conjunction with EVO seems to be reflected by the Commission in the Proposed Release and is certainly supported by the Commission's guidance regarding excluded forward contracts. In all probability, if factors of price can influence the actual exercise of EVO, then the transacting parties likely understand, at the time they enter into the transaction, how the EVO may address price related risks in addition to physical and regulatory risks. Furthermore, the Commission's existing guidance does not support the adoption of a position in which price risk concerns are impermissible for excluded forward contracts. As explained by the Commission in its Statutory Interpretation Regarding Forward Contracts, "forward contracts may be used to acquire raw material, to purchase and sell inventory or for other merchandising or commercial purposes *and, concomitantly, to shift future price risks* incident to commercial operations and other forward commitments."[41] Deeming price risk to be an inappropriate consideration for transactions with EVO would, in effect, require market participants to unrealistically bifurcate their intent: permissible considerations of price risk that, along with regulatory and physical factors, support the entry into the forward component of the transaction would be impermissible with respect to the EVO component of the transaction and could undermine the ability of the parties to manage the transaction as an excluded forward.

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[40] Proposed Interpretation at 69075.

[41] Brent Interpretation at 39191(emphasis added); *see also*, *In re Grain Land Coop*. at 29 ("forward contracts can take many forms and … variations are frequently developed because they permit producers to speculate on factors affecting the price they will receive on delivery. In any case, the touchstone of our analysis of the difference between futures contracts and forward contracts has been the parties' intent regarding delivery…"); Products Release at 48237 (forward transactions with embedded price optionality allow parties to manage price risk via optionality included in forward transactions).

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To address the characterization challenges presented by the Commission's discussion of price risk, EDFTNA believes that the Commission should clarify that price risk related concerns may be considered by the parties in connection with transactions that include EVO so long as the primary intent of the party with the ability to exercise the EVO is otherwise consistent with the seventh prong. Such a clarification would be consistent with the expectations of market participants but not undermine the Commission's concerns regarding the use of EVO as means for merely shifting price risk.

(iv) The Commission should not require market participants to conduct diligence regarding its counterparty's subjective intent in connection with reliance on representations that address the intent underlying the inclusion of EVO.

While generally supportive of the Commission's proposal to allow parties to rely on representations regarding the purpose underlying the inclusion of EVO, EDFTNA does not believe that a transacting entity should, or reasonably could, have an obligation to conduct diligence regarding the subjective intent of its counterparty with respect to EVO. Instead, EDFTNA suggests that the Commission conform the ability to rely on representations regarding intent to the approach taken by the Commission in other contexts in which reliance on representations is important. Under such a conformed approach, parties would be permitted to rely on representations unless it has information that would cause a reasonable person to question the accuracy of such representation.

The question of when and under what circumstances reliance on representations is permissible applies to many rules promulgated by the Commission. Most recently, the issue was addressed in the Exclusion of Utility Operations-Related Swaps with Utility Special Entities From De Minimis Threshold for Swaps With Special Entities final rule.[42] As identified by the Commission in the Utility Special Entity Rule, its original proposal would have allows reliance on representations "so long as the person was not aware, *and should not reasonably have been aware*, of facts indicating the contrary."[43] In the final rule promulgated at 17 C.F.R. 1.3(ggg)(4)(B)(*4*), however, the Commission retreated from the notion that a transacting entity would have an obligation to conduct additional diligence regarding the accuracy of the representations made. By eliminating the additional diligence requirement, the Commission promoted consistency among the various rules that address reliance on representations.

Unfortunately, the ability to rely on representations identified in the Proposed Interpretation follows the approach initially proposed by the Commission in connection the utility operations-related swaps instead of the language adopted in the Utility Special Entity Rule. The language initially proposed in connection with the Utility Special Entity Rule is similar to the corresponding provision of the Proposed Interpretation in that both would only permit reliance if the party "should not reasonably have been aware" of certain facts in connection with the transaction. As a result, a party seeking to rely on its counterparty's representation regarding its intent

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[42] Exclusion of Utility Operations-Related Swaps with Utility Special Entities From De Minimis Threshold for Swaps With Special Entities, 78 FR 57767 (September 26, 2014) (the "Utility Special Entity Rule").
[43] Utility Special Entity Rule at 57770 (emphasis added).

underlying EVO would need to conduct reasonable diligence in order to ensure that facts suggesting an alternate purpose for the EVO are not present.

Ultimately, an obligation to conduct diligence is infeasible and could undercut the benefits offered by the Commission's proposed modifications to the seventh prong of the current seven-part interpretation. Considering the seventh prong's focus on the subjective intent of the party rather than any objectively determinable set of facts, it is unclear what form of diligence would be required in order to ensure that the relying party does not overlooked facts that would suggest an alternative reason for the EVO. Transacting entities may therefore determine the ability to rely on representations is of minimal value because it fails to allocate to the proper party the responsibility for determining what the subjective intent underlying the EVO actually is. That is, because the representing party is best able to know its intent with respect to EVO, it is difficult to understand why, in the absence of known facts that indicate the representation is not correct, its counterparty should not be permitted to accept, and reasonably rely, on the representations at face value. As a result, unless adjusted to remove an additional diligence requirement, the adjustments to the seventh prong may not resolve the disagreement over whether or not the prong is satisfied for any particular transaction.

(e) **The Interim Final Rule for Commodity Options is not an acceptable substitute for clear guidance with respect to when a transaction with EVO, considered as a whole in light of its underlying purpose, is or is not an excluded forward contract.**

As part of the Proposed Interpretation, the Commission is seeking comments with respect to whether the IFR "provides a clear and well-understood mechanism though which contracts with volumetric optionality can be exempted that avoids many of the difficulties of determining whether a particular contract with volumetric optionality would satisfy the seven elements of the CFTC's interpretation."[44] Although not expressly stated by the Commission, the question at its core appears to ask whether or not it would simply be easier for market participants to manage EVO under the IFR provisions applicable to CTOs instead of attempting to analyze the various prongs of the current seven-part interpretation or any final revised seven-part interpretation. While appreciative of the difficulties faced by the Commission in its attempts to implement workable rules, EDFTNA does not believe that eliminating the analysis of transactions with EVO, whether under a final revised seven-part interpretation or a facts and circumstances approach, in favor of the exemption from certain swap regulations provided by the IFR for CTOs is appropriate.

The fundamental challenge of categorizing commodity derivative transactions as a "swap,"[45] "future", "forward", or "option" is reflected in myriad interpretative statements, enforcement actions, and other guidance issued by the Commission during its history. Transactions all too often defy easy characterization by virtue of the inclusion of attributes common to multiple categories. As the Commission identified in the 1985 OGC Interpretation and cases such as *In re Wright*, forward transactions can include option-like pricing terms and

[44] Proposed Interpretation at 69076.
[45] The use of the term "swap" in this instance is intended to apply to the term as historically understood rather than the expansive definition of the term under the Commodity Exchange Act.

premiums.[46] Compounding the challenge, and as explained by the Commission in other contexts, the categories themselves tend to escape precise definition.[47] The fact that transactions are often not easily categorized, however, does not suggest that characterization is not possible (even if characterization is simply that the transaction is not a swap for purposes of the Commodity Exchange Act). Addressing the distinction between futures and forwards in *CFTC v. Co Petro Marketing Group, Inc*., Judge Canby articulately and concisely expressed the issue: "In determining whether a particular contract is a sale of a commodity for future delivery over which the Commission has regulatory jurisdiction …, no bright-line definition or list of characterizing elements is determinative. The transaction must be viewed as a whole with a critical eye towards its underlying purpose."[48]

Arguably, the emphasis placed on the current seven-part interpretation by market participants and the Commission represents a significant departure from Judge Canby's "critical eye" analysis. The suggestion by the Commission that the evaluation of EVO could be simplified by reliance on the IFR and characterization of transactions as CTOs seemingly rejects any need to analyze the underlying purpose of the transactions as a whole. The rejection is also evident in the comments of market participants and the Commission regarding transactions that "fail" a prong of the current seven-part interpretation. If the failure of a single prong is fatal to the analysis and characterization of the transaction as an excluded forward contract, then the seven-part interpretation has become a "bright line" test rather than interpretive guidance.

Commissioner Bowen's concurring statement in the Proposed Interpretation seems to express a similar predisposition towards characterization without significant regard to the underlying purpose of the transaction as a whole. Even assuming that "Congress said, quite clearly, that commodity options are swaps, not forwards,"[49] it did not attempt to define the universe of transactions properly characterized as one or the other. Historically, the Commission has managed the task of further defining the scope of the forward contract exclusion and the term "commodity option". Unless Commissioner Bowen is suggesting that market participants should apply a quantum theory of characterization that breaks each transaction into its fundamental components[50] rather considering the transaction as a whole, the simplistic approach suggested cannot be a reasonable solution. A transaction that includes EVO may "look like an option", be "used like an option" and "work like an option" and simultaneously look like a forward, be used like a forward and work like a forward. The problem is not that market participants are trying to achieve clarity by "calling something what it is not." Instead, much like Schrödinger's Cat, the problem is that until the Commission provides clear guidance that

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[46] 1985 OGC Interpretation; *In re Wright* at 12.
[47] Brent Interpretation at 39190 ("Just as there is no definitive list of the elements of a futures contract, there is no definitive list of the elements of those transactions which are excluded from regulation under section 2(a)(1) of the [Commodity Exchange] Act."); *In re Grain Land Cooperative*. at 24 ("respondents are correct in claiming that the ALJ's legal analysis strayed from our approach eschewing any bright-line definition or list of characterizing elements.")
[48] *CFTC v. Co Petro Marketing Group, Inc.*, 680 F.2d 573 (9th Cir. 1982)
[49] Proposed Interpretation at 69078 (concurring statement of Commissioner Bowen).
[50] Oddly, such an approach is not without support in the Commission's guidance. The Division of Market Oversight, in its Commodity Options FAQs, noted that if "a transaction includes both a fixed amount that must be delivered or received and an embedded volumetric option to make or take delivery of an additional amount, the fixed amount … is not reportable on Form TO."

permits characterization as one or the other based on the underlying nature of the complete transaction, the transaction with EVO is, in some respects, both a forward and an option.

The suggestion that it would be easier to assume that all transaction with EVO are commodity options bears a striking resemblance to the suggestion that all transactions with EVO are properly characterized as excluded forward contracts.[51] Both approaches ignore the fundamental purpose underlying the different applicable regulatory treatment of forwards and commodity options (now swaps) in favor of a one-size-fits-all approach to regulation. Likewise, both approaches fail to consider that a transaction at issue may be neither an excluded forward nor a commodity option. Although not a perfect solution to characterization, the fundamental question that should be asked in connection with any analysis of transactions with EVO is summed up in the first prong of the current seven-part interpretation. That is, does the nature of the EVO undermine the characterization of the transaction as a forward? Through this lens, the remaining six prongs of the current seven-part interpretation could be viewed as guidance that, when the transaction is considered as a whole, informs the answer to the first question and thereby enables the determination of whether or not the transaction with EVO is an excluded forward contract. With this approach, only once it is determined that the nature of the EVO undermines the characterization as of the transaction as an excluded forward does it become necessary to consider whether the regulation of the transaction as a commodity option (and, by extension, a swap) is correct.

(f) **The costs to end-users resulting from lack of clarity concerning the seventh prong of the current seven-part interpretation are attributable to more factors than just compliance with the IFR.**

In the Proposed Interpretation, the Commission expresses an assumption that the increased costs associated with the seventh-prong's ambiguity are attributable to compliance with the IFR. EDFTNA believes that the Commission's assumption is only partially correct.[52] The ambiguity with respect to the seventh prong, and the related characterization of a transaction with EVO as a CTO, only causes an increase in IFR compliance related costs if the characterization of the transaction as a CTO is incorrect. If the transaction is properly characterized as a CTO, then the compliance costs associated with CTOs under the IFR are not incremental to the affected market participants. Thus, while some of the increased costs associated with the seventh prong's ambiguity are attributable to IFR compliance, such costs likely do not represent the majority of the total amount. Instead, EDFTNA suggests that the majority of the increased costs are incurred by market participants as part of the initial characterization process.

If the parties agree on the characterization of a transaction as a forward or a CTO and the characterization is correct, then the ambiguity associated with the seventh prong does not result in any increased

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[51] *See*, *e.g.*, Products Release at 48237 ("Several commenters in response to the Proposing Release argued that commodity options should not be regulated as swaps. In general, these commenters believed that commodity options should qualify for the forward exclusion from the swap definition.")

[52] Likewise, EDFTNA questions whether the Commission's assertion that "contracts that fail one or more of the seven elements would be regulated as exempt commodity trade options under the IFR" is correct. Proposed Interpretation at 69076. The Commission's statement fails to consider the possibility that a transaction that does not qualify as an excluded forward may also be excluded from the definition of swap.

costs to the transacting counterparties. From the perspective of the parties, the costs are those that would ordinarily be incurred in connection with any CTO or forward, as applicable. Increased costs associated with IFR compliance are only incurred if the parties erroneously determine (whether by agreement or by agreeing to disagree) that the transaction is a CTO. In such situation, however, the increased costs to the transacting party are only the marginal costs associated with the management of an additional CTO.[53] While certainly not insubstantial, EDFTNA believes that these costs will likely fluctuate based on the entity in question: the marginal cost to an entity with an established system for managing CTOs may be less than the marginal cost to an entity that manages CTOs on a case by case basis.

When considering the additional cost to end-users, the ambiguity concerning the seventh prong becomes particularly relevant if transacting counterparties disagree on the characterization of a particular transaction. Based on EDFTNA's experience, disagreements regarding transaction characterization typically delay the execution and confirmation of the transaction and require the involvement of traders, confirmations teams, and internal and/or external legal counsel. Often, the disagreement regarding characterization first becomes apparent when an entity objects to (or adds) CTO related representations in a transaction confirmation issued by its counterparty. Once this occurs, each party is likely to escalate the disagreement to its respective legal department for resolution. Unfortunately, because most entities have adopted an interpretation of the seventh prong as a matter of policy, disagreements with respect to characterization are typically not subject to quick resolution.[54] Instead, legal counsel for both parties will likely review the transaction to confirm its own analysis, exchange correspondence explaining the party's rational for the characterization before ultimately agreeing to disagree, and then finally negotiate a confirmation solution that is acceptable to both parties. While each situation is unique, in EDFTNA's experience the foregoing process has taken as long as two weeks to complete and necessitated calls with partners at major law firms.

In addition to the transaction specific costs, the Commission should also note that market participants have invested significant resources in order to better understand the seventh prong and the associated ambiguity. For example, many market participants have engaged external legal counsel to help develop internal policies specific to the seventh prong, provide insight with respect to the interpretation of the seventh prong by market participants generally, and better understand the Commission staff's views regarding the seventh prong. Likewise, since the publication of the Product Release over two years ago, market participants have contributed vast amounts of time and resources drafting various comment letters and engaging in other outreach efforts intended to educate the Commission on the challenges presented by the current seven-part interpretation and to encourage the Commission to make changes similar to those included in the Proposed Interpretation. While not easily quantifiable, such costs are in the aggregate undoubtedly substantial.

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[53] Conversely, transacting parties that erroneously characterize the transaction as an excluded forward contract avoid the costs associated with the management of the transaction as a CTO.

[54] Departing from an established interpretation of the seventh-prong on a transaction-by-transaction basis would potentially result in inconsistent characterization of transactions within the entity. If such a departure were to occur, an entity may end up applying different characterizations to transactions that are structurally equivalent.

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IV. Conclusion

EDFTNA appreciates the opportunity to provide the Commission with the foregoing comments in connection with the Proposed Interpretation. If you would like additional information or have any questions regarding this submission, please feel free to contact Mr. Paul McBride, Corporate Counsel for EDFTNA, at 281-921-9764 or Mr. Paige Lockett, Manager of Regulatory Affairs for EDFTNA, at 281-921-9826.

Respectfully submitted,

EDF Trading North America, LLC