



SUTHERLAND

THE COMMERCIAL ENERGY  
WORKING GROUP



December 22, 2014

**VIA ELECTRONIC SUBMISSION**

Mr. Christopher J. Kirkpatrick  
Secretary of the Commission  
Commodity Futures Trading Commission  
Three Lafayette Centre  
1155 21st Street, NW  
Washington, DC 20581

cc: Mr. Kevin M. O'Neill  
Deputy Secretary  
Securities and Exchange Commission  
100 F Street, NE  
Washington, DC 20549

***Re: Forward Contracts with Embedded Volumetric Optionality, RIN3038-AE24***

Dear Secretary Kirkpatrick:

**I. INTRODUCTION.**

On behalf of The Commercial Energy Working Group (the “**Working Group**”) and the Commodity Markets Council (“**CMC**,” together with the Working Group, the “**Commercial Alliance**”), Sutherland Asbill & Brennan LLP hereby submits these comments in response to the Commodity Futures Trading Commission’s (the “**CFTC**”) and Securities and Exchange Commission’s (the “**SEC**,” and together with the CFTC, the “**Commissions**”) Proposed Interpretation, *Forward Contracts with Embedded Volumetric Optionality* (the “**Proposed Interpretation**”).<sup>1</sup> The Commercial Alliance appreciates the continued efforts to clarify the treatment of forward contracts with embedded volumetric optionality under the definition of “swap.” Volumetric optionality is a crucial element of many energy market participants’ ability to manage the physical commodity needs of their commercial business. The Proposed Interpretation moves in the direction of providing much needed clarity. With a few minor additional clarifications, the Proposed Interpretation could provide the degree of clarity necessary for market participants to be certain of the regulatory classification of the majority of their forward contracts with embedded volumetric optionality.

The Working Group is a diverse group of commercial firms in the energy industry whose primary business activity is the physical delivery of one or more energy commodities to others, including industrial, commercial, and residential consumers. Members of the Working Group are producers, processors, merchandisers, and owners of energy commodities. Among the

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<sup>1</sup> See *Forward Contracts with Embedded Volumetric Optionality*, Proposed Interpretation, 79 Fed. Reg. 69,073 (Nov. 20, 2014), available at <http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2014-27285a.pdf>.

members of the Working Group are some of the largest users of energy derivatives in the United States and globally. The Working Group considers and responds to requests for comment regarding regulatory and legislative developments with respect to the trading of energy commodities, including derivatives and other contracts that reference energy commodities.

CMC is a trade association that brings together exchanges and their industry counterparts. Its members include commercial end-users that utilize the futures and swaps markets for agriculture, energy, metals, and soft commodities. CMC industry member firms include regular users and members of designated contract markets such as the Chicago Board of Trade, the Chicago Mercantile Exchange, ICE Futures U.S., the Minneapolis Grain Exchange, and the New York Mercantile Exchange (each a “**DCM**”). They also include users of swap execution facilities (“**SEFs**”). The businesses of all CMC members depend upon the efficient and competitive functioning of the risk management products traded on DCM, SEFs, and over-the-counter (“**OTC**”) markets. As a result, CMC is well-positioned to provide consensus views of commercial end-users of derivatives on the impact of the Proposed Interpretation.

## **II. CLARIFICATION OF THE SEVENTH FACTOR.**

The Commercial Alliance greatly appreciates the Commissions issuing the Proposed Interpretation, and specifically the proposed clarification with respect to the so-called seventh factor of the seven part test to qualify certain contracts for the forward contract exclusion from the definition of swap.<sup>2</sup> The lack of clarity about the seventh factor introduced significant uncertainty about the classification of forward contracts with embedded volumetric optionality. The Commissions’ proposed changes to the seventh factor would materially reduce that uncertainty.

In particular, the removal of the phrase “exercise or non-exercise” appropriately altered the analysis of forward contracts with embedded optionality from a framework where counterparties were effectively required to accurately predict the predominant reason for the future exercise of volumetric optionality to a framework where they properly focus on the intent at the time of contract execution. This small change will make the analysis of whether a contract satisfies the seven part test more straight forward as the counterparties can know, at the time of execution, why they are including volumetric optionality in a contract.

The Proposed Interpretation makes clear how the CFTC intends to interpret the seventh factor when it states that if embedded volumetric optionality is primarily “intended as a means of assuring a supply source or providing delivery flexibility in the face of uncertainty regarding the quantity of the nonfinancial commodity that may be needed or produced in the future,” the

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<sup>2</sup> See, e.g., *Further Definition of “Swap,” “Security-Based Swap,” and “Security-Based Swap Agreement;” Mixed Swaps; Security-Based Swap Agreement Recordkeeping*, Joint Final Rule, Interpretations, and Request for Comment on an Interpretation, 77 Fed. Reg. 48,208, 48,238 (Aug. 13, 2012) (listing the seven factors that must be met to qualify for the forward exclusion from the definition of swap).

contract would satisfy the seventh factor.<sup>3</sup> The Proposed Interpretation further expands on that concept by stating:

in choosing whether to obtain additional supply by exercising the embedded volumetric optionality under a given contract or turning to another supply source—whether storage, the spot market, or another forward contract with embedded volumetric optionality—commercial parties would be able to consider a variety of factors, including price, provided that 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.<sup>4</sup>

This guidance settles much of the current uncertainty with respect to the application of the seventh factor. To prevent any further confusion, the Commercial Alliance recommends that the CFTC replace the current wording of the seventh factor with the language used in the interpretive guidance to explain that factor, so that the seventh factor reads:

“the embedded volumetric optionality must primarily be intended as a means of assuring a supply source or providing delivery flexibility in the face of uncertainty regarding the quantity of the nonfinancial commodity that may be needed or produced in the future, consistent with the purposes of a forward contract.”<sup>5</sup>

### **III. CLARIFICATION OF FACTORS FOUR AND FIVE.**

In the Proposed Interpretation, the CFTC states that it “is proposing to modify only the fourth and fifth elements, to clarify that the CFTC’s interpretation applies to embedded volumetric optionality in the form of both puts and calls.”<sup>6</sup> The Commercial Alliance appreciates the Commission’s willingness to clarify the intent of the fourth and fifth factors to cover both increases and decreases in volume under forward contracts with embedded volumetric optionality. Textual changes of the fourth and fifth factors will properly reflect the Commission’s intent for the regulatory treatment of certain forward contracts. The Commercial Alliance respectfully suggests that the Commission make the following changes to its proposed fourth and fifth factors:

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 more or less of 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

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<sup>3</sup> Proposed Interpretation, 79 Fed. Reg. at 69,075.

<sup>4</sup> *Id.* at 69,075 n.18.

<sup>5</sup> *Id.* at 69,075.

<sup>6</sup> *Id.* at 69,074.

agreement, contract, or transaction, to take delivery of more or less of the underlying nonfinancial commodity if the embedded volumetric optionality is exercised;

**IV. RESPONSE TO SPECIFIC REQUESTS FOR COMMENT.**

- 1. Market participants have expressed concerns about whether various types of volumetric optionality fit within the CFTC's interpretation....The CFTC notes that, in April, 2012, the CFTC adopted an Interim Final Rule for Commodity Options (the "IFR")....it appears that the IFR provides a clear and well-understood mechanism through 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. The CFTC invites comment on whether the IFR's approach to defining the universe of swaps subject to its exemption may provide a clearer and easier mechanism for providing relief from swaps requirements than the CFTC's interpretation of forwards with embedded volumetric optionality and whether the IFR currently provides sufficient relief for such contracts.*

The IFR and the Proposed Interpretation serve different purposes and are both necessary to provide adequate relief for physically settled options and forwards with embedded volumetric optionality. While the relief provided by the IFR is welcome and necessary for physically settled options, it is not a substitute for a workable interpretation with respect to the regulatory treatment of forwards with embedded volumetric optionality. The IFR provides relief for transactions that are intended to be physically settled, but are ostensibly captured by the definition of "swap." The Proposed Interpretation would provide clarity as to whether certain forwards with embedded volumetric optionality are in fact swaps. Said another way, the Proposed Interpretation is intended to answer the question of whether certain forwards are swaps while the IFR provides necessary relief to transactions that are intended to be physically settled that fall within the definition of swap.

- 2. Market participants have argued that the lack of clarity around the seventh element of the CFTC's interpretation has led to costs to end-users. Conceivably, since contracts that fail one or more of the seven elements would be regulated as exempt commodity trade options under the IFR, these costs are attributable to complying with the IFR. The CFTC invites comment on whether or not this is the case, and invites the submission of data quantifying those costs.*

The lack of clarity around the seventh factor of the CFTC's interpretation has led to costs to end-users in a number of ways. *First*, the lack of clarity has resulted in, and continues to result in, the disagreement between counterparties as to the classification of certain forwards with embedded volumetric optionality. Such disagreement has increased the costs of negotiating and obtaining representations with respect to the regulatory treatment of forwards with embedded volumetric optionality.

*Second*, the lack of clarity around the seventh factor has caused many market participants to take what is likely an overly conservative view as to whether a transaction satisfies the seventh factor. As such, many market participants have likely been over inclusive in the universe of forwards with embedded volumetric optionality that they consider to be swaps. Though the vast majority of those forwards qualify for the IFR, complying with the IFR, including identifying, tracking, and calculating the notional value of those contracts, can be costly. For many companies, forwards with embedded volumetric optionality are captured by systems designed for physical markets – not financial markets. Those physical systems are typically not designed in a way that will allow companies to comply with the IFR without system modifications or workarounds, both of which are costly.

Even with system modifications and workarounds in place, the costs related to determining which physical transactions are exempt forwards vs. trade options and then meeting the requirements applicable to trade options are not trivial. Individual Commercial Alliance members devote significant resources to analyzing contracts, negotiating contractual representations with counterparties, calculating the notional value of trade options, and proper reporting under the IFR. In some cases, these efforts require multiple full-time employees and significant outside legal fees. It is also necessary to train both commercial employees and back-office personnel to ensure compliance. Clear guidance with respect to the treatment of forwards with embedded volumetric optionality will reduce the number of transactions being treated as trade options and therefore will lower, but not eliminate, market participants' burden associated with complying with the IFR.

3. *What factors should the CFTC consider in determining whether the proposed modifications and clarifications to the CFTC's interpretation are appropriate in view of CFTC precedent regarding the interpretation of the CEA's forward contract exclusion? Do the proposed changes provide sufficient clarity on how contracts with embedded volumetric optionality may satisfy all seven elements of the interpretation, particularly the first and second elements? Are there reasons why trying to provide further relief through the swap definition's forward contract exclusion would not be in the public interest?*

Providing further relief for forward contracts with embedded volumetric optionality through the swap definition's forward contract exclusion is in the public interest. The regulatory construct for swaps set forth in Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Dodd Frank Act**") is designed to regulate financial contracts like swaps and financially settled options – not physically settled commodity transactions. The application of the requirements for swaps laid out in Title VII and the CFTC's related rules to transactions that are intended to be physically settled does not further the Dodd-Frank Act's goal of reducing systemic risk and increases costs on participants in physical commodity markets with no recognized benefit. As such, the extension of relief under the forward contract exclusion to the greatest extent possible is in the public interest.

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V. **CONCLUSION.**

The Commercial Alliance appreciates this opportunity to provide comments on the Proposed Interpretation and respectfully requests the Commissions' consideration of these comments as they develop final guidance on these matters.

If you have any questions, please contact the undersigned.

Respectfully submitted,

/s/ David T. McIndoe

David T. McIndoe

Alex S. Holtan

Sutherland Asbill & Brennan LLP

700 Sixth Street, NW, Suite 700

Washington, DC 20001-2980

*On Behalf of the Commercial Alliance*