December 22, 2014

Mr. Christopher Kirkpatrick
Secretary of the Commodity Futures Trading Commission
Three Lafayette Center
1155 21st Street, N.W.
Washington, DC 20581

Re: Forward Contracts with Embedded Volumetric Optionality (RIN 3235-AK65)

Dear Mr. Kirkpatrick:

Better Markets Inc.[1] appreciates the opportunity to comment on the above-captioned request for comment on Forward Contracts with Embedded Volumetric Optionality ("Proposed Interpretation") issued by the Commodity Futures Trading Commission ("CFTC" or "Commission").

INTRODUCTION

The Commission has made it a priority to examine the impact its derivatives regulations have on genuine commercial end-users, and to amend certain rules to minimize undue burden.[2] Consistent with this goal, the Proposed Interpretation seeks to address concerns that certain commercial transactions need not be subject to all of the swap rules mandated by the Dodd-Frank Act.

However, the proposed approach is reminiscent of the infamous "Enron loophole," is inappropriately broad, and needlessly sacrifices important anti-fraud protections.

The Proposed Interpretation may provide regulatory relief[3] to certain end-users entering certain forward contracts with embedded volumetric optionality ("EVO Contracts"), but would do so in a manner that unnecessarily removes those contracts entirely from the swaps regulatory framework overseen by the Commission. As a result, these transactions would no longer be entitled to

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1 Better Markets, Inc. is a nonprofit organization that promotes the public interest in the capital and commodity markets, including in particular the rulemaking process associated with the Dodd-Frank Act.

2 "For the last six months, we have made it a priority to address some of the concerns of commercial end-users—such as manufacturers, farmers, ranchers, and other businesses that rely on these markets to hedge commercial risks." *See* Testimony of Chairman Timothy Massad before the U.S. Senate Committee on Agriculture, Nutrition & Forestry (Dec. 10, 2014), *available at* http://www.cftc.gov/PressRoom/SpeechesTestimony/opamassad-6.

3 It is unclear that the Proposed Interpretation, which maintains a cumbersome seven-part test, meaningfully decreases uncertainty such that it provides substantial end-user relief.

important protections, such as fraud oversight, provided by the Commission to transactions within its purview.

In this comment letter, we will address the following points with respect to the Proposed Interpretation:

1. The proposed approach unnecessarily harms EVO Contract counterparties by removing important protections.

2. It violates the statutory mandate to regulate swap transactions.

3. Appropriately tailored and targeted end-user relief could be provided without these adverse consequences, through the existing definition of Trade Option.

The current proposals have similarities with the deregulation amendments made through the Commodity Futures Modernization Act ("CFMA") in 2000, which effectively codified the CFTC's regulatory exemption of 1993. As the Congressional Research Service report "The Enron Loophole" noted, Section 2(h) of the CEA exempted certain classes of transactions from most CFTC regulation, leading to soaring energy prices and raising concerns about whether the CFTC had enough information about those unregulated markets.[4] These exemptions are now popularly known as the "Enron loopholes."

The concerns raised by Sheila Bair in her dissenting statement in 1993 for what became known as the "Enron loophole" are precisely the same concerns raised by the Proposed Interpretation now.[5] Indeed, these concerns ring even truer today with the benefit of hindsight: The massive fraud of the Enron Corporation and the historic financial crash of 2008 prove beyond doubt that de-regulation and lack of oversight can lead to catastrophic consequences.

The Commission has made it clear that it believes that the Proposed Interpretation is just an example of "fine-tuning" its regulations and that more of the same can be expected in the coming months.[6] However, the Proposed Interpretation is an overly and unnecessarily broad deregulatory fix that can be – and should be – done in a much more tailored and targeted manner. While "fine-tuning" may be justified in particular instances, relief for genuine end-users does

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4 CRS July 7, 2008, The Enron Loophole, Mark Jickling, Specialist in Financial Economics, Government and Finance Division *available at* assets.opencrs.com/rpts/RS22912_20080707.pdf.

5 Meeting transcript, CFTC Exemption for Certain Contracts Involving Energy Products, Tuesday, April 20, 1993.

6 "As directed by Congress, the CFTC is committed to ensuring that our rules to bring the derivatives markets out of the shadows do not impose unintended consequences on the nonfinancial commercial companies who were not responsible for the financial crisis. To that end, I am scheduling an open meeting of the Commission on Monday, November 3 to consider three matters that I would describe as further fine-tuning of our rules." *See* Statement of CFTC Chairman Tim Massad on the upcoming open Meeting of the Commission (Oct. 27, 2014), *available at* http://www.cftc.gov/PressRoom/SpeechesTestimony/massadstatement102714.

not require the creation of loopholes or the complete elimination of CFTC jurisdiction. Such potential consequences have to be carefully considered and minimized before engaging in any "fine-tuning."

DISCUSSION

The Proposed Interpretation Removes Important Protections from Certain Swap Transactions

The Proposed Interpretation aims to ease the 7-part test that the Commission has established for identifying which trades are to be considered forward contracts and excluded from regulation as a swap.[7] It will effectively allow a greater number of contracts to claim inappropriate status as an exempt forward. Forward contracts are excluded from the jurisdiction of the CFTC altogether, and so they are not subject to its regulations and the contracting parties are not entitled to its protections.

For decades, the CFTC has provided a number of important protections to participants in derivatives markets, and its authority to police fraud in these markets is foremost among them. To market participants, such protections may seem peripheral, as they are not the primary context in which industry engages with regulators, but that does not diminish their importance. One rarely appreciates the protection of the police department until one is robbed or otherwise the victim of a crime. Importantly, there is **no** federal authority over forward transactions at all – they are covered only by the state's historically insufficient anti-fraud authority.[8]

Among the various ways the Commission is able to grant regulatory relief to end-users, banishing a subset of swaps entirely from the jurisdiction of CFTC oversight is surely the most extreme. End-users engaged in swap transactions should not lose anti-fraud oversight as a consequence of reduced reporting requirements, the purported intent of the Proposed Interpretation. All swap transactions, regardless of counterparty type, deserve the benefit of some degree of federal oversight, certainly including anti-fraud protections.

The Proposed Interpretation takes an unnecessary, harmful and counterproductive approach that in effect exacts a price from end-users for the regulatory relief they are receiving. This is one of several ways in which the Proposed Interpretation does *not* serve the public interest.

The Proposed Interpretation Contradicts the Statutory Mandate to Regulate Swaps

Even if the Commission determines it is appropriate to deprive certain swaps of important protections, as described above, it lacks the statutory authority to exempt transactions from the definition of swap. The Commodity Exchange Act

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[7] 77 FR 48238, *available at* http://www.gpo.gov/fdsys/pkg/FR-2012-08-13/pdf/2012-18003.pdf.

[8] Meeting transcript, CFTC Exemption for Certain Contracts Involving Energy Products, Tuesday, April 20, 1993 ("It is important to remember that it was the historical inadequacy of state law protections, however, that gave rise to federal regulation of financial markets in the first place.").

defines "swap" to include transactions meeting an extremely broad definition of option or optionality, in no uncertain terms. The statute states in relevant part:

> [T]he term "swap" means any agreement, contract, or transaction—
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> (i) that is a put, call, cap, floor, collar, or similar option of any kind that is for the purchase or sale, or based on the value, of 1 or more interest or other rates, currencies, commodities, securities, instruments of indebtedness, indices, quantitative measures, or other financial or economic interests or property of any kind;
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> (ii) that provides for any purchase, sale, payment, or delivery (other than a dividend on an equity security) that is dependent on the occurrence, nonoccurrence, or the extent of the occurrence of an event or contingency associated with a potential financial, economic, or commercial consequence;[9]

While the statue explicitly excludes futures *and options on futures,*[10] it does not explicitly mention options on forward contracts in the forward contract exclusion – indeed, commodity options are explicitly included in the definition.[11] It is clear that Congress chose not to exclude options on forwards, since it deliberately excluded options on other excluded instruments. Further, Congress proactively removed the CFTC's ability to make exemptions from the definition of swap.[12]

The statue does not present conditions or circumstances when its exclusions may apply. For instance, there is no indication that a party's intentions upon entering into a commodity option, or its settlement type, is a meaningful factor in determining whether or not a transaction meets the definition of swap. This therefore conflicts with the implications in the employment of the 7-part test: that there is some threshold level of optionality above which a transaction is deemed to be a swap but below which it is deemed to be an excluded forward contract. The statute draws bright clear lines: commodity options are swaps.

Nor is there any genuine doubt that forward contracts with embedded optionality are options in form, substance, and even name. At the CFTC's recent roundtable discussion on this issue, a market participant eloquently noted the nature of EVO Contracts:

> [T]he question is not whether there are options. **These are options.** They are structured as puts or calls. They have a

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9 7 U.S.C. § 1(a)(47)(A).

10 7 U.S.C. § 1(a)(47)(B) ("The term "swap" does not include... any contract of sale of a commodity for future delivery (or option on such a contract)...").

11 *Id.* ("any sale of a nonfinancial commodity or security for deferred shipment or delivery, so long as the transaction is intended to be physically settled"). In order for EVO Contracts to fit into this exclusion, "sale" must be synonymous with "sale or option to sell." It is unlikely that this is the case, given the explicit inclusion of futures options in the futures exclusion.

12 7 U.S.C. § 6(c)(1).

> premium associated with them. We invoice for the premium and we expect to get paid. There are provisions that describe how exercise -- these are options.[13]

As options, EVO Contracts must be regarded and regulated as swaps under the clear language of Section 1(a)(47)(A) quoted above.

The Commission Can Provide Similar Relief Through The Trade Option Definition

Dodd-Frank's Title VII regime was designed to bring oversight and transparency to the universe of unregulated derivatives, reigning in risky or unsound practices without unduly burdening genuine commercial end-users. In exchange for some new compliance and reporting requirements, swaps market participants now receive the important protections provided by the CFTC, including in particular their anti-fraud protections. EVO Contracts, both substantively and legally, are options, and therefore considered to be swaps subject to Title VII regulations.

While, as noted above, the Commission is not permitted to exclude transactions from the definition of swap, it is permitted to exempt certain swaps or classes of swap from certain regulatory requirements[14]. Indeed, as noted in the release, EVO Contracts would generally meet the existing requirements for treatment as a "Trade Option", and thus be exempted from all swap regulations except a single annual filing. Treating EVO Contracts as Trade Options would provide targeted and tailored regulatory relief to commercial end-users *and* maintain important market surveillance and anti-fraud protections, all within the limits of the CFTC's statutory authority.

Furthermore, the primary concern of market participants is that the uncertainty surrounding compliance with the 7-part test is costly and inefficient. The Trade Options approach provides immediate certainty to EVO Contract participants specifically, and all hybrid contracts generally, reducing regulatory costs to end-users across the board.

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[13] CFTC Public Roundtable to discuss Dodd-Frank End-User Issues, Washington DC, Thursday, April 3, 2014, Transcript p.141, *available at* http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/transcript040314.pdf.

[14] "Congress did maintain the Commission's authority to determine how swaps that are commodity options should be regulated since Congress did not repeal the Commission's plenary authority over options, including options that are swaps." Proposed Interpretation, Concurring Statement of CFTC Commissioner Sharon Y. Bowen, *available at* http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2014-27285a.pdf.

CONCLUSION

We hope these comments are helpful in your consideration of the Proposed Interpretation.

Sincerely,

Dennis M. Kelleher
President & CEO

Caitlin Kline
Derivatives Consultant

Better Markets, Inc.
Suite 1080
1825 K Street, N.W.
Washington, D.C. 20006
(202) 618-6464

dkelleher@bettermarkets.com
ckline@bettermarkets.com

www.bettermarkets.com