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December 2, 2010

David Stawick, Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, NW
Washington, DC 20581

VIA ELECTRONIC MAIL

RE: *Position Reports for Physical Commodity Swaps, Notice of Proposed Rulemaking,* RIN 3038-AD17

Dear Secretary Stawick:

I. INTRODUCTION.

On behalf of the Working Group of Commercial Energy Firms (the "Working Group"), Hunton & Williams LLP respectfully submits these comments to the notice of proposed rulemaking on "*Position Reports for Physical Commodity Swaps*" issued by the Commodity Futures Trading Commission ("CFTC" or the "Commission") pursuant to Section 737 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Act") and published in the *Federal Register* on November 2, 2010.[1]

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 energy producers, marketers and utilities. The Working Group considers and responds to requests for public comment regarding regulatory and legislative developments with respect to the trading of energy commodities, including derivatives and other contracts that reference energy commodities.

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[1] *Position Reports for Physical Commodity Swaps*, 75 Fed. Reg. 67,258 (Nov. 2, 2010) ("*Proposed Transitional Reports Rule*").

II. **EXECUTIVE SUMMARY.**

The *Proposed Transitional Reports Rule* seeks to gather data on swaps in exempt and agricultural commodities transacted in over-the-counter ("OTC") markets that are "economically equivalent" to futures traded on designated contract markets ("DCMs") to (i) determine whether position limits for such swaps are appropriate, and (ii) monitor compliance with any position limits established by the Commission. The regulations set forth in proposed CFTC Rule 20 are primarily intended to be transitional in nature and likely will remain in effect until such time that Swap Data Repositories ("SDRs") become operational.

The policy goals of the *Proposed Transitional Reports Rule* can be achieved more efficiently by prioritizing certain key provisions of Title VII, namely the (i) the implementation of mandatory central clearing requirements set forth in new Section 2(h) of the Commodity Exchange Act ("CEA"), (ii) the commencement of SDR operations, and (iii) the implementation of final rules on reporting and recordkeeping of swap transaction data, the real-time reporting of such data, and the reporting of pre-enactment swaps. Until such time that these provisions of Title VII are in place, most, if not all, of the positional data for physical commodity swaps sought by the *Proposed Transitional Reports Rule* can be obtained through the ongoing special call issued in 2008 to a limited group of financial firms transacting in OTC physical commodity swaps ("Covered Financial Entities").

It is presumed that the limited group of Covered Financial Entities subject to the special call are likely to be subject to Commission oversight as swap dealers under the Act and are likely counterparties to a substantial cross-section of existing physical commodity swaps. Due to their continuing obligation to comply with the special call, they are able to modify their reporting systems to provide such positional swap data at significantly lower costs than market participants that do not have similar systems in place. This alternative approach (i) avoids creating unnecessary, competing resource demands for market participants and the Commission that could otherwise be dedicated to establish interfaces with SDRs and accommodate other CFTC reporting requirements, and (ii) effectively eliminates the need for a stand-alone, data collection requirement for physical commodity swaps.

Should the Commission move forward with the *Proposed Transitional Reports Rule*, it should stay this proceeding until final rules further defining the terms "swap dealer" and "swap" set forth in new CEA Sections 1a(49) and 1a(47), respectively, are jointly issued by the CFTC and Securities and Exchange Commission ("SEC"). Such action would alleviate the need for a number of large commercial firms and large end-users (collectively, "Commercial Firms") to make substantial and possibly unnecessary capital investments to comply with the *Proposed Transitional Reports Rule* before they definitively know (i) whether they are a swap dealer and, thus, a Reporting Entity, and (ii) the universe of swap transactions that are reportable under proposed CFTC Rule 20.4.

Finally, as set forth in Section III.A.3., below, the *Proposed Transitional Reports Rule* grossly underestimates the costs that are likely to be incurred by Commercial Firms deemed to be Reporting Entities under proposed CFTC Rule 20.1. The Commission should more fully and accurately consider these cost impacts in order to provide a reasoned basis why the need for duplicative regulation under the *Proposed Transitional Reports Rule* outweighs the substantial costs imposed on such Commercial Firms and, ultimately, on consumers.

III. COMMENTS OF THE WORKING GROUP OF COMMERCIAL ENERGY FIRMS.

A. GENERAL COMMENTS.

As noted above and as described in more detail below, the Working Group proposes an alternative and less costly approach for collecting the positional data for physical commodity swaps through the implementation of identified key provisions of Title VII of the Act and the use of the ongoing special call issued in 2008 to a limited group of Covered Financial Entities. In addition, Section III.A.3., below, presents cost information provided by a cross-section of Working Group members demonstrating that the *Proposed Transitional Reports Rule* fails to adequately consider the costs imposed on Commercial Firms that are deemed to be Reporting Entities subject to the requirements of proposed CFTC Rule 20.4.

1. THE PROPOSED TRANSITIONAL REPORTS RULE IS NOT NECESSARY TO COLLECT DATA NEEDED TO DETERMINE WHETHER POSITION LIMITS IN PHYSICAL COMMODITY MARKETS ARE REQUIRED.

The Working Group recognizes that the mandate imposed on the Commission by Section 4a(a)(3) of the CEA, as amended by Section 737 of the Act, is to prevent excessive speculation and deter market manipulation, while concurrently ensuring liquidity for bona fide hedgers and protecting price discovery in physical commodity markets from disruption. Further, CEA Section 4a(a)(1), which was not amended, repealed or otherwise modified by Title VII of the Act, requires the Commission to make an affirmative finding that position limits "are necessary to diminish, eliminate, or prevent" burdensome excessive speculation before imposing position limits.[2]

As noted in Section II, the stated purpose of the *Proposed Transitional Reports Rule*, a rulemaking not required by Title VII of the Act, is to gather data on physical commodity swaps transacted in OTC markets for a potentially limited period to (i) determine whether position limits for such swaps are appropriate, and (ii) monitor compliance with any position limits

[2] Consistent with the mandate of CEA Section 4a(a)(1), the Working Group takes the view that position limits for economically equivalent swaps should only be imposed following an affirmative finding by the Commission based on an empirically sound substantive analysis that such limits are "necessary" to prevent burdensome speculation.

established by the Commission.[3] However, the Working Group respectfully submits that the regulations set forth in proposed CFTC Rule 20 are not necessary to meet the policy goals of the *Proposed Transitional Reports Rule* or to comply with the mandate of CEA Section 4a(a)(1).

A more effective and efficient alternative for meeting the policy goals of the *Proposed Transitional Reports Rule* would be to prioritize certain key provisions of Title VII, particularly the (i) implementation of the mandatory centralized clearing requirement set forth in new CEA Section 2(h), (ii) commencement of SDR operations, and (iii) implementation of technologically intensive final rules addressing (a) real-time public reporting of swap transaction data, (b) swap data recordkeeping and reporting requirements, and (c) reporting of pre-enactment swaps (collectively, "Swap Reporting Rules").[4] This approach would avoid the imposition of any unnecessary, competing demands on the limited internal resources of market participants and the Commission created by compliance with the *Proposed Transitional Reports Rule* that otherwise could be dedicated to the establishment of systems to interface with SDRs.

Further, it would effectively eliminate the need for a stand-alone, positional reporting requirement for physical commodity swaps. Specifically, mandatory central clearing will allow Derivatives Clearing Organizations and Futures Commission Merchants ("FCMs") to capture the information on large trader positions for physical commodity swaps. Once SDRs become operational, the proposed rules addressing the reporting of swap transaction data will ensure that all swap transactions are reported to a SDR or the Commission, as applicable, regardless of (i) who the counterparties are, and (ii) whether the transaction is centrally cleared or uncleared.

Until such time that centralized clearing is instituted, SDRs become operational and the Swap Reporting Rules become effective, the Commission may use its ongoing special call issued in 2008 to the limited Covered Financial Entities to facilitate reporting of most, if not all, of the positional data for physical commodity swaps sought by the *Proposed Transitional Reports Rule*.[5] Because they are already subject to a special call, any costs incurred by these entities to

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3 Section 737 of the Act amends CEA Section 4a(a)(2) to provide the Commission with authority to promulgate regulations, as appropriate, to limit the amount of positions, other than *bona fide* hedge positions, that may be held by any person with respect to commodity futures and options contracts in exempt and agricultural commodities traded on or subject to the rules of a DCM within 180 or 270 days, respectively, of the enactment of the Act. New CEA Section 4a(a)(6)(A) requires the Commission to set position limits to apply aggregately to contracts that are based on the same commodity across DCMs, certain contracts listed on Foreign Boards of Trade and swaps that perform a significant price discovery function. Further, new CEA Section 4a(a)(5) charges the Commission with establishing position limits, including aggregate limits, for swaps that are economically equivalent to futures contracts in exempt and agricultural commodities traded on DCMs.

4 *See Real-Time Public Reporting of Swap Transaction Data*, Notice of Proposed Rulemaking, RIN: 3038-AD08 (Nov. 19, 2010); *Swap Data Recordkeeping and Reporting Requirements*, Notice of Proposed Rulemaking, RIN: 3038-AD19 (Nov. 19, 2010); *Interim Final Rule for the Reporting of Pre-enactment Swap Transactions*, 75 Fed. Reg. 63,080 (Oct. 14, 2010). Section 723 of the Act, which creates new CEA Section 2(h)(5), also requires the Commission to issue final rules for the reporting of pre-enactment swaps.

5 *See* CFTC, *FY 2010 Performance and Accountability Report*, at 83, 126 (Nov. 15, 2010); CFTC, *Staff Report on Commodity Swap Dealers & Index Traders with Commission Recommendations*, at 15-24 (Sept. 2008).

modify their existing reporting systems would be significantly less than the costs incurred by market participants that do not have such systems in place.[6]

2. THE COMMISSION SHOULD EXERCISE ITS DISCRETION TO TAKE THE TIME NECESSARY TO ADEQUATELY COLLECT AND ANALYZE DATA BEFORE SETTING POSITION LIMITS IN PHYSICAL COMMODITY MARKETS.

The proposed alternative of using the ongoing special call for the limited group of Covered Financial Entities to collect data on physical commodity swaps until SDRs become operational does not conflict with the Commission's mandate under new CEA Section 4a(a)(2)(B) to implement position limit rules for exempt commodities and agricultural commodities within 180 and 270 days of the enactment of the Act, respectively. The "as appropriate" language in CEA Section 4a(2)(A) provides the Commission with authority to exercise discretion and set position limits in phases using data as it becomes available (i) beginning with data currently in its possession, and (ii) progressing as new data becomes available through the key steps contemplated by Congress (*i.e.,* mandatory clearing and the establishment of SDRs).[7]

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[6] To the extent deemed necessary and appropriate, the Commission may tailor the on-going special call to ensure it captures the nuanced positional data on physical commodity swaps subject to the reporting requirements of proposed CFTC Rule 20.4. The special call should not, however, be expanded to cover market participants beyond those currently subject to the special call.

[7] In fact, Commissioners Dunn, Sommers, and O'Malia publicly raised concerns that the pace at which the CFTC is issuing rules is too fast. *See* Statements of Commissioners Dunn, Sommers, and O'Malia at the CFTC's "Open Meeting on its Fifth Series of Proposed Rulemakings under the Dodd-Frank Act" (Nov. 19, 2010). In this regard, even for final rules subject to statutorily imposed deadlines in Title VII, the Commission retains the discretion to adopt a different schedule for purposes of ensuring it has the opportunity to engage in reasoned decision making.

The Court of Appeals for the District of Columbia Circuit has taken a deferential approach to missed statutory deadlines, requiring an agency to issue a rule only when agencies have "unreasonably" missed statutory deadlines. Specifically, the Court employs a balancing test for whether a delay is unreasonable and missing a statutory deadline is one of several factors it considers and is not itself dispositive. *See Telecommunications Research and Action Center v. FCC*, 750 F.2d 70 (D.C. Cir. 1984); *In re Barr Laboratories, Inc*., 930 F.2d 72, 74 (D.C. Cir. 1991). The magnitude of the required rulemakings that must be undertaken by the Commission, and its concomitant lack of resources, make for strong arguments that any delay should be found reasonable. *See Mashpee Wampanoag Tribal Council, Inc. v. Norton*, 336 F.3d 1094, 1102 (D.C. Cir. 2003) ("[a delay] cannot be considered in the abstract, by reference to some number of months or years beyond which agency inaction is presumed to be unlawful, but will depend in large part . . . upon the complexity of the task at hand, the significance (and permanence) of the outcome, and the resources available to the agency.").

This view is supported by the Congressional intent underlying Title VII of the Act. It is clear that the Commission is not expected to set position limits for exempt commodity and agricultural commodity contracts for which it has inadequate data, or collect and analyze all the necessary data for the implementation of such limits within 180 and 270 days of enactment for exempt and agricultural commodities, respectively. Had Congress intended otherwise, it would not have provided the Commission with 360 days to issue final rules for full recordkeeping and reporting. Rather, Congress would have incorporated a transitional reporting rule analogous in nature to the Interim Final Rule for Reporting Pre-Enactment Swap Transactions required by Section 729 of the Act.[8]

The same underlying Congressional intent applies to the establishment of position limits for economically equivalent contracts pursuant to new CEA Section 4a(5). To reiterate, the Commission is not expected to set position limits for economically equivalent contracts for which it has inadequate data, or collect and analyze all the necessary data for the implementation of such limits by the statutory deadlines imposed for position limits for exempt commodities and agricultural commodities. Finally, so long as existing CEA Section 2(h) remains in effect, the Working Group respectfully submits that the Commission lacks authority to set position limits, including the collection of data for the imposition of such limits, or take other regulatory action (with the exception of promulgating rules for later effectiveness) with regard to economically equivalent swaps that have not been previously designated as significant price discovery contracts under existing CEA Section 2(h)(7).

3. THE BENEFITS DO NOT JUSTIFY THE COSTS IMPOSED BY THE PROPOSED TRANSITIONAL REPORTS RULE ON COMMERCIAL FIRMS THAT ARE REPORTING ENTITIES.

CEA Section 15 requires the Commission to consider the costs and benefits of the *Proposed Transitional Reports Rule*.[9] However, the *Proposed Transitional Reports Rule* fails to reflect the true, anticipated compliance costs that would be incurred by Commercial Firms as Reporting Entities. Specifically, the proposal estimates that the overall cost imposed on the average swap dealer non-clearing member will be $80,000. In addition, the Commission estimates that it will require 375 man-hours (21% of a full-time employee) for the average swap dealer non-clearing member to comply with the *Proposed Transitional Reports Rule.*

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[8] Interim Final Rule for Reporting Pre-Enactment Swap Transactions, 75 Fed. Reg. 63,080 (Oct. 14, 2010).

[9] 7 U.S.C. § 19. Specifically, CEA Section 15 provides, in relevant part, that "costs and benefits of the proposed Commission action" shall be evaluated in light of:

(A) considerations of protection of market participants and the public;

(B) considerations of the efficiency, competitiveness, and financial integrity of futures markets;

(C) considerations of price discovery;

(D) considerations of sound risk management practices; and

(E) other public interest considerations.

Id.

As illustrated herein, the anticipated costs that will be incurred by Commercial Firms are well in excess of the costs stated in the *Proposed Transitional Reports Rule*. Contrary to the proposal's assumptions, Commercial Firms (large and small) generally do not have substantial experience with reporting requirements stemming from the regulation of financial institutions.

Prior to issuing a final rule in this proceeding, the Commission must more fully and accurately address the anticipated cost impacts associated with adopting a definition of Reporting Entity that could include a broad array of Commercial Firms. The *Proposed Transitional Reports Rule* fails to do this. Moreover, the *Proposed Transitional Reports Rule* fails to address the uncertainty and potential cost impacts created by the issuance of a final rule in this proceeding in advance of a final rule implementing the definition of swap set forth in new CEA Section 1a(47). As discussed in Section III.B.1.b., below, this shortcoming is particularly onerous for Commercial Firms because significant questions remain as to whether certain physically-delivered forwards and options on physical commodities will be included in the definition of swap.

The Working Group anticipates that, if included in the definition of Reporting Entity, Commercial Firms will be required to take the following steps to develop and deploy the reporting infrastructure necessary to comply with the requirements set forth in proposed CFTC Rule 20.4:

- Identify the universe of covered transactions (*i.e.*, swaps);
- Identify the transactions that are "paired" or matched with exchange-traded futures products (based on the methodology for pairings designed by the Commission);
- Distinguish transactions by legal entity (within corporate structure);
- Capture transactions by counterparty;
- Establish details for all contracts;
- Calculate the proprietary positions in "paired" transactions in an exchange-equivalent number/contract size;
- Calculate the counterparty positions in "paired" transactions in an exchange-equivalent number/contract size;
- Produce position reports consistent with these elements on a daily basis;[10] and

[10] As noted in Section III.B.3, below, the Commission has not yet defined the content, format or submission mode for the position reports required to be submitted pursuant to the *Proposed Transitional Reports Rule*. These features will have a significant impact on the cost to prepare the reports.

- Store the data in a manner that would allow reproduction on an as-of-date basis, if necessary.

The implementation of each of these steps will require the dedication of substantial time and capital resources. As noted above, unlike FCMs or swap dealers currently subject to the Commission's special call, Commercial Firms must develop, implement and test the systems necessary to comply with the reporting requirements of proposed CFTC Rule 20.4. For instance, some members of the Working Group estimate that total costs of complying with the *Proposed Transitional Reports Rule*, prorated over 5 years (inclusive of initial capital costs), ranges up to \$80,000 to \$750,000 per year.[11] Depending on a Working Group member's existing infrastructure and capabilities, upfront costs could range as high as \$1.5 million, and would be subject to numerous variables that could drive these costs higher. These estimated costs highlight that the cost analysis undertaken in the *Proposed Transitional Reports Rule* grossly underestimated likely cost impacts to Commercial Firms that are Reporting Entities subject to the requirements of CFTC Rule 20.4.

Further, the *Proposed Transitional Reports Rule* fails to adequately consider the costs imposed on Commercial Firms deemed to be Reporting Entities associated with implementing a CFTC-designed methodology intended to identify swap transactions that are "paired" with exchange-traded futures products. The Working Group submits that the implementation of such a methodology will not only have material cost impacts on Commercial Firms that must be addressed by the Commission pursuant to CEA Section 15, it also will result in inconsistencies in information reported by Reporting Entities.

The Working Group respectfully requests the Commission to undertake a thorough cost-benefit analysis evaluating and addressing the cost concerns raised above, as required by CEA Section 15.[12]

B. CONCERNS RAISED BY THE PROPOSED TRANSITIONAL REPORTS RULE.

Should the Commission exercise its discretion under new CEA Section 4a(a) to issue a final rule in this proceeding, the Working Group hereby submits the following comments addressing specific concerns raised by the *Proposed Transitional Reports Rule*.[13]

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11 These estimates do not include the potential to have to recreate positions at a historical point in time (as opposed to simply archiving reports). From the Working Group's perspective, there are no technology solutions in place to "snapshot" a database or subset of tables on an hourly or bi-hourly basis.

12 *See, e.g.*, *Advocates for Highway & Auto Safety v. Fed. Motor Carrier Safety Admin.*, 429 F.3d 1136 (D.C. Cir. 2005) (finding that the cost-benefit analysis in favor of the final rule lends no support to the agency's position).

13 Notwithstanding the Commission's intention to move forward with this rulemaking proceeding, the Working Group respectfully notes that existing CEA Section 2(h) remains in effect, at a minimum, until Title VII of the Act becomes effective on July 16, 2011. Consequently, it would appear that a final rule requiring the position reports of physical commodity swaps may not become effective before this date at the earliest.

1. Definitional Concerns.

Section 712(d) of the Act expressly requires the CFTC and SEC to further define several key definitions contained in Title VII through a series of joint rulemakings, including "swap dealer" and "swap" as set forth in new CEA Section 1a(49) and 1a(47), respectively. Section 712(d) of the Act states that such rulemakings must be completed by no later than 360 days after enactment of the Act. As of the date of these comments, the CFTC and SEC have not issued a formal notice of proposed rulemaking further defining "swap dealer" or "swap."[14] Moreover, it is not anticipated that a final rule further defining either term will be issued prior to the issuance of a final rule in this proceeding.

Further definition of the terms "swap dealer" and "swap" by the CFTC and SEC will have direct and material impacts on the implementation of the definitions of "Reporting Entity," "swap," and "swaption" set forth in proposed CFTC Rule 20.1.[15] For the reasons discussed below, the Working Group respectfully requests that the Commission stay this proceeding until such time that the joint final rules further defining the term "swap dealer" and "swap" are issued by the CFTC and SEC, so that (i) the identity of Reporting Entities, and (ii) the universe of transactions covered by the *Proposed Transitional Reports Rule*, are known and understood.

a. Reporting Entity.

Based on the definition of Reporting Entity in proposed Section 20.1 of the CFTC regulations, a Commercial Firm could only be subject to the requirements of the *Position Reporting Rule* if it is deemed a "swap dealer."[16] Although a final rule further defining the term "swap dealer" has not been issued by the CFTC and SEC, the preamble to the *Proposed Transitional Reports Rule* states that:

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[14] On August 20, 2010, the Commission issued an advanced notice of proposed rulemaking seeking industry comment on, among other things, the definition of "swap dealer" and "swap," as set forth in new CEA Sections 1a(49) and 1a(47), respectively. *See Definitions Contained in Title VII of Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010*, 75 Fed. Reg. 51,429 (Aug. 20, 2010) ("*Definition ANOPR*"). On September 20, 2010, the Working Group submitted separate sets of comments in the *Definition ANOPR* proceeding respectively addressing the definition of "swap dealer" and "swap."

[15] A broad and inclusive definition of "swap dealer" would significantly advantage financial firms, which comprise nearly all of the true "dealing" activity in physical commodity markets. Financial firms already act as, and are regulated as, intermediaries, and have the underlying infrastructure and experience to meet the regulatory and compliance obligations with much greater ease and at significantly lower costs. By regulating Commercial Firms in a manner analogous to financial firms, the Commission risks putting Commercial Firms at a substantial disadvantage that will result in significant new costs to these businesses that are not justifiable in relation to their core operations.

[16] The term "Reporting Entity" in proposed Section 20.1 of the CFTC's regulations is defined as:

> (1) A clearing member; or
>
> (2) swap dealer as the term is defined in section 1a of the Act and any Commission definitional regulations adopted thereunder, unless determined otherwise by the Commission for the purpose of excluding entities that are not commonly known as swap dealers from the reporting requirements of § 20.4.

> The definition of reporting entity is intended to identify financial firms that regularly make markets in swaps, *as well as divisions or subsidiaries of large commercial swap market participants that provide risk management services to other commercial entities in the normal course of business*. (Emphasis added). Proposed regulation 20.4 is intended to require reports from such financial firms and not from commercial end-users with swap activities of limited scope. By requiring reporting from these large commercial market participants, proposed regulation 20.4 could provide visibility into the majority of paired swaps trading activity without burdening commercial entities that may have less experience with compliance and reporting requirements stemming from the regulation of financial institutions.[17]

The above-quoted passage appears to reflect an intent by the Commission to create a new subcategory of swap dealers/Commercial Firms that would fall within this definition. However, the Working Group respectfully submits that this interpretation (i) highlights the uncertainty associated with any attempt to implement the definition of Reporting Entity in advance of a final rule issued by the CFTC and SEC further defining the term "swap dealer," and (ii) raises several questions associated with the use of new, undefined phrases, including, but not limited to, the following:

- Is it the Commission's intention to regulate all large commercial swap market participants as "swap dealers" and, if so, on what basis?[18]

- What does the phrase "provide risk management services to other commercial entities in the normal course of business" actually mean?[19]

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[17] *Proposed Transitional Reports Rule* at 67,262.

[18] The *Proposed Transitional Reports Rule* appears to create a presumption that large commercial swap market participants have sophisticated and integrated physical and swap trading operations and are "swap dealers." The *Proposed Transitional Reports Rule*, however, provides no basis for such an interpretation.

[19] For example, does this phrase relate in any way to the activities of Commercial Firms in physical energy markets where they may provide asset management services or other services pursuant to the terms of energy management services agreements? Substantially all of these activities relate to the operation and optimization of physical assets and physical commodity portfolios in physical energy markets. In addition, periodically, Commercial Firms will enter into swaps with customers to whom they deliver physical energy commodities. This activity is inextricably intertwined with their physical business. The counterparties to such swaps often view the swaps as a hedge and Commercial Firms' motivation for entering into such swaps can be hedging or entering into a speculative position at a favorable price. Given (i) the limited nature and direct correlation with Commercial Firms' physical trading activities and (ii) the fact that the counterparties are not "price neutral," the Working Group submits that Commercial Firms entering into such transactions are not engaging in activities commonly viewed as swap dealing.

- Is the Commission intentionally creating a distinction between a large commercial firm and an end-user (which are generally viewed to be one-and-the-same) and, if so, what is the basis for such a distinction?[20]

- What does the Commission mean by the phrase "commercial end-users with swaps activities of limited scope?"

Without further clarification or guidance addressing these questions, the Commission's stated interpretation of the definition of Reporting Entity in the *Proposed Transitional Reports Rule* is overly broad.

b. Swap and Swaption.

The definitions of "swap" and "swaption" in proposed CFTC Rule 20.1 appear to preempt the pending joint CFTC/SEC rulemaking further defining the statutory definition of the term "swap" set forth in new CEA Section 1a(47). The Working Group is concerned that adoption of these definitions in advance of a final rule issued by the CFTC and SEC further defining the term "swap" will create uncertainty regarding the universe of transactions that would be subject to the requirements of the *Proposed Transitional Reports Rule*. Specifically, the Working Group is concerned that these definitions are intended to cover transactions that would otherwise should be excluded from the definition of "swap" under new CEA Section 1a(47)(B)(ii).[21]

This concern is highlighted by the definition of "swaption" in proposed CFTC Rule Section 20.1. "Swaption" is a subset of the definition of swap and includes an "option to enter into a swap or *a physical commodity option included in the definition of "swap" under Section 1a of the Commodity Exchange Act ("CEA") or CFTC definitional regulations adopted thereunder*." (Emphasis added). The direct inclusion of physical commodity options in the definition of "swaption" and implied inclusion of these transactions in the definition of "swap" in new CEA Section 1(a)(47) is a clear and significant departure from existing CFTC interpretations of the forward contract exclusion under CEA Section 1a(19) and the basic trade

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20 If the Commission is making such a distinction, the *Proposed Transitional Reports Rule* does not provide a reasoned basis for this distinction.

21 CEA Section 1a(47)(B)(ii) excludes from the statutory definition of "swap" all transactions that are "intended to be physically settled." As noted in the Working Group's *Definition ANOPR* comments addressing the definition of "swap," many physical delivery forwards executed in energy markets contain elements of options or actual options within the contract, including options on the quantity to be delivered, price or delivery point. Such physical delivery forwards should be treated as single contracts and not as separate contracts or options. Such treatment is consistent with both Supreme Court precedent treating "contract[s] as a whole, not individual portions piece-by-piece" and CFTC precedent "evaluating the complete transaction when considering forward contracts that contain elements of options." Accordingly, because physical energy delivery options, like physical delivery forwards, are entered into with the intent that such option contracts will physically settle, they should be treated as a single integrated contract and not as "swaptions" as defined in proposed Section 20.1 of the CFTC's regulations. The Working Group's *Definition ANOPR* comments addressing the definition of "swap" are attached hereto as Appendix A and incorporated by reference.

option exemption set forth in CFTC Rule 32.4.[22] The Commission does not provide a reasoned basis for this departure from long-standing and well-established CFTC precedent and guidance.[23]

2. **PAIRING OF ECONOMICALLY EQUIVALENT CONTRACTS.**

The *Proposed Transitional Reports Rule* introduces the concept of "Paired Swaps" [24] in an effort to gather information necessary for the Commission to impose aggregate position limits on economically equivalent contracts under new CEA Section 4a(a)(5). The determination of economic equivalence between non-identical contracts is a complex undertaking. The Working Group is concerned that the examples of economically equivalent contracts set forth in the *Proposed Transitional Reports Rule*, and the definition of "Paired Swaps" in proposed Section 20.1 fail to appropriately capture the concept of economic equivalence.

Of particular concern is the CFTC's inclusion of swaps based on the same commodity with delivery "locations with substantially the same supply and demand fundamentals as that of a commodity futures contract listed in §20.2." An example provided by the Commission in the preamble to the *Proposed Transitional Reports Rule* suggests that two natural gas delivery locations, Transco Zone 6 and Henry Hub, have substantially the same supply and demand fundamentals.[25]

Based on the Working Group's analysis of the returns at each delivery location based on the daily spot prices from 2005 to the present, these two locations show some periods of high correlation; however, there are significant periods of stress during which the correlations dramatically break down (*e.g.*, constrained transport or weather events).[26] During these outlier events, there is a significantly greater need for managing risk exposures by location. "Pairing" contracts at locations and constraining positions under the same position limits may have negative consequences during stressful scenarios.

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22 17 C.F.R. § 32.4 (2010). Under Section 32.4, an option is generally exempt from CFTC oversight if it is offered to the "producer, processor, or commercial user of, or a merchant handling, the commodity, who enters into the commodity option transaction solely for purposes related to its business as such."

23 The Commission and Congress have clearly recognized both the importance and unique characteristics of certain forwards and options transactions, particularly as these transactions relate to energy commodities. *See* Statutory Interpretation Concerning Forward Transactions, 55 Fed. Reg. 39,188-92 (Sept. 25, 1990), reprinted at [1990-1992 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 24,925. Energy markets are unique in that they are inextricably intertwined with a physical market structure which provides the capability for market participants to make and take delivery of a transaction's underlying commodity. *See* the Working Group's *Definition ANOPR* comments addressing the definition of "swap," attached hereto as Appendix A. Various forms of transactions are routinely executed in physical energy markets, including physical delivery forwards and physical delivery options on energy commodities. *Id.* These transactions are critical for energy companies and consumers of energy commodities to make or take physical delivery of energy commodities and to manage various commodity risks. *Id.*

24 Proposed CFTC Rule 20.1.

25 *Proposed Transitional Reports Rule* at 67,261.

26 *See* Appendix B (attached hereto).

The Working Group respectfully submits that the Commission should undertake a thorough analysis of the economic equivalency of any potential Paired Swaps, especially during periods of stress, before implementing any of the data collection in the *Proposed Transitional Reports Rule*. In doing so, the Commission should establish some correlative standard or measurement for pairing swaps, rather than simply pairing unrelated swaps based on arbitrary considerations, such as delivery location. In this regard, the Working Group submits that the mere fact that power generation, natural gas, coal or oil production facilities are interconnected due to the existence of transmission, pipeline or rail networks does not, in and of itself, make all locations economically equivalent.

3. FORM AND MANNER OF REPORTING.

Proposed CFTC Rule 20.7(a) states that the Commission will specify, in writing to persons required to report, the format, coding structure, and electronic data transmission procedures for these reports and submissions.[27] The stated purpose of Rule 20.7(a) is to provide notice on how the Commission will determine the means by which position reports for physical commodity swaps are to be formatted and submitted.[28]

The form and manner of reporting is as significant as the actual substantive data being sought by the Commission pursuant to this proposal. However, proposed Rule 20.7 suggests that the Commission will unilaterally, without providing stakeholders an opportunity to comment, decide in what form and in what manner the required information should be submitted. The formatting, coding structure and electronic data submission requirements established by the Commission will have material cost and timing implications for Reporting Entities subject to the requirements of the *Proposed Transitional Reports Rule*. Accordingly, the Commission should specify in this proceeding its proposed format, coding structure, and electronic data transmission procedures and provide interested parties an opportunity for comment. Given the commercially sensitive nature of the information to be submitted under the *Proposed Transitional Reports Rule*, interested parties should also be provided the opportunity to comment on how the Commission plans to protect such data from disclosure.

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27 *Proposed Transitional Reports Rule* at 67,263.

28 *Id.*

IV. **CONCLUSION.**

The Working Group supports tailored regulation that brings transparency and stability to the energy swap markets in the United States. We appreciate the balance the CFTC must strike between effective regulation and not hindering the energy swap markets. The Working Group respectfully submits that the Commission consider its comments set forth herein regarding the *Proposed Transitional Reports Rule*.

If you have any questions, or if we may be of further assistance, please contact the undersigned.

Respectfully submitted,

/s/ R. Michael Sweeney, Jr._
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APPENDIX A

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September 20, 2010

David A. Stawick, Secretary
Commodity Futures Trading Commission
Three Lafayette Center
1155 21st Street, NW
Washington, DC 20581

VIA ELECTRONIC MAIL

Re: *Definitions and Required Rulemakings Contained in Title VII of Dodd-Frank Wall Street Reform and Consumer Protection Act - Definition of Swap*

Dear Secretary Stawick:

I. INTRODUCTION.

On behalf of the Working Group of Commercial Energy Firms (the "Working Group"), Hunton & Williams LLP respectfully submits this letter in response to the Advanced Notice of Proposed Rulemaking jointly issued by the Commodity Futures Trading Commission ("CFTC") and the Securities and Exchange Commission ("SEC") (collectively, the "Commissions") published in the *Federal Register* on August 20, 2010, concerning the further definition of certain key terms (specifically "Swap," "Security-Based Swap," "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant," "Eligible Contract Participant," and "Security-Based Swap Agreement").[1]

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 energy producers, marketers and utilities. The Working Group considers and responds to requests for public comment regarding legislative and regulatory developments with respect to the trading of energy commodities, including derivatives and other contracts that reference energy commodities.

[1] Definitions Contained in Title VII of Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, 75 Fed. Reg. 51,429 (Aug. 20, 2010) ("ANOPR").

The comments herein specifically address the definition of "Swap" set forth in new Section 1a(47) of the Commodity Exchange Act (the "CEA") as adopted in Title VII, Subtitle A, Section 721(a) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act"), and in particular the exclusion from the definition of "Swap" of contracts for the "sale of a nonfinancial commodity…for deferred shipment or delivery, so long as the transaction is intended to be physically settled," (the "Physical Delivery Exclusion").[2] The Working Group appreciates the opportunity to submit these comments in response to the ANOPR and looks forward to working with the Commissions to further define the term "Swap" as part of the formal rulemaking process for implementing this and other key definitions contained in Title VII.

II. EXECUTIVE SUMMARY.

Physical delivery transactions in energy commodities, such as physical delivery forwards and physical delivery options, should be excluded from the definition of Swap under the Physical Delivery Exclusion.

The term Swap should be defined in a manner that is consistent with the forward contract exclusion in the CEA.[3] In addition, the definition of Swap should not include options on the physical delivery of a commodity. Physical delivery forwards that contain elements of options or embedded options should be considered one contract, the characterization of which should be a physical delivery forward.

In addition, physical delivery forwards and physical delivery options in "environmental commodities" should be excluded from the definition of Swap under the Physical Delivery Exclusion.

Finally, the definition of Swap should include documents commonly understood by the markets to constitute an entire Swap contract. However, documents not considered by the market as part of such contract should be excluded from the definition of Swap.

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2 New CEA Section 1a(47)(B)(ii).

3 *See* CEA Section 1a(19), 7 U.S.C. § 1a(19) and 17 C.F.R. § 32.4, respectively.

III. COMMENTS OF THE WORKING GROUP OF COMMERCIAL ENERGY FIRMS.

A. GENERAL COMMENTS.

Title VII of the Act grants the Commissions jurisdiction to oversee and regulate the over-the-counter ("OTC") derivatives markets. Congress imposed such oversight and regulation to, among other things, "mitigate cost and risks to taxpayers and the financial system."[4]

The instruments over which the CFTC has jurisdiction pursuant to the Act are Swaps. New Section 1a(47) of the CEA sets forth a broad and inclusive definition of Swap that captures a substantial portion of OTC derivatives, including many energy-based derivatives. The definition of Swap includes, among other things, any agreement:

> "(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 one 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; . . .
>
> "(iv) that is, or in the future becomes, commonly known to the trade as a swap; . . . [or]
>
> "(vi) that is any combination or permutation of, or option on, any agreement, contract, or transaction described in any of clauses (i) through (v)."[5]

New Section 1a(47) of the CEA excludes several things from the definition of Swap, including futures and securities. The Physical Delivery Exclusion from the definition of Swap covers contracts for the "sale of a nonfinancial commodity . . . for deferred shipment or delivery, so long as the transaction is intended to be physically settled." As discussed below, this exclusion is analogous to the definition in CEA Section 1a(19) for "future delivery"[6] that is commonly known as the "forward contract exclusion."

Energy markets rely on a number of forms of transactions that are intended to be physically settled, including physical delivery forwards and physical delivery options on energy commodities. These transactions are not speculative in nature. On the contrary, such transactions are critical for energy companies and consumers of energy commodities to make or take physical delivery of energy commodities and to manage various commodity risks. The imposition of Title VII of the Act's regulatory requirements upon these transactions will

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4 S. Rep. No. 111-176, at 92 (2010).

5 New CEA Section 1a(47)(A).

6 "(19) Future delivery - The term "future delivery" does not include any sale of any cash commodity for deferred shipment or delivery." 7 U.S.C. § 1a(19).

hinder the efficient operation of energy markets, which is a perverse result as these transactions do not pose systemic risk to the financial system of the United States.

Physical delivery transactions in the energy markets, whether forward transactions or options to deliver a physical commodity, do not, by structure and design, require the same type of regulation as do OTC derivatives transactions in securities, interest rates or other financial markets. The energy markets are unique and tied to a physical market structure, where the participants have the capability to make and take delivery of the transactions' underlying commodities. Further, in some cases, the physical market and its participants are already subject to robust regulatory oversight, operational controls, and mandatory reliability guidelines. Any additional regulation by the CFTC will be at best duplicative and at worst contradictory. Such regulation might make transacting in these markets overly complex, imposing an unnecessary regulatory burden on energy market participants, possibly leading to higher costs for consumers.

The CFTC and Congress have previously recognized both the importance and unique characteristics of certain forwards and options transactions related to energy commodities.[7] It is critical that the Commissions continue such recognition and clarify that physical delivery forwards and physical delivery options on energy commodities are "intended to be physically settled" and within the Physical Delivery Exclusion.

Separately, the definition of Swap should not include transactions taking place in organized wholesale energy markets administered by regional transmission organizations or independent system operators pursuant to the terms and conditions of tariffs, market rules, or other rate schedules approved by, and on file with, the Federal Energy Regulatory Commission ("FERC") or state regulatory agencies, such as the Public Utility Commission of Texas ("PUCT"). In addition, the Commissions should clarify that forward and option transactions involving instruments such as greenhouse gas emission allowances and offset credits and renewable energy certificates are not Swaps.

B. <u>PHYSICAL DELIVERY FORWARDS</u>.

The Commissions should issue guidance that the Physical Delivery Exclusion covers forward contracts that contain an obligation for physical delivery of a commodity. Under current law, physical delivery forwards are distinguished from futures. Physical delivery forwards should be distinguished from Swaps under identical standards.

Congress intended the application of the Physical Delivery Exclusion "be consistent with the forward contract exclusion that is currently in the Commodity Exchange Act and the CFTC's established policy and orders on this subject, including situations where commercial

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7 *See* Statutory Interpretation Concerning Forward Transactions, 55 Fed. Reg. 39,188-92 (Sept. 25, 1990), reprinted at [1990-1992 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 24,925.

parties agree to 'book-out' their physical delivery obligations under a forward contract."[8] There is no policy rationale to afford different legal treatment of physical delivery forwards under the forward contract exclusion and the Physical Delivery Exclusion. Having separate standards will only add unnecessary confusion to the markets.

Congress intended to apply, and the CFTC and courts have applied, the forward contract exclusion under CEA Section 1a(19) to "private commercial merchandising transactions which create enforceable obligations to deliver but in which delivery is deferred for reasons of commercial convenience or necessity."[9] Transactions such as these involve two parties in the commercial marketing chain seeking to reduce the risks and costs associated with transacting in the underlying commodity. Each party likely is trying to minimize risk associated with a physical exposure. These transactions ensure the efficient delivery of nonfinancial commodities to companies that require them to conduct their core business. Physical delivery forwards thus, do not pose a systemic risk or offer any other basis for the application of the comprehensive regulatory regime for Swaps established under Title VII of the Act.

The Seventh Circuit Court of Appeals in *Nagel v. ADM Investor Services Inc.*[10] set out a test for distinguishing between forward contracts and futures contracts. A forward contract has all of the following indicia:

- unique terms for place of delivery, quantity and other terms such that the contract is not fungible with other contracts for the sale of the referenced commodities. (This indicia is not present when one party agrees to enter into an opposite, offsetting transaction if requested.)

- contract is between industry participants, and not arbitrageurs or speculators that are primarily interested in the value of the contract and not the delivery of the underlying commodity.

- delivery of the reference commodity cannot be deferred indefinitely.

The Commissions should provide guidance that physical delivery forwards that come within this test are not Swaps.

Furthermore, the Commissions should define the Physical Delivery Exclusion as applying to any trading contract that meets the criteria for the CFTC's Energy Forward

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8 *See* Letter from Sen. Dodd, Chairman, Committee on Banking, Housing, and Urban Affairs and Sen. Lincoln, Chairman, Committee on Agriculture, Nutrition, and Forestry to Rep. Frank, Chairman, Committee on Financial Services, and Rep. Peterson, Chairman, Committee on Agriculture (June 30, 2010).

9 *See* Statutory Interpretation Concerning Forward Transactions *supra* note 6, at 39,190.

10 217 F.3d 436, 441 (7th Cir. 2000).

Exemption. Prior to the Commodity Futures Modernization Act of 2000, the CFTC, pursuant to a 1993 order for exemptive relief, created a limited exemption from the CEA for certain forward contracts referencing energy commodities (the "Energy Forward Exemption").[11] The exemption applied to contracts for the purchase and sale of "crude oil, condensates, natural gas, natural gas liquids, or their derivatives which are used primarily as an energy source." In addition, eligible contracts must:

- be entered into by persons reasonably believed to be within a specified class of commercial entities that incur risks, in addition to price risk, related to the underlying commodity and have the capacity or ability to make or take delivery of the underlying commodity;[12]
- be bilateral contracts between parties acting as principals, the principal economic terms of which are subject to individual negotiation;[13] and
- impose binding obligations on the parties to make and receive delivery of the underlying commodity, with no right to effect a cash settlement of their obligations without the consent of the other party, except pursuant to a *bona fide* termination right (such as upon default).[14]

Parties that enter into such forward contracts may enter into subsequent cancellation or "book-out" agreements providing for settlement other than by physical delivery.[15]

The exclusion of forward contracts from the CEA is integral to the efficient operation of energy markets.[16] For example, physical delivery forward transactions in power markets,

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[11] 58 Fed. Reg. 21,286 (Apr. 20, 1993).

[12] The CFTC recognized that contracts subject to the Energy Forward Exemption gave the counterparties the substantial economic risk of a commercial cash market transaction in which delivery of the product is required. 58 Fed. Reg. 21,286, 21,293.

[13] Such contracts would include the following types of standardized trading contracts: The Master Power Purchase and Sale Agreement (the EEI Master), the WSPP Agreement; the LEAP Master Agreement for Purchasing and Selling Refined Products and Crude Oil; the ISDA Oil Annex; the ISDA Power Annex and the ISDA Gas Annex; the Base Contract for Sale and Purchase of Natural Gas (the NAESB Agreement); the Base Contract for Short-Term Sale and Purchase of Natural Gas (the GISB Agreement); the Midcontinent Association Capacity and Energy Tariff; the ERCOT Electricity Enabling Agreement; the ACORE/ABA Master Renewable Energy Certificate Purchase and Sale Agreement; and any other master agreement or transaction entered into under any market-based rate tariff or cost-based tariff.

[14] 58 Fed. Reg. 21,286, 21,294.

[15] *Id.*

[16] The CFTC, in creating the Energy Forward Exemption, found the exemption to be in the public interest as reducing legal uncertainty and allowing market participants to negotiate and structure contracts for energy commodities in ways that most effectively meet their economic needs, and thereby enhancing the global competitiveness of U.S. businesses. 58 Fed. Reg. 21,286, 21,292.

including those that are "booked out," are essential to cost-effective delivery scheduling, and their regulation as futures or Swaps would substantially limit their utility. A power producer may enter into a year-long contract with a counterparty to provide a certain amount of power over the duration of the contract. However, demand variability may lead the producer to purchase power from that counterparty during the term of their contract. Instead of the inefficient outcome of both parties delivering power, the two transactions are netted, yielding one transaction and one delivery of power. If there are price differences between the two trades, then they are settled in a manner similar to the financial settlement of the first transaction.

The regulation of physical delivery forwards that financially settle as Swaps would impose a regulatory burden on the efficient operation of energy markets comparable to the burden imposed by the regulation of such transactions as futures. Such regulation may also lead to inefficiencies in energy markets as commercial energy firms engage in duplicative transactions with redundant delivery obligations in order to avoid transactions being regulated as Swaps.

In accordance with the Congressional intent regarding the exclusion of transactions "intended to be physically settled" from the definition of Swap and the Congressional intent and policy rationale underlying the CEA's current forward contract exclusion, the Commissions should clearly define the Physical Delivery Exclusion to include, among other things, all contracts currently covered by the CEA's forward contract exclusion and the Energy Forward Exemption.

C. PHYSICAL DELIVERY OPTIONS FOR ENERGY COMMODITIES.

The Commissions should exclude from the definition of Swap all option contracts that contain an obligation for the physical delivery of a commodity. Like physical delivery forwards, parties entering into physical delivery options have the requisite intent for the Physical Delivery Exclusion as the parties intend that such option contracts will physically settle.

Physical delivery options and physical delivery forwards, for purposes of the Physical Delivery Exclusion, are analogous. They are both entered into to mitigate the price and supply risks associated with a core business in nonfinancial commodities. The material difference between a forward and an option is that, in an option contract, one party (the option holder) is not obligated to exercise its right. This difference is not sufficient to distinguish such options from forwards for purposes of the Physical Delivery Exclusion. At their core, physical delivery forwards and physical delivery options involve the sale of a physical commodity. Moreover, as each transaction relates to, and is bounded by, the physical markets for energy commodities, they pose no systemic risk.

Physical delivery options are commonly used in the energy market to mitigate price and volume risks. For example, participants in natural gas markets enter into puts and calls on the price of natural gas to ensure a degree of price stability or to ensure the availability of energy commodities to address variable demand.

Exclusion of physical delivery options through the Physical Delivery Exclusion would be "consistent" with the current forward contract exclusion and, thus, Congressional intent to exclude physically settled transactions from the definition of Swap. As noted above, physical delivery options and physical delivery forwards are both used to mitigate underlying risks and allow delivery of nonfinancial commodities to occur in a cost-efficient manner. In addition, like physical delivery forwards, physical delivery options between commercial entities generally are not regulated as futures under the CEA.[17] Therefore, to ensure the continuing efficient operation of markets in nonfinancial commodities, such as energy markets, the Working Group respectfully requests that the Commissions clearly exclude physical delivery options from the definition of Swap in new CEA Section 1a(47), as transactions in nonfinancial commodities that are "intended to be physically settled."

The CFTC has long recognized the value and unique nature of physical delivery options in commodity markets. When the trading of options on commodities was banned in the 1970s, Congress and the CFTC provided the "trade option exemption" found in CFTC Regulation 32.4. CFTC Regulation 32.4 exempts off-exchange options on commodities (other than certain enumerated agricultural commodities) that are "offered by a person which has a reasonable basis to believe that the option is offered to a producer, processor or commercial user of . . . the commodity . . . and such [person] is offered or enters into the commodity option transactions solely for purposes related to its business as such." This description of an option transaction generally describes physical delivery options as used in the energy markets. In creating the trade option exemption for certain commodities, the CFTC recognized the value of such options in the operation of cash markets. As there was no need to regulate physical delivery options as futures prior to the passage of the Act, there exists no policy reason to regulate such options as Swaps.

D. Embedded Options in Physical Delivery Forwards.

Many physical delivery forwards contain elements of options or actual options within the contract, including options on the quantity to be delivered, price or delivery point. The Commissions should treat such physical delivery forwards as single contracts that are physical delivery forwards and not as separate contracts or options.

Market participants, such as commercial energy firms, frequently enter into physical delivery forwards that contain elements of options or options. For example, in a day-ahead shapeable call option, an electricity provider will enter into a contract for a specific amount of energy with an embedded option to purchase additional energy in the event that demand

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17 Privately negotiated physical delivery options on nonfinancial commodities between Eligible Contract Participants are exempt from most provisions of the CEA under Sections 2(g) and 2(h)(1) of the CEA.

outstrips expectations. Such contracts are essential to the efficient delivery of energy. Contracts with embedded options, such as day-ahead shapeable call options should be considered single contracts by the Commissions. This treatment is consistent with both Supreme Court precedent treating "contract[s] as a whole, not individual portions piece-by-piece"[18] and CFTC precedent "evaluating the complete transaction when considering forward contracts that contain elements of options."[19] Another example is that commercial energy firms sometimes include a "trigger price" option in physical delivery natural gas contracts, whereby a counterparty may elect to exercise a "trigger price" option to purchase natural gas under the contract at a fixed price as opposed to an index price.

When assessing the character of a physical delivery forward with an embedded option, the Commissions should again evaluate the complete transaction.[20] The primary purpose of the parties to such a contract is to enter into a transaction that creates an enforceable delivery obligation for power on a certain date. The inclusion of the option to purchase additional energy adds an additional risk mitigation tool to the transaction. It does not change the characterization of the contract from a physical delivery forward to an option. Accordingly, like other physical delivery forwards, a physical delivery forward with embedded options should be covered by the Physical Delivery Exclusion.

E. <u>TRANSACTIONS IN CERTAIN REGULATED MARKETS</u>.

The CFTC should clarify that the definition of Swap excludes any transactions in organized markets regulated by FERC or state regulatory agencies, such as the PUCT.

These transactions are not associated with systemic risk. There is comprehensive regulation and oversight of all transactions taking place in organized wholesale energy markets administered by regional transmission organizations or independent system operators pursuant to the terms and conditions of tariffs, market rules, or other rate schedules approved by, and on file with the FERC or state regulatory agencies, such as the PUCT. Pursuant to the terms and credit provisions in their respective tariffs or market rules, regional transmission

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18 *See In re Cargill, Inc.*, Comm. Fut. L. Rep. (CCH) ¶ 28,425, n.47, *citing Mastrobuono v. Shearson Lehman Hutton, Inc.*, 514 U.S. 52, 59 (1995) (quoting Restatement (Second) of Contracts § 202(2) (1979)).

19 *See 1985 Interpretative Statement*, ¶ 22,718 at 31,029-31 (the Commission's General Counsel finds minimum price contacts to be forward and spot contracts even though they each contained the element of a "cash settled put option"); *CFTC Interpretative Letter No. 96-23*, [1994-1996 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 26,646 at 43,697-98 (CFTC Mar. 14, 1996) (Commission's Division of Economic Analysis considering contract "in its entirety," regarded "producer option contract" as a forward contract, although it contained provisions whereby the elevator buys an exchange-traded call option for the benefit of the producer); *CFTC Interpretative Letter No. 98-13*, [1996-1998 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 27,264 at 46,152-53 (CFTC Dec. 3, 1997) (Division of Economic Analysis viewed contract that establishes a minimum and maximum price and "includes characteristics of an option" to be a forward contract "based upon the nature of the instrument as a whole.")

20 *See In re Cargill, Inc.*, n.47, citing *1985 Interpretative Statement*, at 31,029-31.

organizations and independent system operators currently function as clearinghouses governing the operation of wholesale markets subject to their respective jurisdictions.

The CFTC should afford the same degree of deference to transactions in FERC or other organized markets, such as the PUCT, as is afforded securities and certain other derivatives in the definition of Swap. Although the definition of Swap is wide in scope, the definition excludes certain instruments that are already regulated. For example, the exclusions from the definition of Swap includes securities and derivatives regulated under the Securities Act of 1933 and the Securities Exchange Act of 1934, as well as certain foreign exchange transactions executed on regulated exchanges. Section 722 of the Act clarifies that both FERC and state regulatory agencies, such as the PUCT, maintain jurisdiction over their organized markets and transactions in those markets. Thus, the CFTC would be acting consistently with the intent of Congress in excluding transactions in FERC or other organized markets, such as the PUCT, from the definition of Swap as instruments already subject to pervasive regulation.

In addition, Congress gave the CFTC the authority to work with FERC in addressing the regulation of transactions in FERC-organized markets. Addressing the status of such transactions could be part of the memorandum of understanding between the CFTC and FERC required by Section 720 of the Act. Moreover, Section 722 of the Act explicitly provides the CFTC with statutory authority to exempt such transactions from the definition of Swap.

F. CONTRACTS FOR ENVIRONMENTAL COMMODITIES.

The CFTC should clarify that forward contracts and options for environmental commodities such as compliance and voluntary greenhouse gas emission allowances and offset credits and renewable energy certificates are not Swaps. The efficient trading of such "environmental commodities" is important for national and state policy objectives. For example, these transactions are inextricably intertwined with well functioning markets in renewable energy. The transfer of emission allowances and offset credits and other "environmental commodities" is of critical importance to energy companies as they meet environmental compliance and other regulatory requirements. In each case, the settlement of such contracts is accomplished by physical delivery as title to a commodity is passed from one counterparty to the other.

However, for purposes of the Physical Delivery Exclusion, the Commissions should issue regulations that afford physical delivery forwards and physical delivery options on such "environmental commodities" the same regulatory treatment as contracts referencing excluded commodities, such as energy commodities.

G. INTERPRETATIONAL CONCERNS WITH "INTENDED TO BE PHYSICALLY SETTLED."

In establishing what constitutes intent under the Physical Delivery Exclusion, the Commissions should consider the totality of the circumstances that are commonly analyzed with respect to the forward contract exclusion. A narrower analysis focused only on the specific intent of the parties raises numerous issues in practical application. For example:

(1) Which party must hold the requisite intent? Is it the intent of both parties, or is the intent of one party sufficient? What if one party is indifferent and does not have an intent as to the type of settlement (or will decide the settlement method closer to the delivery date)? Is the requisite intent present if a party enters into an onward sale to a third party?

(2) At what point does the intent have to be present? Must the intent be present at the beginning of the contract term, or must the intent be maintained throughout the term of the contract?

(3) How do parties memorialize and establish the intent to physically settle? How does a party assure itself of its counterparty's intent?

(4) How do the parties account for change in circumstances that may change their intent during the contract term?

Legal uncertainty will exist in the energy and other nonfinancial commodity markets without guidance from the Commissions on how parties can establish the existence of the requisite intent for the Physical Delivery Exclusion. Transacting parties, based on the language of the Act alone, have no criteria on which to determine whether the requisite intent necessary to qualify under the Physical Delivery Exclusion has been established. This legal uncertainty will be a hindrance to the otherwise efficient markets for energy and other nonfinancial commodities.

The Commissions can promote legal certainty with respect to the Physical Delivery Exclusion by creating a presumption that such intent is present for certain contracts. A presumption, though not conclusive, will provide enough legal certainty for parties to continue to engage in such transactions efficiently and with certainty. The current treatment of the forward contract exclusion has worked well for commercial energy markets and has provided the CFTC with the appropriate level of flexibility and authority to prohibit transactions structured to avoid regulation as futures through abuse of the forward contract exclusion.[21]

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[21] *See In re MG Refining & Marketing, Inc.*, 1995 CFTC LEXIS 190, CFTC Docket no. 95-14, 1995 WL 447455*2, *6 (July 27, 1995).

The Working Group respectfully suggests that there should be a rebuttable presumption that parties entering into contracts that contain an enforceable obligation (contingent or otherwise) of one party to physically deliver a commodity have the necessary intent for the Physical Delivery Exclusion to apply to such contracts. An enforceable contractual provision is a legal obligation of a party to settle a transaction with physical delivery, which is strong evidence that the parties both contemplated, were capable of, and intended physical delivery. The act of providing for the enforceable right of physical delivery within the contract is a clear indication of the intent of the parties.

The presumption that contracts that contain a physical delivery obligation come within the Physical Delivery Exclusion should remain even if a contract contains an option for the parties to financially settle. This is consistent with the CFTC's current treatment of physical delivery forwards, which allows the application of the CEA's forward contract exclusion to transactions that permit cash settlement.[22] As discussed above, the nature of a contract should not be altered by terms providing optionality to a party, such as delivery place, delivery method, price or quantity.

H. DOCUMENTATION STANDARDS.

Swaps are commonly documented on standardized master agreements and confirmations. Traditionally, each transaction is considered to be documented under one contract, even though that contract may be represented by several writings. Congress recognized this in the definition of Swap. New CEA Section 1a(47)(C) states:

> "(i) IN GENERAL.—Except as provided in clause (ii), the term 'swap' includes a master agreement that provides for an agreement . . . that is a swap . . . together with each supplement to any master agreement . . .
>
> "(ii) EXCEPTION.—For purposes of clause (i), the master agreement shall be considered to be a swap only with respect to each agreement…covered by the master agreement that is a Swap."

The Working Group requests the Commissions, in further defining the term Swap, clarify that the phrase "supplement to" refers to documents such as schedules to master agreements, credit support annexes, and physical annexes that are understood by the markets to be part of a Swap contract. Certain documents that are not considered by the market as part of such contract should be excluded from the definition of Swap. Such documents include, but are not limited to, credit support agreements (to be distinguished from credit support annexes as they are provided by third parties) and master netting agreements. Although instrumental to the trading relationship between two parties, these are not integral to the core economic terms of any particular transaction and should be considered separate agreements.

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22 *See* Statutory Interpretation Concerning Forward Transactions at 39,191.

IV. CONCLUSION.

The Working Group appreciates this opportunity to comment, and requests that the Commissions consider these comments as it develops proposed rules or regulations further defining the term Swap. The Working Group looks forward to offering its views in response to the notice of proposed rulemaking addressing this definition.

Respectfully submitted,

/s/ R. Michael Sweeney, Jr.

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David T. McIndoe
Mark W. Menezes

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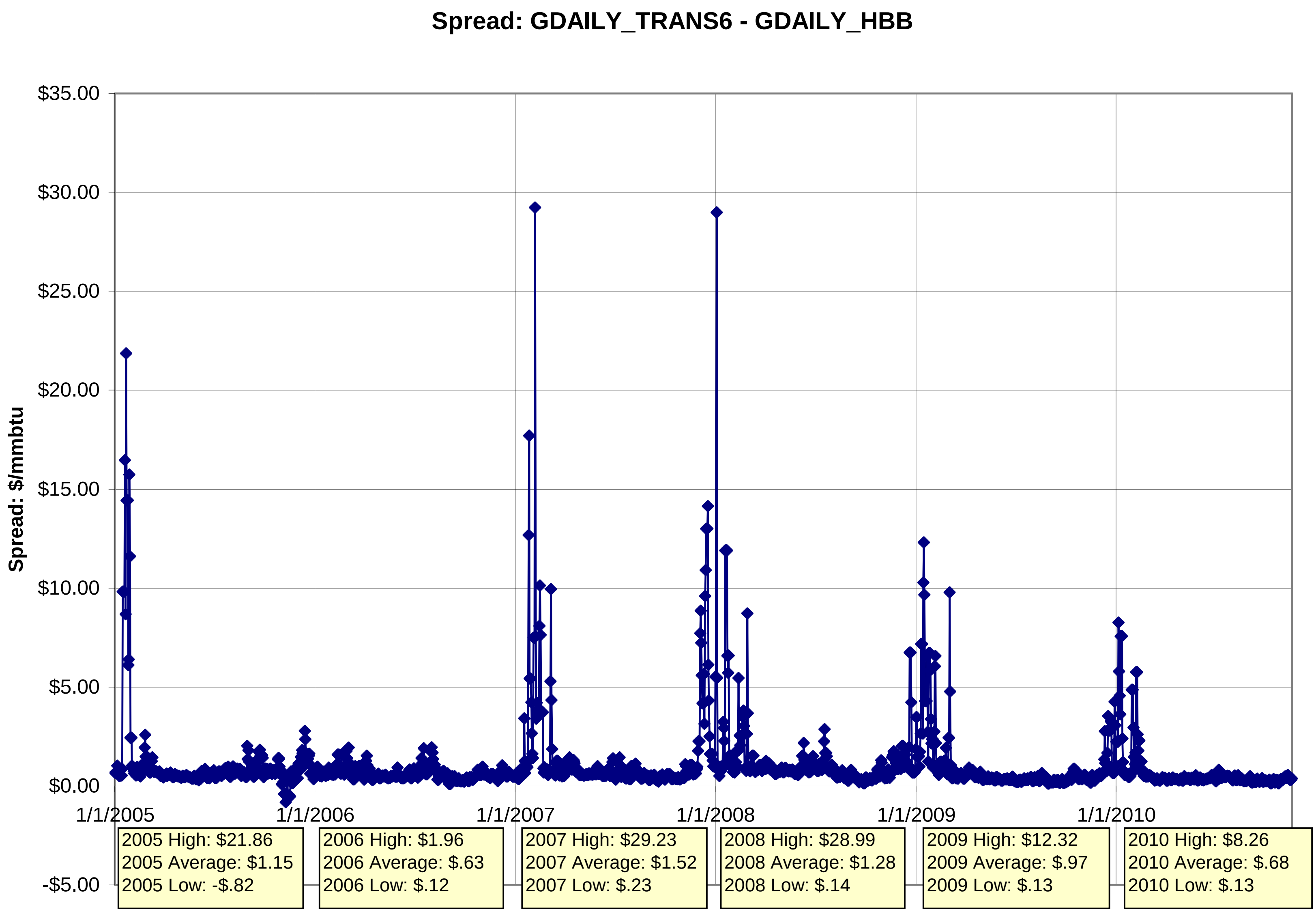
Working Group of Commercial Energy Firms

APPENDIX B



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2009 Low: $.13
2010 High: $8.26
2010 Average: $.68
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