FINAL

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June 26, 2012

Mr. David A. Stawick, Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, D.C. 20581
Telefacsimile: (202) 418-5521 and
Email to secretary@cftc.gov and electronically to http://comments.cftc.gov

Re: Comments of the International Energy Credit Association ("IECA") to Commodity Futures Trading Commission ("CFTC" or "Commission") Interim Final Rule ("IFR") respecting the "Trade Option Exemption" incorporated into the Final Rule on Commodity Options (17 CFR Part 32.3, RIN 3038-AD62, 77 Federal Register 25320, April 27, 2012) pursuant to Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("DFA")

Dear Mr. Stawick:

The Commission by the above-referenced IFR requests public comments on the Trade Option Exemption set forth in new Section 32.3 of the CFTC's regulations, which was incorporated into the Commission's Final Rule on Commodity Options. This letter responds to the IFR.

I. Introduction.

The International Energy Credit Association ("IECA") is not a lobbying group. Rather, we are an association of several hundred energy company credit management professionals grappling with credit-related issues in the energy industry. Our members' concerns regarding the DFA have led us, for the first time in our almost ninety-year history, to submit numerous comments to the Commission on its rule-makings under the DFA.

Correspondence with respect to these comments should be directed to the following individuals:

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II. Comments on the Interim Final Rule.

As discussed in more detail below, the IECA believes it is absolutely clear that Congress did not intend for Trade Options to be regulated as swaps. According to the Commission's proposed regulation on Trade Options, *i.e.*, section 32.3, certain DFA requirements applicable to swaps will nevertheless be applicable to commodity options that are "intended to be physically settled…." However, this directly conflicts with Congress's own wording in the DFA, which specifically excludes from the definition of swap "any sale of a nonfinancial commodity or security for deferred shipment or delivery, so long as the transaction is intended to be physically settled." The IECA is concerned with the Commission's willingness to go beyond this boundary set by Congress. Accordingly, the IECA respectfully requests that the Commission issue a final rule that excludes Trade Options from the DFA requirements applicable to swaps as mandated by Congress.

In addition, to the extent that Trade Options are subject to the CFTC's plenary jurisdiction under CEA Section 4c(b), the IECA's comments below include some alternate suggestions to minimize the costs and burdens that will result from the Commission's regulation of Trade Options. In this regard, the IECA suggests limiting section 32.3 to recordkeeping requirements and foregoing the intermittent, duplicative Form TO reporting requirement. If the Commission elects not to adopt this alternate suggestion, the IECA believes, at a minimum, that all market participants should be allowed to report their Trade Options using an annual Form TO filing. In addition, the Commission should adopt a threshold that would limit which entities are subject to the full part 45 reporting requirements due to their Trade Option activities. Finally, the comments below also respond to specific questions raised in the IFR.

A. Physically-settling nonfinancial commodity options (i.e., Trade Options) should not be defined as "swaps" under the DFA

In the IFR, the Commission provides "an exemption from certain swaps regulations for trade options on exempt and agricultural commodities as between commercial and sophisticated counterparties."[1] The IECA appreciates the efforts of the Commission to reinstate a "trade

[1] See 77 Fed. Reg. 25326.

option exemption" in new Part 32.3 of the Commission's Regulations, but the IECA believes the Commission is too constrained by its interpretation of the DFA and submits that the Commission could, and should, go further in providing this trade option exemption.

In the IFR, the Commission has said that "the final rule issued herein adopts the Commission's proposal to generally permit market participants to trade commodity options, which are statutorily defined as swaps, subject to the same rules applicable to every other swap. The interim final rule adopted herein includes a trade option exemption for physically delivered commodity options purchased by commercial users of the commodities underlying the options, subject to certain conditions."[2]

The Commission bases its final rule and IFR on Section 721 of the DFA, which added new section 1a(47) to the CEA, defining "swap" to include not only "any agreement, contract or transaction commonly known as," among other things "a commodity swap," but also "an option of any kind that is for the purchase or sale, or based on the value, of 1 or more … commodities."[3]

In Footnote 6 of its final rule and IFR, the Commission says that it "uses the term 'commodity options' to apply solely to commodity options not excluded from the swap definition set forth in CEA section 1a(47)(A), 7 U.S.C. 1a(47)(A)."[4] The Commission then describes the pending final rule defining a "swap," which is being developed jointly with the SEC, and says: "The final rule and interpretations that result from the Product Definitions NPRM will address the determination of whether a commodity option or a transaction with optionality is subject to the swap definition in the first instance. If a commodity option or a transaction with optionality is excluded from the scope of the swap definition, as further defined by the Commission and the SEC, the final rule and/or interim final rule adopted herein are not applicable."[5]

The IECA suggests that the Commission's interpretation of CEA §1a47 as including all options on physical commodities contains a fundamentally flawed statutory interpretation.

In this regard, CEA §1a47(A) defines the new statutory term "swap," and begins with the phrase: "<u>Except as provided in subparagraph [CEA §1a47](B)…". CEA 1a47(A)</u> then goes on to include in the statutorily defined term 'swap,' in CEA 1a47(A)(i), "any agreement, contract or transaction that is a put, call, cap, floor, collar or similar option of any kind that is for the purchase or sale … of 1 or more … commodities … ." In other words, §1a47(B) <u>takes precedence</u> over all of §1a47(A). CEA §1a47(B) begins with the phrase "The term "swap" does not include….and then CEA §1a47(B)(ii) provides "<u>any sale</u> of a nonfinancial commodity … for deferred shipment or delivery, so long as the transaction is <u>intended to be physically settled</u> … ." (emphasis supplied).

In other words, the statute clearly provides that if the parties to a deferred shipment or delivery transaction for a nonfinancial commodity intend to physically settle, then CEA section

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[2] See 77 Fed. Reg. 25321.
[3] Id.
[4] Id.
[5] See 77 Fed. Reg. 25321.

§1a47(B)(ii) trumps CEA §1a47(A)(i) and the CFTC was not given jurisdiction over such commodity options as "swaps." The Commission has plenary jurisdiction over such commodity options pursuant to CEA §4c and provisions of the CEA pre-dating DFA, but not as "swaps" pursuant to DFA.

This is consistent with Congress's intent: nonfinancial commodity option transactions are not exchanges of cash flows, nor did they have or present any risk of deleterious effect on the economy or contribute to the 2008 financial crisis. The DFA was not intended to give the CFTC new jurisdiction over the broad "real economy" world of nonfinancial commodities, as asserted by the Commission in its final rule and IFR, nor with the intent of imposing the new reporting obligations on Main Street end-users of nonfinancial commodities and nonfinancial commodity options, as done by the Commission.

Accordingly, the IECA submits that an option for deferred shipment or delivery of a nonfinancial commodity that is intended to be physically settled (a "Trade Option") can not be a swap under CEA sections 1a47(B)(ii) and 1a47(A)(i).

B. The Commission has not identified any practical uses for the Trade Option data that will be reported; such reporting requirements are in violation of the Paperwork Reduction Act; and the Commission should consider a complete reporting exemption for such data.

The Commission has acknowledged that it is in the public interest to not subject Trade Options to the full reporting requirements of Part 45. *See* 77 Fed. Reg. 25320, 25334. In addition, the Commission has concluded that "requiring full compliance with part 45's recordkeeping and reporting requirements by commercials would be *unnecessary* to achieve the desired and expected benefits of the interim final rule." *See* 77 Fed. Reg. 25333 (emphasis added).

In this regard, the Commission stated:

> [It] had a range of alternatives with respect to regulatory requirements applicable to trade option transactions. For commercials, the Commission considered alternatives ranging from requiring full compliance with part 45 to *no requirements in light of its special call authority to request and obtain information*.

See 77 Fed. Reg. 25333 (emphasis added). The Commission further stated:

> Given that one of the purposes of the Dodd-Frank Act is to increase market transparency and regulatory visibility into OTC markets, however, the Commission does not believe an exemption with no attendant *recordkeeping or reporting* requirements for commercials is a reasonable alternative.

See 77 Fed. Reg. 25333 (emphasis added).

As discussed above in Section II.A., the IECA believes that Trade Options were not intended by Congress to be "swaps" or to be subject to the Dodd-Frank Act's requirements applicable to swaps. However, if the Commission asserts jurisdiction over Trade Options, the IECA is not requesting that the Commission have "no attendant recordkeeping or reporting requirements." Rather, the IECA believes that it is sufficient for the Commission to adopt certain recordkeeping requirements and forego the onerous Part 45 reporting requirements altogether.

In addition, the Commission correctly points out in the final rule that the Commission is obligated to minimize the duplicative information collections across the government:

> [t]he purposes of the Paperwork Reduction Act of 1995, 44 U.S.C. 3501 et seq. (''PRA'') are, among other things, to minimize the paperwork burden to the private sector, ensure that any collection of information by a government agency is put to the greatest possible uses, **and minimize duplicative information collections across the government**.

See 77 Fed. Reg. 25337 (emphasis added). For electric utilities, a large portion of the trade option data requested to be collected is already being reported to the FERC and such data is readily available for this Commission's review. The Federal Trade Commission, the Energy Information Administration and other agencies collect other information on Trade Options. However, the IFR does not include any discussion on why these other agencies' data cannot be used to achieve the same result.

Accordingly, the IECA submits that the public interest and the Paperwork Reduction Act dictate that the Commission provide a complete exemption from reporting requirements for Trade Options.

Should a need arise in the future for the Commission to collect information on Trade Options, the Commission can amend the exemption and collect data specifically responsive to the articulated regulatory purpose.

C. In the alternative, no longer subject to the Part 45 reporting obligations applicable to swaps, because Trade Options are not swaps, all market participants should be allowed to submit Form TO on an annual basis to report their Trade Options.

To the extent that the Commission does require reporting of Trade Options despite the reasons discussed herein, the IECA believes that all market participants should be allowed to submit the Form TO on an annual basis.

We submit that Trade Options cannot be swaps, and therefore the full reporting requirements for swaps under Part 45 should not apply to Trade Options.

The IECA also recognizes, however, that with the DFA's repeal of the Commodity Futures Modernization Act (CFMA), and particularly the repeal of CEA sections 2(g) and 2(h)(1), which previously authorized commodity options in exempt commodities, such Trade

Options may yet remain subject to the Commission's pre-DFA jurisdiction, which could now prohibit such Trade Options as unauthorized commodity options.

The IECA is aware of the Commission's plenary authority under CEA section 4c(b). As the Commission stated in its proposed rule on commodity options: "Even before the Dodd-Frank Act, commodity options have been subject to the Commission's plenary authority under CEA section 4c(b). Based on that general prohibition of any option transactions contrary to any Commission rule, regulation or order prohibiting options, or allowing them under such conditions as the Commission may prescribe, the only options currently authorized under the CEA are those specifically provided for in the Commission's regulations."[6]

If that is the case, then the Commission's proposed Trade Option Exemption under Part 32.3 in the IFR may still be needed to allow offerors to continue to provide Trade Options to offerees that are "a producer, processor or commercial user of, or a merchant handling the commodity that is the subject of a commodity option transaction, or the products or byproducts thereof, and such offeree is offered or entering into the commodity option solely for purposes related to its business as such."[7]

Under the Trade Option reporting requirements set forth in the Trade Option Exemption under the IFR, certain trade option transactions will be reported on an annual basis in the Form TO, which only includes a high level summary of the entity's Trade Options. The IECA submits that if the annual Form TO information is sufficient for a non-SD/MSP reporting party to a Trade Option, then it is sufficient for all market participants entering into a Trade Option, including SDs and MSPs.

This approach will provide the Commission with consistent data set across all reporting entities which is necessary for the Commission to conduct any meaningful analysis.

We have seen the Federal Energy Regulatory Commission ("FERC") and other agencies use similar types of quarterly and annual reporting requirements, the ability to review books and records, and the jurisdiction to undertake enforcement investigations to effectively enforce its authority and investigate allegations of wrongdoing by generators and marketers selling power pursuant to negotiated bilateral agreements entered into under FERC's grant of market-based rate authorization.

The IECA submits that similar annual reporting requirements for Trade Options should be similarly adequate to achieve this Commission's legitimate purposes of protecting the Trade Options markets from fraud and market manipulation.

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[8] *See* 77 Fed. Reg. 25327 (emphasis added).

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D. A threshold limit should be applied to the Form TO.

If the Commission requires a non-SD/MSP counterparty to report Trade Options under Part 45, and the Commission continues to require the Form TO despite the concerns provided herein, there should be a *de minimus* threshold so that reporting a few "swaps" with other non-SD/MSPs under part 45 does not impact a company's ability to use the Form TO. As noted in the IFR, the Commission does not intend to require companies to implement "costly and time consuming" part 45 reporting systems solely due to their Trade Option activities. In this regard, the Commission stated:

> To the extent that neither counterparty to a trade option has previously submitted reports to an SDR as a result of its swap trading activities as described above, the Commission recognizes that requiring these entities to report trade options to an SDR under part 45 of the Commission's regulations *solely with respect to their trade options activity would be costly and time consuming*.[8]

In addition, the Commission stated: "[b]y taking this approach, the Commission ensures that no market participant is *compelled to comply with part 45's reporting requirements based solely on its trade options activity*."[9] Companies that agree to be the reporting party for a "swap" under the part 45 rules due to an unusual circumstance or on a limited basis are highly unlikely to implement a fully-functional part 45 reporting system for such circumstances. However, under the IFR, if a company reports a *single* "swap" in a calendar year, then it is prohibited from filing the next Form TO, and must report each of its Trade Options with other non-SD/MSPs thereafter under part 45.

As a result, to meet the Commission's stated goal of "ensur[ing] that no market participant is compelled to comply with part 45's reporting requirements based solely on its trade options activity," a threshold should be adopted into the Form TO reporting requirements. The IECA proposes the following rewording of regulatory text to accomplish the Commission's intent (proposed changes are redlined):

> "(2) For any counterparty that enters into [~~one or more~~] commodity options pursuant to § 32.3(a) and is a counterparty described in paragraph (b)(1) for 25 or fewer nonfinancial commodity "swaps" in a calendar year, or is not otherwise a counterparty described in paragraph (b)(1) of this section, file with the Commission by March 1 of the following year an ''Annual Notice Filing for Counterparties to Unreported Trade Options'' on Form TO, as set forth in Appendix A to this part, to be completed and submitted in accordance with the instructions thereto and as further directed by the Commission."

E. The Commission significantly underestimates the reporting burden and costs.

In the IFR, the Commission assumes incorrectly that "[w]ith respect to reporting, … the form prescribed by the Commission for annual reports will entail *some administrative and legal costs* for such commercials." *See* 77 Fed. Reg. 25333 (emphasis added). However, the costs

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[9] *Id.* at FN14 (emphasis added).

associated with reporting Trade Options will be much more than "some administrative costs," because the Trade Option data is distinctly different and generally maintained in different recordkeeping systems than transaction data for financial commodity swaps or transactions that are intended to settle financially.

To implement the annual reports, "commercials" that must now be reporting entities will likely have to expend resources to review and interpret all the Commission's new regulations for "swaps" and apply it to their nonfinancial business operations, hire new personnel with experience in financial markets rather than in the nonfinancial commodity transactions (including options) related to its commercial business, incur additional costs related to software changes, regulatory oversight, data collection and data review efforts. The IECA believes that the new data collection, monitoring, reconciling and reporting burden for commercial energy companies for the Form TO will be overly burdensome. For the entities that have to comply with the full requirements for part 45 for all Trade Options, these new regulatory costs will be exponentially higher for the same reasons and due to the tight reporting deadlines in part 45.

E. Responses to Specific Question Asked by the Commission in Section VI 2 a, b and d of the IFR.

The IECA would like to address the following questions specifically raised by the Commission in its request for comments in its IFR:

Commission Questions 2.a: *What types of entities offer Trade Options pursuant to the existing trade option exemption? Is the scope of the trade option exemption offeror requirement in the interim final rule (i.e. offerors must be ECPs or commercials) appropriate? Alternatively, is this offeror requirement either too broad or too narrow?*

The IECA is concerned that the CFTC has been too narrow in defining who may be a permitted offeror or offeree in the purchase or sale of a trade option.

Under the IFR, the Commission proposes to encompass sales arrangements that are common in the wholesale markets for sales of electricity and natural gas, which previously had been exempt from CFTC regulation. In order to maintain the reliability and stability of electric and natural gas service, participants in commercial markets involving these commodities need to maintain the current broad array of potential purchasers and sellers of their products which they currently enjoy.

Traditionally, a nonfinancial commodity put or call transaction for electric power has been linked to specific electric resources, and as to natural gas has been tied to specific pipeline delivery points, such that it would not be possible to strip out the option component of a transaction and trade it independently of the component of the transaction specifying terms for the purchase and sale of energy or natural gas. This inseparable linkage between an option and a concomitant right to deliver or purchase the linked nonfinancial commodity makes these sorts of options unsuitable for clearing on an exchange.

By way of example, in the electric industry, an owner of an electric generating unit might sell a call option to a utility company seeking to meet the variable electric demand of its fluctuating load. This call option would give the buyer rights to call for the unit to generate and deliver up to a specified amount of electric power at a specific delivery point during specified hours at a specified negotiated strike price. If the buyer exercises the option, the generator will generate and deliver the amount of energy called upon by the buyer.

This arrangement gives the generator fixed income for setting aside a portion of its generating capacity to stand ready to deliver to the buyer with call rights, and gives the call holder a committed source of energy which can be used to meet any anticipated increase in its fluctuating energy requirements.

Conversely, the generator may seek an assured market into which it can make sales at times of the generator's choosing. For example, the generator may plan to run tests of its facilities, and be uncertain what exact quantity the facility will generate during the test run, but will need to have a buyer ready to take whatever quantities the generator can produce during the testing process. In that case, the generator may seek to purchase put rights, under which the generator can "put" power to the buyer, and require the buyer to purchase whatever quantities up to some negotiated quantity that the generator produces over the time period designated in the confirmation memorializing the put transaction.

In the natural gas industry, a natural gas distribution utility may seek to have a source of supply standing ready to meet varying demand from consumers on its system, and contract with a natural gas marketer or producer to have a call right on quantities of natural gas at certain pipeline delivery points at a negotiated strike price. On the flip side, a natural gas producer or marketer may seek to "put" natural gas to a counterparty in circumstances in which the seller anticipates having surplus supply it needs to unload. Put rights may be critical to a natural gas producer, who may face damaging its producing reservoir or loss of its lease or other penalties if it shuts in wells for any length of time.

In many cases, both parties to a transaction involving a typical put or call option for deliveries of physical natural gas or electric power will be commercial users. But in some cases, the party requiring a put or call may not have contracts with, or be unable to negotiate an acceptable arrangement with another commercial entity in time to meet its pressing commercial need to arrange an option to either call for variable, intermittent supply or to put excess product to a buyer.

In those cases, the commercial entity needs to be able to turn to an ECP entity to meet its need to hedge this commercial risk. The ECP typically will have greater ability than the commercial user to step in and facilitate either a put or a call which is so inextricably linked to taking or delivering of a nonfinancial commodity. The ECP often has broad market reach and scope, and may be able to help the commercial entity reach a supply source or access a buyer not otherwise readily available to that entity.

Whether the commercial entity is the offeror or the offeree of a put or call, the commercial entity may need to transact with an ECP on the other side of the transaction in order

to hedge the commercial physical risk by assuring a needed supply source or market for his nonfinancial commodity requirements.

The Commission proposes in the IFR to define an eligible offeror as either (i) an eligible contract participant as defined in Section 1(a)(18) of the Commodity Exchange Act; or (ii) a producer, processor, or commercial user of, or a merchant handling, the commodity that is the subject of the commodity option transaction, or the products or by-products thereof, and such offeror is offering or entering into the commodity option transaction solely for purposes related to its business as such (a "Commercial User").

The Commission will further require the offeror to have a reasonable basis to believe that the transaction is offered to a Commercial User and further, that the commodity option must be intended to be physically settled, so that, if exercised, the option would result in the sale of an exempt or agricultural commodity for immediate or deferred shipment or delivery.

The Commission has limited an eligible offeree to a Commercial User.

To preserve maximum flexibility for a commercial user to meet its critical needs for flexible arrangements to meet its supply requirements and to manage occasional surpluses in its nonfinancial commodity delivery or production capability, the commercial entity needs to be able to turn to the strength and resources of an ECP, whether the commercial user is a buyer or a seller of a call or put option. The IECA suggests that to allow Commercial Users this flexibility in hedging commercial risks, the Commission define an eligible offeree in exactly the same manner as it has defined an eligible offeror.

To ensure that Trade Options do not involve ECPs on both sides of the option, with no linkage to a specific commercial risk involving the use of the linked nonfinancial commodity product, the Commission could address this concern with a provision that would disqualify options between two ECPs from the trade option exemption.

Commission Question 2.d: *Is the range of commodity option transactions that would qualify for the trade option exemption appropriate?*

i. *By requiring that a trade option, when exercised, must result in the immediate (spot) or deferred forward) shipment or delivery of an exempt or agricultural commodity, would the interim final rule improperly exclude other commodity option transactions, including other transactions with optionality, that should be eligible for a trade option exemption?*

ii. *ii. In the alternative, is this physical delivery requirement of the trade option exemption too broad?*

The IECA finds it challenging to comprehensively address these issues because the Commission has not yet defined the term "swap". Without this critical piece of information, IECA members will not know whether the trade option exemptions, as currently structured under

the interim rule, will be sufficient to allow them the commercial risk hedging tools required to meet their ongoing needs.

The linkage to physical settlement may be particularly troubling if the Commission subsequently defines a swap to include Congestion Revenue Rights (CRRs as currently traded in the ERCOT market), Financial Transmission Rights (FTRs as currently traded in the PJM market) and other similar rights. These products are essential commercial risk hedging tools for nonfinancial entities transacting in electric products in the "organized markets" managed by FERC regulated ISOs and RTOs. They are vital to managing the cost and price volatility of transmission congestion when transacting in the electric industry markets.

When a party acquires CRRs or FTRs he will not take on physical settlement obligations of any nonfinancial commodity product. But the revenues received or paid out will offset obligations the party is incurring with respect to delivering or receiving energy at certain electric transmission points covered by the particular FTRs or CRRs acquired. If the Commission is to define the term "swap" to encompass these products, then it will become essential that these vital commercial risk hedging tools be eligible for trade option exemption treatment, or nonfinancial commercial users of energy markets may be denied or restricted in their ability to acquire these needed commercial risk hedging tools.

To that end, exempt trade option transactions will need to clearly include these transactions that are an essential element of hedging commercial entities' delivery risks in the organized markets. In such event, the Commission will need to also reexamine its definition of eligible offeror and offeree.

An FTR or CRR is offered for auction by the particular ISO/RTO responsible for conducting the market in that region, as designated by FERC and so the particular ISO/RTO logically would be the offeror if this product is defined as a trade option. It is unclear whether an ISO is either an ECP or a commercial user, as currently defined by the CFTC in the interim rule, and may fail to meet either prong of the test for eligibility as an offeror.

The IECA submits that the CFTC should clarify or expand its offeror definition to enable an ISO/RTO to qualify as an eligible offeror, so that the FTR/CRR product may be offered by an ISO/RTO as a trade option, and meet the Commission's exemption criteria. Further, in order to implement this procedure, for all the reasons set forth above, the IECA believes it is imperative that that Commission reopen its comment period after the definition of "swap" has become final.

III. <u>Conclusion.</u>

The IECA appreciates the opportunity to provide the foregoing comments and information to the Commission. This letter represents a submission of the IECA, and does not necessarily represent the opinion of any particular member. If you would like for us to expand our discussion of any of the above-listed discussion points, please let us know.

Yours truly,
INTERNATIONAL ENERGY CREDIT ASSOCIATION

/s/	/s/
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