July 22, 2011

VIA ONLINE SUBMISSION
Mr. David Stawick, Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, NW
Washington, DC 20581

RE: Commodity Options and Agricultural Swaps, RIN No. 3038-AD21; Product Definitions (Further Definition of "Swap," *et al.*), RIN No. 3038-AD46

The National Corn Growers Association ("NCGA") and the Natural Gas Supply Association ("NGSA") submit the following comments in response to two Notices of Proposed Rulemaking recently issued by the U.S. Commodity Futures Trading Commission (the "Commission" or the "CFTC"): Commodity Options and Agricultural Swaps, 76 Fed. Reg. 6095 (Feb. 3, 2011) (the "Commodity Options NPRM") and Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement"; Mixed Swaps; Security-Based Swap Agreement Recordkeeping, 76 Fed. Reg. 29,818 (May 23, 2011) (the "Product Definitions NPRM"). References made herein to the Commodity Exchange Act (the "CEA") refer to that statute as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act" or the "Act"). Correspondence regarding this submission should be directed to:

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Founded in 1957, NCGA is a nonprofit member organization representing 35,000 dues-paying corn farmers nationwide and the interests of more than 300,000 growers who contribute through corn checkoff programs in their states. NCGA and its 48 affiliated state associations and checkoff organizations work together to create and increase opportunities for their members and their industry.

Established in 1965, NGSA represents integrated and independent companies that produce and market approximately 40 percent of the natural gas consumed in the United States. NGSA encourages the use of natural gas within a balanced national energy policy and promotes the benefits of competitive markets to ensure reliable and efficient transportation and delivery of natural gas and to increase the supply of natural gas to U.S. customers.

Because of the potential for the Dodd-Frank Act to unnecessarily limit the hedging tools available to corn producers and to impede what is and has been a healthy, competitive, and resilient natural gas market, NCGA and NGSA played an active role in the shaping of the Act during its passage and wish to continue this role in ensuring the Act's successful implementation.

COMMENTS

The Commission's proposed rules under the Commodity Options NPRM and Product Definitions NPRM threaten to subject important commercial merchandising transactions in physical commodity markets, including natural gas and corn markets, to regulation as "swaps," despite clear indications from the Act's text and underlying policies that such contracts were not intended to be subject to the new regulatory regime. Because there is substantial overlap between the two NPRMs, specifically with respect to the proper scope of the "forward contract exclusion" from the definition of a "swap" under section 1a(47)(B)(ii) of the CEA, NCGA and NGSA have combined their comments on the two rulemakings in this letter. In light of this overlap and interdependence between the NPRMs, NCGA and NGSA respectfully request that the Commission consider these comments with respect to both NPRMs, despite their submission after the designated comment period for the Commodity Options NPRM.

I. Physical Options Should be Excluded From the Definition of a "Swap."

The Commission is proposing to replace the current "trade option exemption" under section 32.4 of its regulations, 17 C.F.R. § 32.4, with a new rule that would make physically settled commodity option contracts ("Physical Options") subject to regulation as "swaps" under the CEA. This contravenes the forward contract exclusion from the definition of a "swap" that Congress has provided in section 1a(47)(B)(ii) of the CEA and would cause serious harm to end users in natural gas, corn and other physical commodity markets, without providing significant benefits to those markets or to the U.S. financial system. Therefore, the Commission should modify its proposed rules in the Commodity Options NPRM to recognize that Physical Options are not swaps.

A. Physical Options Are Essential Transactions in the Physical Natural Gas Market.

Physical Options are essential transactional tools used by many local natural gas distribution companies[1] and industrial consumers, such as corn processors, to manage their natural gas supply needs. Such needs can vary widely based on a variety of factors, including day-to-day weather conditions and business demand. For example, during the winter heating

[1] Local natural gas distribution companies are typically state-regulated utilities with an obligation to provide reliable natural gas delivery to all customers in their service territories.

season, local distribution companies must ensure that they have adequate natural gas supply to meet customer demand under the coldest weather conditions that might occur. On most days, however, they need only a fraction of such amounts to meet actual consumer demand. Rather than purchasing amounts required to meet the maximum demand and then either selling back the inevitable excess amounts on the spot market or making individual arrangements for natural gas storage, the distribution companies, or industrial end users subject to similar variable demand, often find it advantageous to enter into Physical Options with natural gas suppliers. Under such contracts, the suppliers agree to deliver whatever amounts the end users call on for delivery (up to the maximum amounts specified under the contracts). In exchange, the local natural gas distribution companies or end users may pay a specified amount for such a right to call. In many cases, suppliers are simply better positioned to manage the underlying supply, whether through production or storage, and Physical Options provide the most effective means to realize the potential economic efficiencies. Importantly, these options require natural gas to be physically delivered when called upon by the utility, are not settled financially, and are not purchased and resold in organized markets.

B. Physical Options Are Excluded From the Definition of a "Swap" by the Act's Forward Contract Exclusion.

Physical Options meet the criteria of the so-called "forward contract exclusion" under section 1a(47)(B)(ii) of the CEA and therefore must be excluded from the definition of a "swap" under section 1a(47). Section 1a(47)(A) of the CEA provides:

> (A) IN GENERAL.—Except as provided in subparagraph (B), the term ''swap'' means any agreement, contract, or transaction—(i) that is a put, call, cap, floor, collar, or similar option of any kind that is for the purchase or sale, or based on the value, of 1 or more interest or other rates, currencies, commodities, securities, instruments of indebtedness, indices, quantitative measures, or other financial or economic interests or property of any kind; . . . .

Thus, although "options" are generally classified as "swaps" under this definition, that classification is subject to any and all exceptions provided in subparagraph (B).

Accordingly, the so-called "forward contract exclusion" in section 1a(47)(B)(ii) provides:

> (B) EXCLUSIONS.—The term ''swap'' does not include . . . (ii) any sale of a nonfinancial commodity or security for deferred shipment or delivery, so long as the transaction is intended to be physically settled.

This exclusion plainly covers the Physical Options discussed in the section above with respect to the physical natural gas market. First, they are contracts for the sale of natural gas—a physical, *i.e.*, nonfinancial, commodity. Second, they are sales for deferred delivery—the purchasers do not take immediate delivery but, rather, obtain the rights to physical delivery sometime in the future according to their contract terms. Finally, the contracts are intended to be physically settled. The purchasers have an absolute right to physical delivery under the contracts, up to the maximum amounts specified, and the sellers have an absolute obligation to physically deliver such amounts called on by the purchasers.[2]

Importantly, the forward contract exclusion applies to transactions "intended" to be physically settled. As described above, Physical Options are only intended to be physically settled, merely leaving open the exact quantities that will be physically settled. The forward contract exclusion contains no limitations or exceptions requiring that such quantities be fixed or nonzero. Simply put, Physical Options provide for deferred physical delivery, and Congress, through the forward contract exclusion, has required that such contracts in the physical commodity markets be excluded from regulation as "swaps" under the Dodd-Frank Act. As such, the Commission should explicitly recognize that Physical Options are excluded from the definition of a "swap" in its final version of rule 1.3(xxx). Alternatively, as described in more detail below, the Commission could treat Physical Options as forward contracts with embedded options targeting the contracts' quantity terms, which would exclude the contracts from regulation as swaps under the Commission's proposed interpretive guidance regarding embedded options in forward contracts.

C. Regulation of Physical Options as "Swaps" Would Cause Serious Harm to Physical Markets, Without Providing Significant Benefits.

Moreover, regulation of Physical Options as "swaps" would cause serious harm to the natural gas and other physical commodity markets, without providing significant benefits. First, many smaller end users may be prevented from entering into Physical Options altogether if such contracts are swept into the definition of "swaps." Pursuant to section 2(e) of the CEA, only eligible contract participants are allowed to enter into swaps outside of designated contract markets.[3] Since, in general, market participants must meet certain net worth thresholds to qualify as an "eligible contract participant"[4] and many Physical Options used by small end users are customized or illiquid and thus not traded on exchanges, the ability of small end users to transact in Physical Options would be limited to on-exchange contracts that do not exist or do not match their needs.

Second, for those end users that would remain eligible to transact in Physical Options, regulating such contracts as swaps would add unnecessary regulatory burdens and costs to transactions and markets that do not pose any systemic risk to the U.S. financial system. As Congress has noted, "[i]f the regulators raise the costs of end user transactions, they may create more risk" instead of less risk, by making the use of risk mitigation tools, such as Physical Options, cost-prohibitive.[5] However, treating such contracts as swaps threatens to subject even market participants that transact solely in physical contracts to comprehensive regulation as swap

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[2] Any modification or optionality with respect to such physical delivery obligations can be addressed in the manner the Commission has proposed in the Product Definitions NPRM's interpretive guidance regarding the forward contract exclusion.

[3] "It shall be unlawful for any person, other than an eligible contract participant, to enter into a swap unless the swap is entered into on, or subject to the rules of, a board of trade designated as a contract market under section 5." CEA § 2(e).

[4] *See* CEA § 1a(18).

[5] *See* Letter from Sen. Christopher Dodd and Sen. Blanche Lincoln to Rep. Barney Frank and Rep. Colin Peterson 1 (June 30, 2010).

dealers, real time and permanent reporting requirements, and other regulatory burdens to which Congress never intended to subject physical markets.

Not only is such regulation unauthorized under the Act (in light of the forward contract exclusion, as discussed above), but it would be completely unwarranted. Unlike swaps, Physical Options in natural gas and other physical commodities are generally not traded by speculators and do not serve a price discovery function. As such, subjecting such contracts to position limits or real-time reporting requirements would serve no useful purpose. Moreover, such contracts in the natural gas market are already subject to certain regulatory oversight by the Federal Energy Regulatory Commission and state public utility commissions with respect to price, prudence, and manipulation. Finally, with respect to Physical Options in energy and agricultural commodities, such contracts, if included as swaps, would constitute only a small portion of all swaps in energy and agricultural commodities, which themselves represent, combined, less than two percent of the total notional value of the global over-the-counter derivatives market.[6] As such, Physical Options clearly do not present a systemic risk to the U.S. financial system. For these reasons, the Commission must recognize in its final rule, either in the definition of a "swap" or by preserving the trade option exemption, that Physical Options are excluded, or are eligible for exemption, from regulation as swaps.

II. The Commission Should Provide Certain Clarifications Regarding Application of the Forward Contract Exclusion to "Book-Out" Transactions and to Forwards with Embedded Options.

NCGA and NGSA generally support the Product Definitions NPRM's interpretive guidance regarding the forward contract exclusion. Forward contracts are an important and widely used form of commercial merchandizing transaction in the energy and agricultural industries that Congress never intended to regulate as "swaps." Therefore, NCGA and NGSA support the Commission's proposal to interpret the forward contract exclusion with respect to swaps under section 1a(47)(B)(ii) of the CEA consistent with its historical exclusion of forward contracts from the definition of the term "future delivery." However, the Commission should provide certain clarifications regarding "book out" transactions and embedded optionality with respect to forward contracts to provide important regulatory certainty to participants in physical markets.

A. The Commission Should Provide a Safe Harbor Under the Forward Contract Exclusion for "Book Outs" of Contracts That Have Binding Physical Delivery Obligations and For Which Book Outs Can Only Be Achieved by Subsequent, Separately Negotiated Agreements.

NCGA and NGSA generally support the Commission's proposal to apply the principles underlying the "Brent Interpretation"[7] to the forward contract exclusion from swaps with respect to "book out" transactions but believe that certain clarifications are necessary to provide much-

[6] *See* Bank for International Settlements, Semiannual OTC derivatives statistics at end-June 2010, Table 19: Amounts outstanding of over-the-counter (OTC) derivatives, available at http://www.bis.org/statistics/otcder/dt1920a.pdf.

[7] Statutory Interpretation Concerning Forward Transactions, 55 Fed. Reg. 39,188 (Sept. 25, 1990) (the "Brent Interpretation").

needed certainty to market participants who rely on such transactions. While market participants in the natural gas industry commonly buy or sell gas for deferred delivery under forward contracts, when the time arrives for delivery, the parties to such transactions often discover that physical delivery would be economically inefficient for one or both of the parties involved. In such instances, the parties can find it mutually advantageous to "book out" such transactions by settling them financially and mutually agree to do so. In such instances, the parties intended, at the time at which such transactions for deferred delivery were entered, to physically settle the transactions, but later find it has become more efficient to settle them financially. The Commission has long excluded such book outs from its regulation of futures contracts under the Brent Interpretation and is right in extending this exclusion to swaps, in light of Congress's requirement that a forward contract be excluded from regulation as a swap "so long as the transaction is *intended* to be physically settled" as opposed to requiring that the transaction *actually* be physically settled.[8]

That said, the Commission wrongly suggests in the Product Definitions NPRM that transactions or market participants should perhaps be required to meet or exceed certain thresholds, such as a minimum contract size or minimum frequency of making or taking delivery,[9] to qualify for the safe harbor of the Brent Interpretation. Section 1a(47)(B)(ii) of the CEA says nothing about restricting application of the forward contract exclusion based on such thresholds. The Commission should not make its regulations unnecessarily burdensome or impose unnecessary uncertainty on smaller market participants, including numerous end users, who might not engage in as large or as many transactions as others.[10] The only condition Congress has placed on the forward contract exclusion is intent to physically settle a transaction. Contract size obviously has nothing to do with such intent, and while frequency of making or taking delivery may be an indicator of such intent, it is by no means determinative. Rather, if the parties have entered into a forward contract with a binding delivery obligation at the time of execution, they have clearly demonstrated an intent to deliver, since neither party can escape such an obligation without a subsequent, independent agreement by the other party. While the Commission recognizes in the NPRM that intent to make or take delivery can be "inferred" in such instances,[11] the Commission should go farther, to provide much-needed regulatory certainty to market participants, by explicitly providing in its definition of a "swap" that contracts with binding physical delivery obligations, for which book outs can only be achieved by subsequent, separately negotiated agreement by the parties, qualify for the exclusion.

B. The Commission Should Clarify that Forward Contracts with Embedded Options that Target the Contracts' Quantity Terms Qualify for the Forward Contract Exclusion.

As mentioned above, one way the Commission can provide for the necessary exclusion of Physical Options from regulations as swaps would be to recognize that such contracts are essentially forward contracts with embedded options that target the contracts' quantity terms.

[8] CEA § 1a(47)(B)(ii) (emphasis added).

[9] *See* Product Definitions NPRM at 29,831 (Question Nos. 27, 28).

[10] *See* Executive Order—Regulation and Independent Regulatory Agencies (July 11, 2011) (charging independent agencies to promote the goals of economic growth, competitiveness, and job creation and to make their regulatory programs less burdensome).

[11] Product Definitions NPRM at 29,829.

With respect to embedded options, the Commission has proposed a framework that follows the 1985 interpretive statement recently adhered to in *In re Wright*, whereby:

> [A] forward contract that contains an embedded commodity option or options [ ] would be considered an excluded nonfinancial commodity forward contract (and not a swap) if the embedded option(s): (i) May be used to adjust the forward contract price, but do not undermine the overall nature of the contract as a forward contract; (ii) do not target the delivery term, so that the predominant feature of the contract is actual delivery; and (iii) cannot be severed and marketed separately from the overall forward contract in which they are embedded.[12]

The Physical Options, as described above with respect to the natural gas market, are contracts that are only intended to be physically settled, merely leaving open the exact quantities to be physically settled. The Commission should recognize in its final rule, at least if it does not provide the exclusions or exemptions discussed in section I of this letter, that such contracts are effectively forward contracts with embedded options that target the quantity term of the underlying contracts (even if the quantity ultimately exercised is zero), and not the "delivery term" as such term is used in the Product Definitions NPRM. Congress's intent in Title VII of the Act was to regulate financial derivatives. Congress did not intend to regulate vital forms of physical delivery contracts merely because they provide market participants needed flexibility with respect to the quantities for deferred physical delivery. As such, the Commission should provide a clarification in its final rule that the distinction to be drawn with respect to embedded options "target[ing] the delivery term" is whether such options provide an option to financially settle, as opposed to physically settle, the underlying transactions.

CONCLUSION

NCGA and NGSA respectfully submit that the modifications to the proposed rules described above are necessary to make the rules conform to the text of the Dodd-Frank Act and to Congress's intent in passing the Act. NCGA and NGSA appreciate the opportunity to provide these comments. Should you require further information, please do not hesitate to contact us.

Sincerely,

National Corn Growers Association
Natural Gas Supply Association

[12] Product Definitions NPRM at 29,830 (internal footnote omitted) (citing *In re Wright*, CFTC Docket No. 97-02, 2010 WL 4388247 (Oct. 25, 2010); Characteristics Distinguishing Cash and Forward Contracts and ''Trade'' Options, 50 Fed. Reg. 39,656 (Sept. 30, 1985)).