Natural Gas Supply Association

NATIONAL CORN GROWERS ASSOCIATION

March 19, 2014

The Honorable Frank D. Lucas
Chairman
House Committee on Agriculture
1301 Longworth House Office Building
Washington, DC 20515

The Honorable Collin C. Peterson
Ranking Member
House Committee on Agriculture
1301 Longworth House Office Building
Washington, DC 20515

DELIVERED VIA ELECTRONIC MAIL

Dear Chairman Lucas and Ranking Member Peterson:

The National Corn Growers Association (NCGA) and the Natural Gas Supply Association (NGSA) appreciate the opportunity to provide input to the Committee as you prepare to review the Commodity Exchange Act (CEA) and reauthorize the Commodity Futures Trading Commission's (CFTC) oversight of the futures and swaps markets.

Founded in 1957, the National Corn Growers Association represents more than 40,000 dues-paying corn farmers nationwide. NCGA and its 48 affiliated state 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 30 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. consumers.

Because of the potential for the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the Dodd-Frank Act or the Act) to impede what are and have been healthy, competitive, and resilient corn and natural gas markets, NCGA and NGSA played an active role in the shaping of the Act during its passage and have continued this role in ensuring the Act's successful implementation by the CFTC.

The CEA as amended by the Dodd-Frank Act excludes forward contracts and includes options in commodities in the definition of "swap." This raises the practical question of how to treat forward contracts containing terms that provide for some form of flexibility in delivered volumes, i.e., "embedded optionality."

Flexibility in the terms of physical commodity forward contracts is essential in everyday commerce given the commercial uncertainties that exist in commodity delivery and receipt. One important form of such flexibility involves the volumes to be transacted in a forward contract. This flexibility is necessary because parties cannot always accurately predict the required or optimal amounts of physical commodities to meet their business needs and objectives. The CFTC refers to this flexibility as "volumetric optionality" and has formulated rules that suggest that the CFTC will regulate forward contracts with such "optionality" as swaps.

Volumetric optionality is a contractual tool used in the physical commodity industry to "right size" physical delivery. The ability to appropriately size a physical commodity delivery via a contractual tool facilitates market efficiency because it allows commercial market participants to adjust delivery volumes seamlessly in response to changes in supply and demand requirements at the time of delivery. Volumetric optionality is a delivery tool that mitigates the uncertainty inherent in any physical commodity contract, making both parties aware of potential delivery variability embedded within the intent to deliver. Thus, volumetric optionality in a physical forward contract allows commercial uncertainties to be accommodated up front, providing a process for orderly physical delivery and settlement even in the absence of precision in the delivery volume. Importantly, the intent to physically deliver remains despite the variability in final delivery terms.

In August of 2012, the CFTC issued the final rule further defining the term "swap," Final Rule, *Further Definition of "Swap," et al.*, 77 Fed. Reg. 48, 208 (August 13, 2012) (Swap Definition Final Rule or Final Rule). As part of the definition of swap, the Final Rule provides an interpretation that an agreement, contract or transaction with embedded optionality falls within the forward exclusion when seven criteria are met. The seventh criterion or element requires that:

> 7. The exercise or non-exercise of the embedded volumetric optionality is based primarily on physical factors, or regulatory requirements, that are

outside the control of the parties and are influencing demand for, or supply of, the nonfinancial commodity.

In the Final Rule, the Commission specifically requested comments on whether this seventh element is necessary, appropriate and sufficiently clear and unambiguous. On October 12, 2012, NCGA and NGSA submitted written comments to the CFTC highlighting the market uncertainty that the new seven-criterion test creates in light of very clear statutory language stating that contracts with the intent to physically deliver are physical forward contracts. (See attached.) Specifically, NCGA and NGSA asked the Commission to affirm that the seven criteria identified in the Final Rule are simply illustrative of certain common characteristics in forward contracts with embedded optionality, and thus, a safe harbor instead of requirements for satisfaction of the forward contract exclusion.

NCGA and NGSA recognize the Commission's interest in retaining the ability to regulate physical contracts with embedded options as swaps if the "intent to physically deliver" is not genuine and simply crafted to evade regulation.[*] However, in this case, the Commission has created so much ambiguity in the applicability of the forward-contract exclusion that market participants may be reluctant to use volumetric optionality in their forward contracting. Consequently, the regulatory uncertainty caused by the seven-criterion test compromises the viability of a physical commodity market delivery tool that is critical to market efficiency. The forward-contract exclusion should not be implemented in a way that limits its usefulness to catching bad actors at the expense of physical market efficiency.

The definition of swap has far-reaching effects beyond physical market efficiency. Determining what is and is not a swap impacts the calculation of notional amount and thus, which entities are swap dealers. It also impacts the application of position limits and the appropriate scope of the bona fide hedge exemption, clearing requirements, reporting requirements and capital and margin requirements. In short, the definition of swap is the heart and soul of the end-user protections.

The October 12, 2012 NCGA and NGSA request for clarity regarding the Commission's expected application of the seven-criterion test remains unanswered. In light of the lingering uncertainty created by the seven-criterion test, clarity regarding the applicability of the forward-contract exclusion to volumetric options embedded within a physical contract has become essential to commodity producers and consumers. Given the importance of the definition of swap to implementation of so many other Dodd-Frank-Act-related CFTC regulations, clarity is crucial to the sound implementation the Dodd-Frank Act.

---

[*]The anti-manipulation authority provided by the Dodd-Frank Act is the Commission's tool for ensuring markets that are free of manipulation.

This regulatory uncertainty has complicated the sound implementation of the Dodd-Frank Act and risks harming commodity market efficiency. NCGA and NGSA support H.R. 4267 which would amend Section 1a(47)(B)(ii) of the CEA (the forward-contract exclusion) to read as follows:

> "any sale of a nonfinancial commodity or security for deferred shipment or delivery, so long as the transaction is intended to be physically settled**, including any stand-alone or embedded option for which exercise results in a physical delivery obligation**."

The swap definition is fundamental to implementation of the CFTC's new Dodd-Frank rules and consequently to the on-going availability of cost-effective risk management tools. However, if the definition is too broad, it can bring in common commercial agreements that have no relationship to the types of transactions that the Dodd-Frank Act was intended to regulate. Market participants demonstrating the potential to exercise physical delivery or a history of physical delivery must have confidence in the forward-contract exclusion from the definition of a swap.

H.R. 4267 remedies the unnecessary regulatory uncertainty and provides commodity producers and consumers with the regulatory confidence essential to sound investment and risk management decisions. NCGA and NGSA urge the House Committee on Agriculture to adopt H.R. 4267 as part of the CFTC reauthorization. NCGA and NGSA are committed to working with you to achieve a positive outcome that both protects the integrity of commodity markets and ensures the continued availability of cost effective hedging tools.

Sincerely,

National Corn Growers Association
Natural Gas Supply Association

Attachment

October 12, 2012

VIA ONLINE SUBMISSION
Stacy Yochum, Acting Secretary
Commodity Futures Trading Commission
Three Lafayette Center
1155 21st Street, N.W.
Washington, D.C. 20581

RE: Interpretation Regarding Forward Contracts with Embedded Volumetric Optionality (RIN 3038-AD46)

The National Corn Growers Association ("NCGA") and Natural Gas Supply Association ("NGSA") submit the following comments regarding the interpretation of the U.S. Commodity Futures Trading Commission (the "Commission") of the exclusion of forward contracts with embedded volumetric optionality under the Commission's final rule defining the term "swap," Final Rule, *Further Definition of "Swap," et al.*, 77 Fed. Reg. 48,208 (August 13, 2012) (the "Final Rule"). 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:

Sam Willett	Jennifer Fordham
Senior Director of Public Policy	Vice President, Markets
National Corn Growers Association	Natural Gas Supply Association
Washington, DC Office	1620 Eye Street, NW
122 C Street NW, Suite 510	Suite 700
Washington, DC 20001-2109	Washington, DC 20006
202-628-7001	Direct: 202-326-9317
e-mail: willett@dc.ncga.com	e-mail: jfordham@ngsa.org

Founded in 1957, NCGA is the largest trade organization in the United States, representing 37,000 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 impede what are and have been healthy, competitive, and resilient corn and natural gas markets, 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 seven-element test for forward contracts with embedded volumetric optionality is mostly workable as a set of guideposts. However, for the reasons discussed below, NCGA and NGSA request that the seventh element of the test be revised to clarify that the relevant time for looking at the parties' intent with respect to such embedded optionality is at the time such contracts are entered into, as opposed to the time for exercise or non-exercise of the optionality. In addition, because the test goes beyond the requirements provided for by the CEA and the Commission's own historical interpretation of the forward contract exclusion with respect to futures contracts, the Commission should clarify that the test provides guideposts with respect to contracts with embedded volumetric optionality satisfying the forward contract exclusion, as opposed to absolute requirements. Finally, NCGA and NGSA request that the fourth and fifth element be combined and revised to ensure proper applicability of the test to both call and put options.

I. Overview of the Exclusion of Forward Contracts, Inclusion of Commodity Options, and Resulting Treatment of Forward Contracts with Embedded Optionality, (Including Embedded Volumetric Optionality) Under the Commission's Definition of the Term "Swap"

The CEA explicitly excludes forward contracts[1] and includes options in commodities[2] from the definition of the term "swap," which raises the practical question of how to treat forward contracts containing terms that provide for some form of optionality, *i.e.*, "embedded optionality." The Commission has correctly recognized in the Final Rule, consistent with its historical treatment of the forward contract exclusion with respect to futures contracts, that in many circumstances such embedded optionality does not alter the overall nature of contracts as

[1]The so-called "forward contract exclusion" under the CEA's definition of the term "swap" excludes "any sale of a nonfinancial commodity or security for deferred shipment or delivery, so long as the transaction is intended to be physically settled."7 U.S.C. § 1a(47)(B)(ii).

[2] Accordingly, the Commission has promulgated a rule that, in general, subjects "commodity options" to the same regulation as other swaps. *See Commodity Options*, 77 Fed. Reg. 25320 (Apr. 27, 2012). In the commodity options rule, the Commission provided for a reduced level of regulation with respect to "trade options" involving producers, processors, or commercial users of, or merchants handling, the commodity that is the subject of the commodity option transaction, or related products or byproducts, where such persons are entering into the commodity option transactions solely for purposes related to such commercial businesses and the option is intended to be physically settled.

forward contracts.[3] Like other forward contracts important to everyday commerce in physical commodities, the parties to such contracts have a commercial need to defer delivery of the subject commodity and intend at the time of execution to physically settle the contracts. At the same time, they may have an additional need to provide for certain optionality to address commercial uncertainties that exist at the time such contracts are entered into.

As the Commission has correctly recognized in the Final Rule, one important form of such optionality is volumetric optionality, because parties cannot always accurately predict the required or optimal amounts of physical commodities to meet their business needs and objectives. Contracts containing such optionality retain their essential character as forward contracts because the parties intend at the time of contract execution to physically deliver or take delivery of the nonfinancial commodity. Volumetric optionality is simply a tool to "right-size" physical delivery so that the delivery amount is responsive to supply and demand at some point in the future.

The Final Rule provides an interpretation that an agreement, contract, or transaction with embedded optionality falls within the forward exclusion when seven criteria are met. The seventh criterion or element requires that:

> 7. The exercise or non-exercise of the embedded volumetric optionality is based primarily on physical factors, or regulatory requirements, that are outside the control of the parties and are influencing demand for, or supply of, the nonfinancial commodity."[4]

In the Final Rule, the Commission specifically requested comments on whether this seventh element is necessary, appropriate, and sufficiently clear and unambiguous.[5] While the seven-element test illustrates several common characteristics of contracts containing volumetric optionality that also maintain their essential character as forward contracts, the test goes well beyond what the Commission has historically recognized as the central criterion under the forward contract exclusion: the intent of the parties to make and take physical delivery. Thus, to avoid harm to physical commodity markets and provide commodity producers and consumers with regulatory certainty, the Commission should affirm that the seven criteria identified in the Final Rule are guideposts illustrative of certain common characteristics in forward contracts with embedded optionality, as opposed to requirements for satisfaction of the forward contract exclusion. Consistent with the historical treatment of the forward contract exclusion, it is the *intent to physically deliver* that makes a contract a physical forward contract. As long as the contract characteristics, including embedded optionality, do not compromise this intent,

---

[3]*See* Final Rule at 48237 (citing *Characteristics Distinguishing Cash and Forward Contracts and "Trade" Options*, 50 Fed. Reg. 39656 (Sept. 30, 1985) ("1985 CFTCOGC Interpretation"); *In re Wright*, CFTC Docket No. 97–02, 2010 WL 4388247 at *3 (Oct. 25, 2010).

[4] Final Rule at 48238 (footnotes omitted).

[5] Final Rule at 48241 (question 3).

commodity producers, consumers and the market must be assured that contracts where physical delivery is intended at the time of execution are excluded from regulation as swaps.

II. The Seventh Element of the Commission's Test for Embedded Volumetric Optionality Should be Revised to Clarify that the Parties' Intentions Regarding Such Optionality Must Satisfy the Identified Criterion at the Time a Contract is Entered Into, as Opposed to the Time for Exercise or Non-Exercise of the Optionality.

A. Requested Clarification of the Seventh Element

The Commission's seven-element test is mostly workable as a set of guideposts regarding several common characteristics of forward contracts with embedded volumetric optionality. However, the seventh element is flawed or ambiguous in suggesting that the relevant time for looking at the parties' intent with respect to the embedded volumetric optionality is at the time of exercise or non-exercise of the optionality, as opposed to the time at which the contract was executed. Therefore, NCGA and NGSA request that the seventh element of the Commission's test for embedded volumetric optionality be revised as follows:

> 7. At the time the agreement, contract, or transaction is entered into, the provision for~~The exercise or non-exercise of the~~embedded volumetric optionality is ~~based~~ primarily intended to address factors, such as~~on~~ physical factors, or regulatory requirements, that are outside the control of the parties and are influencing demand for, or supply of, the nonfinancial commodity.

B. The Requested Clarification is Necessary to Preserve Consistency with the Commodity Exchange Act's Definition of the Term "Swap" and the Commission's Treatment of Other Aspects of the Forward Contract Exclusion Under the Definition.

The clarification requested above is necessary to preserve consistency with the CEA's definition of the term "swap." Under the CEA, forward contracts are explicitly excluded from the definition of the term "swap," so long as they are "intended to be physically settled."[6] Since the relevant inquiry is whether a transaction is "intended to be physically settled" rather than "physically settled," it is apparent that the relevant time for determining intent with respect to delivery is the time at which a transaction is executed. Along those lines, the Commission has recognized in a number of circumstances that the parties' intent regarding delivery at the time of execution should be central to the determination of whether a contract should be excluded as a forward contract or regulated as an option, swap, or future. In effect, under both the CEA and

[6] 7 U.S.C. § 1a(47)(B)(ii).

the Commission's general treatment of the forward contract exclusion, either the transaction is a "commercial merchandising transaction" at the time it is entered into—in which case Congress did not intend for it to be regulated as an option, swap, or future—or it is not.

Thus, with respect to netting agreements, the Commission recognized that provisions contemplating the reduction to a net delivery amount of future offsetting delivery obligations do not alter the forward contract nature of the affected transactions "provided that the parties had a bona fide intent, *when entering into the transactions*, to make or take delivery."[7] With respect to termination rights in forward contracts, the Commission recognized that "a bona fide termination right must be triggered by something *not expected by the parties at the time the contract is entered into*."[8] Importantly, such termination need not be completely outside the realm of possibility and expectation at the time the contract is executed—otherwise the parties would never have provided for it; the termination provision allows the parties to provide for the remote possibility of the termination-triggering events, thus addressing the uncertainties regarding whether such events might occur. More generally with respect to bookouts, the Commission recognized in the scenario at issue in the Brent Interpretation the importance of the fact that the "parties enter[ed] into such contracts with the recognition that they may be required to make or take delivery."[9] To be consistent with these treatments and with the CEA, the Commission must revise the seventh element for embedded volumetric optionality to clarify that the parties' intentions regarding such optionality must satisfy the identified criterion at the time a contract is entered into, as opposed to the time for exercise or non-exercise of the optionality.

C. The Commission Has Implicitly Recognized the Appropriateness of Analyzing the Parties' Intentions Regarding Embedded Volumetric Optionality at the Time a Contract is Entered Into And Not Afterwards.

Certain Commission statements in the Final Rule imply that the Commission already recognizes that parties' intentions regarding embedded volumetric optionality should be analyzed at the time they enter into contracts, not afterwards. First, the Commission recognizes that, with respect to the factors affecting the decision whether to exercise volumetric optionality embedded within a contract, the contract "*needs to be a commercially appropriate method* for securing the purchase or sale of the nonfinancial commodity for deferred shipment *at the time it is entered into*."[10]

More broadly, the Commission recognizes that the reason for allowing contracts to contain volumetric optionality while still remaining within the forward contract exclusion is that "supply and demand requirements *cannot always be predicted*," such that the volumetric optionality may be "a commercially reasonable way to address *uncertainty*" associated with

---

[7] Final Rule at 48230 (emphasis added).

[8] Final Rule at 48230 (emphasis added).

[9] Final Rule at 48228.

[10] Final Rule at 48238 n.341 (emphasis added).

factors outside the parties' control.[11] Thus, volumetric options facilitate market efficiency because they allow flexibility to address market uncertainty without compromising the reliability of the physical delivery or the commercial market participants' operations. It is clear that the "uncertainty" such optionality is intended to address is that existing at the time of execution, as opposed to the time of exercise. The very reason for providing optionality is that the party exercising the optionality anticipates that its uncertainty at the time of execution will be removed, or at least reduced, at the time of exercise—otherwise, it could just as well make an outright decision regarding the item of optionality at the time of execution and forego such optionality. Accordingly, the seventh element should be revised as requested to be consistent with these considerations already recognized by the Commission with respect to the seventh element.

D. Several Practical Difficulties Will Result if the Seventh Element is Not Revised as Requested.

Failing to provide the requested clarifications will result in a number of practical difficulties for market participants. First, it will leave uncertainty as to what kinds of transactions satisfy the embedded volumetric optionality test. In this regard, the Commission has identified the importance of providing legal certainty regarding forward contracts with embedded volumetric optionality, so as to not hinder commercial merchandising activity.[12]

Second, the ambiguity regarding the seventh element, if not resolved as requested above, may (i) force market participants to make inefficient choices at the time for exercise of the optionality, in order to avoid unanticipated and ill-fitting regulatory compliance obligations, or (ii) in the light of such possibilities, chill the use of embedded volumetric optionality in contracts in spite of such optionality being an efficient and commercially reasonable means of addressing future market uncertainty associated with physical delivery of a commodity. For example, an industrial natural gas customer may have a contract for natural gas supply containing embedded volumetric optionality that was, at the time of execution, primarily intended to address uncertainties in demand caused by weather variations. At the time for exercise or non-exercise of the optionality, however, other factors, such as new or alternative sources of supply, may impact market conditions and thus the decision regarding exercise of the optionality. In such circumstance, the market participant should not be forced to either (i) make an inefficient market decision or (ii) accept the regulatory compliance challenges associated with its once-excluded transaction suddenly being categorized as a "swap." Regarding the latter, the reporting and other requirements resulting from a "swap" springing into existence based on a parties' intentions at the time of exercise or non-exercise of optionality may be difficult to determine and impossible to satisfy, as with the requirement to report "creation data" for the swap in a timely manner. Such difficulty may be compounded in instances where the reporting counterparty is not the party with the right to exercise the optionality, a situation that could impose unanticipated

[11] Final Rule at 48238-39 (emphasis added).

[12] Final Rule at 48316.

regulatory obligations on the reporting counterparty along with notice and verification difficulties.

In short, the Commission should not hinder commercial market participants from making economically efficient decisions at the time for exercise or non-exercise of embedded volumetric optionality, subject them to unanticipated and ill-fitting regulatory compliance obligations in the alternative, or chill the use of embedded volumetric optionality as a result of such possibilities.

III. The Fourth and Fifth Elements of the Commission's Test for Embedded Volumetric Optionality Should be Combined and Revised to Ensure Proper Applicability to Both Embedded Call and Put Options.

NCGA and NGSA also request clarification with respect to the fourth and fifth elements of the seven-element test applicable to forward contracts with embedded optionality. As drafted, the fourth element requires that the "seller" intends, at the time it enters into the relevant agreement, to "deliver" the underlying nonfinancial commodity if the optionality is exercised, and the fifth element requires that the "buyer" intends at such time to "take delivery" of the commodity in such event.[13] Though this formulation is appropriate with respect to *call* options, in which the option buyer or holder has the right to take delivery from the option seller or writer in exchange for paying the option seller at the strike price, NCGA and NGSA are concerned that it does not match up properly, or may cause unnecessary confusion, with respect to *put* options, in which the option buyer or holder has the right to deliver the underlying commodity to the option seller or writer in exchange for receiving payment at the strike price. Therefore, NCGA and NGSA request that the elements be combined and revised as follows to ensure proper applicability with respect to both call and put options:

> 4. The seller and buyer of the nonfinancial commodity underlying the agreement, contract, or transaction intend, at the time they enter into the agreement, to make or take delivery, as applicable, of the underlying nonfinancial commodity if the optionality is exercised.

[13] Final Rule at 48238.

CONCLUSION

To be consistent with the CEA and the Commission's own historical interpretation of the forward contract exclusion with respect to futures contracts and to avoid creating unnecessary market uncertainty, the Commission must:

- **Affirm that the seven criteria identified in the Final Rule are guideposts illustrative of certain common characteristics in forward contracts with embedded optionality, not requirements for satisfaction of the forward contract exclusion, and that, it is the intent to physically deliver that makes a contract a physical forward contract consistent with historical treatment of the forward contract exclusion.**

- **Revise the seventh element of its test for embedded volumetric optionality in a forward contract to clarify that the relevant time for looking at the parties' intentions regarding such optionality is at the time the contract was entered into, as opposed to the time for exercise or non-exercise of the optionality.**

- **Combine and revise elements four and five into a single element to ensure proper applicability with respect to both embedded call and put options.**

These clarifications will provide the regulatory certainty essential to the continued efficient functioning of physical commodity markets. NCGA and NGSA welcome the opportunity to further discuss with the Commission its requested clarification to the seven-element test for forward contracts with embedded volumetric optionality. If we can provide any additional information, please do not hesitate to contact us.

Respectfully submitted,

National Corn Growers Association
Natural Gas Supply Association