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December 22, 2014

The Honorable Tim Massad, Chairman
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Strebet, NW
Washington, DC 20581

RE: "Forward Contracts With Embedded Volummetric Optionality", RIN 3235-AK65

To Whom it May Concern:

Americans for Financial Reform ("AFR") appreciates this opportunity to comment on the above-referenced proposed interpretation (the "Proposed Interpretation") by the Commodity Futures Trading Commission (the "Commission"). AFR is a coalition of more than 200 national, state, and local groups who have come together to advocate for reform of the financial industry. Members of AFR include consumer, civil rights, investor, retiree, community, labor, faith based, and business groups.[1]

The primary impact of this Proposed Interpretation would be to change the criteria that determine whether or not a commercial contract that includes option-like characteristics can be defined as a forward contract and thus excluded from CFTC jurisdiction. The specific change made by the Proposed Interpretation is to change the seventh element of the requirements to qualify for the forward exclusion from its current wording:

> "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. "

To the new wording in the Proposed Interpretation:

> "7. The embedded volumetric optionality is primarily intended, at the time that the parties enter into the agreement, contract, or transaction, to address physical factors or regulatory

[1] A list of AFR member organizations is available at http://ourfinancialsecurity.org/about/our-coalition/.

requirements that reasonably influence demand for, or supply of, the nonfinancial commodity. "

This is a significant shift. The current wording of the seventh factor requires that the *actual exercise* of the option is based primarily on facts outside of the control of the contracting parties which influence demand or supply of the commodity. The new wording in the Proposed Interpretation simply requires that the primary intent of the contracting parties at the time they concluded the agreement was to address factors that influence the demand or supply of the commodity. This change is important in two ways. First, there is a shift from the terms on which the option is actually exercised to the 'primary intent' of the parties at the time they contracted. Second, the option can be based on factors within the control of the contracting parties, so long as those factors are physical or regulatory elements that influence demand or supply of the commodity. Furthermore, the Commission proposes that the 'physical factors' involved may be interpreted broadly, to include 'operational considerations' or 'social forces' (CFR 69075).

AFR opposes the proposed change in the seventh element of the interpretation. We believe the new interpretation is excessively broad, would likely result in the improper classification of commodity options as excluded forwards, and is unnecessary given the minimal regulatory requirements for trade options.

As pointed out by Commissioner Bowen in Appendix 4 of the Proposed Interpretation, the key aspect of a forward contract is that it creates a binding obligation for physical delivery on the part of a contracting party. The current wording of the seventh factor provides a safe harbor for embedded options in forwards, but only on the condition that both contracting parties have a binding obligation in which the exercise of any optionality is determined only by factors outside of their control (i.e. that the factors affecting the exercise of the option cannot be influenced by the parties). The new proposed wording appears to abandon the concept of a binding obligation and instead only requires that the optionality be conditioned in some way on economically relevant factors.

At CFR 69075-69076, the Commission does specify that 'concerns that are primarily about price risk (e.g. expectations that the cash market price will increase or decrease)' would not generally satisfy the new wording of the seventh element. Clearly, if an option whose exercise is triggered by such price concerns is classified as a forward than all meaningful distinctions between commodity options and commodity forwards would be lost. It is thus positive that the Commission has identified this as a concern. However, we strongly doubt that under the proposed change in wording of the seventh prong the Commission will in fact be able to maintain the distinction between a 'primary intent' to address supply and demand factors in the contract terms and a decision to actually exercise the option based on price expectations.

The new proposed wording also does not appear to be clearer or simpler than the current wording. The current wording keeps a clear focus on the control that can be exercised by contracting parties. In contrast, the new proposed wording requires the Commission to interpret the intent of the parties at the time of the contract, and apparently broadens the triggering characteristics of the embedded option to encompass virtually anything that might affect demand or supply. If the Commission wishes to avoid throwing the door open to classifying almost all commodity options as forwards, it will be forced to make claims about subjective intent and to introduce complex distinctions between option characteristics that involve demand or supply factors and those that involve price expectations. Rather than simplifying the definition, the intent of the Proposed Interpretation seems be to broadening the definition so that a greater range of instruments can qualify for the forward exclusion. Indeed, the discussion in the Proposed Interpretation regarding the intent to 'clarify' the definition does not refer to problems of complexity in the current definition. Instead, it discusses the desire of end users to avoid having to 'specify the exact factors' that would trigger the embedded volumetric optionality (CFR 69075). But if market participants do not need to specify these factors it is difficult to see how the Commission can make any reasonable distinction between a commodity option and a commodity forward.

Given the broadening of the definition it appears that the main factor used by the Commission in distinguishing commodity options from commodity forwards will be the intent to settle the transaction physically. Yet under Section 1a(47) of the Commodity Exchange Act, the Commission is generally required to regulate commodity options, even those involving physical delivery. The exclusion in Section 1a(47)(B)(ii) applies only to forwards that are physically settled (a "sale of a nonfinancial commodity or security for deferred shipment or delivery"), not to all physically settled options, and certainly not to all options that simply have an 'intent' to physically settle.

The broadening of the definition in this Proposed Interpretation does not seem necessary to reduce regulatory burden on end users, as commodity options for physical delivery would generally qualify as 'trade options', a category of transaction that is exempted from almost all requirements imposed on swaps by the CFTC.[2] Trade options are subject only to a minimal once-per-year aggregate reporting requirement and to certain requirements under the proposed position limits rule, and the position limits requirements may be removed in the future. These requirements are the minimum necessary to permit the Commission to track the volume of trade options and gain some information on their use in the market.

We are concerned that if the commodity forward exclusion is broadened as proposed in this Proposed Interpretation, the Commission would receive no information on many instruments that

[2] See 17 CFR § 32.3(a) and the Commodity Options Rules, 77 FR at 25326. An explanation of trade options is also available at https://forms.cftc.gov/_layouts/TradeOptions/Docs/TradeOptionsFAQ.pdf.

are effectively commodity options and would have no means of tracking their use. Furthermore, AFR is concerned that the classification of many commodity options as forwards, and thus excluded from CFTC jurisdiction, could weaken the Commission's authority to prevent fraud and manipulation in the commodity markets. It is unclear whether such commodity options might also qualify as exempt from the anti-manipulation jurisdiction of the Federal Energy Regulatory Commission (FERC), which unlike the CFTC has jurisdiction only over actual sales contracts and not financial options.

The Proposed Interpretation nowhere discusses the potential impact of broadly classifying instruments with embedded optionality as commodity forwards on the CFTC's ability to monitor the commodity markets, and also does not discuss how such classification might affect the coverage of the Commission's anti-fraud and manipulation authority.[3] We believe that any further action on this Proposed Interpretation should include detailed discussion of the impact of a broader definition of the forward exclusion on both the ability to take action against fraud and manipulation and the ability to monitor the commodity markets.

Thank you for the opportunity to comment on these Proposed Rules. Should you have any questions, please contact Marcus Stanley, AFR's Policy Director, at marcus@ourfinancialsecurity.org or (202) 466-3672.

[3] These issues are briefly noted by Commissioner Wetjen in his statement, but not in the Interpretation itself.