



U.S. COMMODITY FUTURES TRADING COMMISSION
ENSURING THE INTEGRITY OF THE FUTURES & OPTIONS MARKETS

SPEECHES & TESTIMONY

Opening Statement of Commissioner Mark Wetjen at Commission Meeting on Releases Related to Forwards with EVO, Residual Interest and Rule 1.35

November 3, 2014

Good morning Chairman Massad and Commissioners Bowen and Giancarlo. I want to thank Chairman Massad for convening this meeting and moving quickly to fine-tune the Commission's Dodd-Frank rulemakings and provide needed clarity and relief to the commercial-end-user community.

Likewise, I would like to thank Commissioners Bowen and Giancarlo for their constructive approach and willingness to collaborate on these releases. And, of course, the staff deserves thanks for their continued work on these complex and important matters.

Few things were clearer to me at the time that Congress considered Dodd-Frank than the view that commercial firms were not responsible for the credit crisis. New swaps rules, therefore, should not place additional costs and compliance burdens on firms operating in the real economy, unless necessary to achieve the purposes of the post-crisis reforms.

In formulating and supporting Dodd-Frank rules since joining the commission, I have tried to keep this principle in mind. Along these lines, I have strived to move policy in a direction that, when implemented, will avoid introducing unnecessary complexity to the operation of firms, and that takes into account practical considerations related to compliance.

Today's releases re-calibrate previous work by the commission and generally move its policy further in the aforementioned direction. I therefore intend to support them.

I. Volumetric Optionality

Today's proposal further clarifying the definition of forward contracts with embedded volumetric optionality, or EVO, is intended to provide commercial firms the regulatory clarity they have sought since the original release of the seven-part test in August 2012.

The definition of a swap in the Commodity Exchange Act includes commodity options, but excludes from that definition forward contracts.¹ There was a policy reason for this, and at its root was a desire to ensure that Dodd-Frank captured many swaps, and swap-like contracts, that were structured to be similar to options, while also ensuring that a new regulatory regime was not inadvertently and inappropriately extended into certain physical markets.

The broad definitional language in question was designed to ensure that financial – as opposed to physical – contracts could not be structured or re-characterized to avoid the new market structure. While the swap definition does not expressly exclude options on energy and agricultural commodities, it does exclude both futures and forwards. I am confident Congress did not intend to pull contracts that historically have been treated as forwards into the new swap regime solely because of optionality in the amount of the physical commodity delivered under the contract.

As a policy matter, Congress surely recognized that the swap definition had to reflect a long-held commission belief that contracts that are physically settled, and where delivery is required, do not pose the same systemic threats to the financial system as contracts used for speculative purposes. Moreover, Congress expanded the commission's fraud² and anti-manipulation authority³ over markets where forward contracts are traded, and left intact the commission's surveillance authority to issue special calls to market participants for all positions and transactions related to a commodity.⁴

As mentioned, in resolving to adopt the appropriate regulatory treatment of forward contracts with EVO, the commission also must weigh the operational and compliance consequences of that treatment. Indeed, the commission should bring a heightened sensitivity to these considerations in the context of the power sector because affordable electricity and heat are such fundamental needs of modern life.

The commission's 2012 interpretation, while intended to be helpful, contained certain ambiguities in the seven-part test that created confusion among commercial end-users.

Last spring, the commission learned at a public roundtable that some market participants

may have withdrawn from the market due to those ambiguities, resulting in inferior execution for commercial firms. It is difficult to measure the exact impact of this phenomenon, but apparently it has not been a positive one for consumers of electricity and gas.

A. Ambiguity in the Seven-Part Test

In discussing the seven-part test, commentators zeroed in on two primary issues. First, many of the roundtable participants noted that the exercise or non-exercise of volumetric optionality depends on a number of factors,⁵ some of which will be outside of the control of the parties, and some that will not.

Many also noted that parties could reasonably disagree on whether, and the degree to which, a factor is outside of the control of the parties. For example, having choice among more than one source of supply, or selecting from those choices the lowest-priced contract, to some commercial firms caused the contract to fail the seventh prong.

This ambiguity contributed to a second issue – market participants stated that they often do not know the exact reasons that optionality will be exercised until the time of exercise. In other words, parties are uncertain how to characterize contracts at the time of execution, and how intent at the time of exercise or non-exercise might affect that analysis.⁶

The seventh factor's ambiguity has caused a host of problems. For instance, parties have been asked to provide vague and possibly unenforceable representations in agreements.⁷ Parties also often disagree about the proper categorization of a transaction, resulting in them "agreeing to disagree" and considering the same transaction to be, at the same time, a swap, trade option, or a forward with EVO.⁸ This has had the unintended consequence of distorting transaction data reported to the commission.⁹

The bottom line is that such uncertainty in the seven-part test increased transaction costs for commercial firms and limited their access to an effective risk-management tool.

B. Proposed Clarifications

Today's proposal appropriately modifies and clarifies the interpretation of the seventh prong. First, it clarifies that concluding whether the seventh prong is met should be determined by looking to the intent of the parties at the outset of contract initiation.

Second, the new proposal also deletes language referring to physical or regulatory factors being "outside of the control of the parties." Deleting this ambiguous language helps clarify that parties having some influence over factors affecting their demand for a nonfinancial commodity will not per se cause a contract to fail the seventh prong.

In that vein, the proposal also notes that parties may take a variety of factors into consideration when determining whether to exercise volumetric optionality, so long as the intended purpose was to address physical factors or regulatory requirements influencing the demand for, or supply of, the commodity.

Prongs one through six of the test are also appropriately crafted to ensure that the EVO does not undermine the forward contract's overall purpose. Prongs two and three help achieve those purposes by requiring the predominant factor to be actual delivery, and prohibiting the embedded optionality from being severed and marketed separately from the overall agreement.

Prongs four and five also help deter the potential for abuse of these contracts by requiring that the seller under the contract intends to deliver, and the buyer intends to receive, the underlying commodity.

Today's proposal should go a long way towards providing commercial firms adequate guidance, but I look forward to comments on whether it is adequate enough.

II. Residual Interest

Today's rulemakings also include an amendment to the phased implementation schedule for the residual-interest rule that was promulgated one year ago. I supported the rule last year because the implementation schedule would provide the commission an appropriate amount of time to investigate and consider the practicability of moving the deadline to the time of settlement. Meanwhile, the automatic nature of such move would incentivize FCMS to improve their margin-collection and risk-management processes.

Today's amendment would provide that the residual-interest deadline will remain at 6:00 p.m. on the date of settlement absent a commission rulemaking. This has the effect of increasing certainty to FCMS that any further change to the deadline would occur only following the robust procedures associated with a rulemaking, in addition to the already required study and roundtable, which is an outcome I support.

The resulting certainty provided to the FCM community outweighs the potential value of incentivizing FCMs to improve their margin-collection practices to comply with a future, time-of-settlement deadline.

This release does, however, highlight a continued policy tension concerning the need to balance risk-management incentives for FCMs, against considerations related to appropriate accessibility to the derivatives markets. Clearly, while the commission must weigh the costs to FCMs of its risk-management requirements, it need not scope them to ensure that every FCM that exists today has systems and practices in place to comply with them. Going forward, the commission should strive to ensure adequate accessibility to the marketplace knowing its importance to market liquidity, but remain vigilant in enforcing current FCM requirements under its rules.

III. Rule 1.35

Finally, I am also supporting today's proposal amending the record-keeping requirements under regulation 1.35.¹⁰ The same staff roundtable mentioned earlier also addressed this topic, particularly the technological challenges and costs associated with complying with the rule.¹¹

Similar to the residual-interest release, this proposal tries to balance certain commission regulatory prerogatives – in this case, the need to efficiently monitor the derivatives markets and enforce our rules – against considerations related to accessibility to the derivatives markets more generally, and certain trading venues more specifically. I look forward to comments on these proposed changes.

Closing

In closing, I want to reiterate my thanks to Chairman Massad, Commissioners Bowen and Giancarlo, and the staff for their constructive work on all three of these proposals.

¹ 7 U.S.C. § 1a(47).

² 7 U.S.C. § 9(c)(1) (“It shall be unlawful for any person, directly or indirectly, to use or employ, or attempt to use or employ, in connection with . . . a contract of sale of any commodity in interstate commerce . . . any manipulative or deceptive device or contrivance, in contravention of such rules and regulations as the Commission shall promulgate. . .”). See also 17 CFR Part 180.

³ 7 U.S.C. § 9(c)(3) (“[I]t shall be unlawful for any person, directly or indirectly, to manipulate or attempt to manipulate the price . . . of any commodity in interstate commerce. . .”).

⁴ 17 C.F.R. 18.05 (b) (maintenance of books and records concerning positions and transactions in the cash commodity); 17 C.F.R. § 1.31 (pursuant to § 1.31(2), the authority to request information required to be kept in accordance with the Act or Commission regulations); 17 C.F.R. § 1.35 (pursuant to § 1.35(3), the authority to request from a futures commission merchant, retail foreign exchange dealer, introducing broker or member of a designated contract market or swap execution facility records required to be kept by § 1.35 in accordance with the requirements of § 1.31); 17 C.F.R. § 23.203 (pursuant to § 23.203(a), the authority to request and receive within 72 hours any records required to be kept by a swap dealer or major swap participant by the Act and by Commission regulations and pursuant to § 23.203(2), the authority to request records of any swap or related cash or forward transaction); 17 C.F.R. § 23.606 (pursuant to § 23.606(c), the authority to request information that a swap dealer or major swap participant is required to maintain under § 23.606(a)(1)); 17 C.F.R. § 45.2 (pursuant to § 45.2(h), the authority to request from swap execution facilities, designated contract markets, derivatives clearing organizations, swap dealers, and major swap participants records required to be kept pursuant to § 45.2.); 17 C.F.R. § 46.2 (the authority, pursuant to § 46.2(e), to request records relating to pre-enactment and transition swaps in existence on or after April 25, 2011).

⁵ Letter from The Edison Electric Institute (“EEI”) and the Electric Power Supply Association (“EPSA”) (April 17, 2014) (“EEI/EPSA Letter”) at 3 (“The exercise or non-exercise of volumetric optionality under a forward energy contract depends on a number of factors, including but not limited to, any or all of the following: (1) the level of demand as affected by weather or market conditions; (2) the amount of unexercised volume remaining under the contract; (3) the time of the change in the level of demand relative to delivery scheduling capabilities, (4) anticipated future weather conditions, (5) the delivery location under the contract relative to the demand location; (6) the price and availability of transportation capacity (e.g. pipeline capacity) to move natural gas; (7) the price of alternative sources of supply; (8) the availability of natural gas or electricity in the spot market; and/or (9) the remaining inventory of the commodity in storage.”).

⁶ Letter from the American Gas Association (April 17, 2014) (“AGA Letter”) at 10 (citing “widespread confusion as to whether counterparties must demonstrate forward contract status as of the time of entering into an agreement, or as of the time of exercise or non-exercise of delivery rights under the agreement.”).

⁷ AGA Letter at 2; EEI/EPISA letter at 3.

⁸ NFP Electric Associations Letter at 3

⁹ EEI/EPISA letter at 3.

¹⁰ See Adaptation of Regulations to Incorporate Swaps—Records of Transactions, 77 Fed. Reg. 75523. (December 21, 2012) (“Final Rule Adopting Release”).

¹¹ See End-User Roundtable Transcript.

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