Client Update
CFTC and SEC Proposed Interpretation Concerning Forward Contracts with Embedded Volumetric Optionality

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On November 13, 2014, the Commodity Futures Trading Commission (the "CFTC") and the Securities and Exchange Commission (the "SEC") jointly issued a proposed interpretation (the "Proposed Interpretation")[1] clarifying the CFTC's existing interpretation concerning forward contracts with embedded volumetric optionality set forth in the Product Definitions Rules (as defined below).

The CFTC has requested public comment on all aspects of the Proposed Interpretation. Comments must be received by December 22, 2014.

BACKGROUND

On July 10, 2012, the CFTC and the SEC jointly adopted final rules and interpretations (the "Product Definitions Rules") further defining the terms "swap" and "security-based swap," among other terms. In the Product Definitions Rules, the CFTC provided an interpretation (the "Existing Interpretation") with respect to forward contracts that provide for variations in delivery amount (i.e., that contain "embedded volumetric optionality"). The Existing Interpretation identifies when an agreement, contract or transaction would fall within the "forward contract exclusion" from the "swap" definition in

[1] The Proposed Interpretation is available at: http://www.gpo.gov/fdsys/pkg/FR-2014-11-20/pdf/2014-27285.pdf.

section 1a(47) the Commodity Exchange Act (the "CEA")[2] notwithstanding that it contains embedded volumetric optionality.

In adopting the Existing Interpretation, the CFTC sought to reconcile the forward contract exclusion with the statutory definition of "swap," which provides that commodity options are swaps, even if physically settled.[3] The Existing Interpretation lists seven conditions that must be met in order to treat an agreement, contract or transaction as an excluded forward notwithstanding that it contains embedded volumetric optionality.

The CFTC received several comments from market participants requesting that it modify or further clarify the Existing Interpretation, particularly with regard to the meaning of certain language in the seventh element of such interpretation, which has caused confusion among market participants as to whether to characterize certain transactions as excluded forwards with embedded volumetric optionality or regulated trade options.

PROPOSED INTERPRETATION

Generally

The Proposed Interpretation clarifies the conditions set forth in the Existing Interpretation for treating an agreement, contract or transaction as an excluded forward notwithstanding that it contains embedded volumetric optionality. Under the Proposed Interpretation, such an agreement, contract or transaction

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[2] The definition of "swap" in section 1a(47) of the CEA excludes "any sale of a nonfinancial commodity [. . .] for deferred shipment or delivery, so long as the transaction is intended to be physically settled." Forward contracts that are intended to be physically settled qualify for this exclusion so long as the parties are "commercial market participants" that regularly make or take delivery of the referenced commodity in the ordinary course of their business and are entering into the transaction for commercial purposes with the ability and intent to deliver and take delivery. While a market participant need not be solely engaged in "commercial" activity to be a "commercial market participant," the business activity in which it makes or takes delivery must be a commercial activity (e.g., a hedge fund's investment activities will not be deemed to be a "commercial" activity for these purposes).

[3] Section 1a(47) of the CEA defines "swap" to include an "option of any kind that is for the purchase or sale, or based on the value of 1 or more . . . commodities." On April 18, 2012, the CFTC adopted (1) a final rule on commodity options, which generally permits market participants to trade commodity options subject to the same rules applicable to all other swaps, and (2) an interim final rule adopting a "trade option exemption" for physically delivered commodity options purchased by commercial users, subject to certain conditions. For additional information on the treatment of commodity options and the trade option exemption, please see our client memorandum, "CFTC Final Rules on Commodity Options," http://www.debevoise.com/insights/publications/2012/04/cftc-final-rules-on-commodity-options.

falls within the forward exclusion if:

1. The embedded optionality does not undermine the overall nature of the agreement, contract or transaction as a forward contract;
2. The predominant feature of the agreement, contract or transaction is actual delivery;
3. The embedded optionality cannot be severed and marketed separately from the overall agreement, contract or transaction in which it is embedded;
4. The seller of a nonfinancial commodity underlying the agreement, contract or transaction (the "underlying commodity") intends, at the time it enters into the agreement, contract or transaction, to deliver the underlying commodity if the embedded optionality is exercised;
5. The buyer of the underlying commodity intends, at the time it enters into the agreement, contract or transaction, to take delivery of the underlying commodity if the embedded optionality is exercised;
6. Both parties are commercial parties; and
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 requirements that reasonably influence demand for, or supply of, the underlying commodity.

The first six conditions are unchanged from the Existing Interpretation, other than slight modifications to the fourth and fifth conditions to clarify that the CFTC's interpretation applies to embedded volumetric optionality in the form of both puts and calls.[4] Thus, the CFTC's discussion of these six elements in the Products Definitions Rules remains relevant and applicable.

Proposed Modifications to the Seventh Condition

The Proposed Interpretation modifies the seventh condition, which addresses the primary reason for including embedded volumetric optionality in a forward

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[4] The fifth condition of the Existing Interpretation did not appear to contemplate circumstances where the seller of the underlying commodity might exercise the embedded optionality. The Existing Interpretation required that the buyer of the underlying commodity must have intended, at the time of entering into the relevant transaction, to take delivery of the underlying commodity "if *it exercises* the embedded volumetric optionality" (emphasis added). The Proposed Interpretation modifies this condition to include any exercise of the optionality (by either party).

contract.

The seventh element ensures that the primary purpose for including embedded volumetric optionality in the contract is to offer commercial parties flexibility to vary the amount of the underlying commodity delivered during the life of the contract in response to uncertainty (at the time of contracting) in the demand for or supply of such commodity due to a variety of factors, such as weather and certain other "operational considerations" (e.g., transportation capacity).

In the Existing Interpretation, the seventh condition requires that 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.

The Proposed Interpretation modifies this condition by removing the reference to the "exercise or non-exercise" of the embedded optionality. This language has created problems during contract negotiations as certain parties feel pressure to specify the exact factors that could lead to the exercise or non-exercise of such optionality. By removing this language, the CFTC intends to clarify that the focus of the seventh condition is intent with respect to the embedded optionality at the time of contract initiation.[5] The CFTC also advises commercial parties that they may rely on counterparty representations with respect to the intended purpose for embedding volumetric optionality in the contract, provided they are unaware, and should not reasonably have been aware, of facts indicating a contrary purpose.

The Proposed Interpretation also removes the reference to physical factors or regulatory requirements being "outside the control of the parties." This phrase has also created problems during negotiations as counterparties often disagree about the degree of control they have over factors influencing their demand for or supply of the commodity. By removing this language, the CFTC intends to clarify that the parties may satisfy the seventh condition even if they have some influence over factors affecting demand or supply of the commodity (e.g., the

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[5] As an example, the CFTC notes that in choosing whether to obtain additional supply by exercising the embedded optionality under a given contract or turning to another supply source (whether storage, the spot market or another forward contract with embedded volumetric optionality), commercial parties would be able to consider a variety of factors, including price, provided that the intended purpose for including the embedded optionality in the contract at contract initiation was to address physical factors or regulatory requirements influencing demand for or supply of the commodity.

scheduling of plant maintenance, plans for business expansion), so long as the embedded optionality is included at contract initiation primarily to address potential variability in supply or demand.

The Proposed Interpretation also clarifies that the phrase "physical factors" should be construed broadly to include any fact or circumstance that could reasonably influence supply of or demand for the underlying commodity, including not only environmental factors (e.g., weather or location), but also relevant "operational considerations" (e.g., the availability of reliable transportation or technology) and broader social forces, such as demographic or geopolitical changes.[6] Concerns that are primarily about price risk (e.g., expectations that the cash market price will increase or decrease), however, would not satisfy the seventh condition absent an applicable regulatory requirement to obtain or provide the lowest price (e.g., the buyer is an energy company regulated on a cost-of-service basis).

Finally, as electric utilities have the right, in certain retail electric market demand-response programs, to interrupt or curtail service to a customer to support system reliability, the Proposed Interpretation clarifies that demand response agreements, even if not specifically mandated by a system operator, may be properly characterized as the product of regulatory requirements within the meaning of the seventh condition.

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Please do not hesitate to contact us with any questions.

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[6] The CFTC also reiterates that, as stated in the Existing Interpretation, system reliability issues that lead to voluntary supply curtailments could be considered "physical factors" within the scope of the seventh condition.