

UPDATED: CFTC Clarifies Regulation of Forward Contracts with Embedded Volumetric Optionality

With recent release, the CFTC hopes to eliminate market uncertainty on forward contracts with embedded volumetric optionality.

UPDATE (June 18, 2015): On May 12, 2015, the CFTC adopted the Proposal as proposed (as used herein, the Final Interpretation)¹ with some additional clarifications. Updates to this client alert related to the Final Interpretation are displayed in italicized type.

The comment period recently closed for a proposed interpretation (the Proposal)² to further clarify what constitutes a forward contract with embedded volumetric optionality. On November 14, 2014, the US Commodity Futures Trading Commission (the CFTC or the Commission) issued the Proposal which primarily focuses on modifying the seventh element of the “embedded volumetric optionality” test³ - a test that has been the center of much concern to the energy industry, which is an industry that heavily relies on the forward contract exclusion from the definition of “swap” under the Dodd-Frank Wall Street Reform and Consumer Protection Act and the regulations promulgated thereunder (Dodd-Frank Act). The comment period for the Proposal ended on December 22, 2014.

Certainty regarding whether a forward contract with embedded volumetric optionality would be eligible for the forward contract exclusion, or would otherwise be regulated as an option, is a threshold matter for industry participants — given that options are considered “swaps” under the Dodd-Frank Act and therefore all swap regulations, including position limits, would apply to such contracts. This Proposal would provide greater certainty by clarifying certain industry confusion surrounding regulation on forward contracts with embedded volumetric optionality and stressing that fact-based analysis relies on the intent of the counterparties at the inception of the contract.

Background

The Dodd-Frank Act defines the term “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”⁴ Further, the CFTC has stated that, as a general rule, commodity options are to be regulated as “swaps.”⁵ However, in the CFTC’s rulemaking further defining the term “swap” (the Final Products Rule), the CFTC concluded that a forward contract containing embedded volumetric optionality may avoid being fully regulated as a swap, so long as the contract satisfies a seven-part test (outlined below).⁶

Both the Commodity Exchange Act (the CEA) and CFTC regulations have long recognized a forward contract exclusion from futures contracts.⁷ Similarly, under the Dodd-Frank Act, non-financial commodity forward contracts continue to be exempt from regulation as swaps.⁸ Some forward contracts, however, include elements of optionality and therefore may arguably qualify as swaps.⁹

In promulgating regulation for forward contracts with optionality under the Dodd-Frank Act, the Commission stated that the forward contract exclusion would be interpreted in a manner consistent with the CFTC's historical interpretation of the existing forward exclusion with respect to futures contracts.¹⁰ Under the Final Products Rule, the CFTC provides that a forward contract that contains an embedded option¹¹ (*i.e.*, price optionality) or an embedded volumetric option (*i.e.*, delivery optionality) would continue to be considered an excluded nonfinancial commodity forward contract, so long as the forward contract would meet certain conditions.¹²

In short, forward contracts with embedded price optionality may still benefit from the forward contract exclusion from the definition of "swap" so long as the delivery obligation is not undermined, and forward contracts with embedded volumetric optionality may still benefit from the forward contract exclusion from the definition of "swap" so long as the option to deliver or not deliver is not exercised as a result of price risk (subject to meeting certain conditions, as discussed further below).

Specifically, the Final Products Rule provides that a forward contract involving the actual delivery of a commodity that contains embedded volumetric optionality may be treated as an excluded forward contract (and not a swap), provided that it meets a seven-part test.¹³

Since its publication in 2012, however, this seven-part test has created several concerns among market participants. Specifically, the seventh element has led to much confusion. Parties have either stopped trading in the marketplace due to the uncertainty in the interpretation of what "exercise or non-exercise" or "outside of the control of the parties" means or counterparties have negotiated representations and agreements as to what the terms mean, in order to be certain to meet the seventh element. Arguably, however, any such agreements or representations are not enforceable. Counterparties have at many times also simply remained at odds with each other as to what would be considered within or outside of their control and/or at the time of such exercise or non-exercise. The Proposal seeks to address, and hopefully settle, such uncertainty which causes inefficient and unnecessary market negotiations.

Proposed Interpretation (*adopted as proposed in the Final Interpretation*)

While the Proposal primarily focuses on modifications to the seventh element, the Proposal also clarifies that the exclusion applies to volumetric optionality in the form of both puts and calls.

With respect to the seventh element, the Proposal would make several changes to the current language:

- (1) The Proposal would remove reference to "exercise or non-exercise" as the language has had the unintended consequence of causing parties to feel as though they must expressly outline the factors that could lead to the exercise or non-exercise of such volumetric optionality. The Commission would further clarify that the focus of the seventh element is the intent with respect to the volumetric optionality at the time of contract initiation and not at the time of exercise.¹⁴ Further, the Commission states that parties may rely on counterparty representations with respect to the intended purpose for the embedded volumetric optionality.
- (2) The Proposal also would remove reference to physical factors or regulatory requirements being "outside of the control of the parties." The industry has struggled with this requirement as parties will often disagree about the degree of control one can have over factors influencing supply or demand. The Commission clarifies that a degree of control over regulatory or physical factors would not be inconsistent with the seventh element, so long as the embedded volumetric optionality is included at contract initiation and primarily to address swings in the party's supply of or demand for the nonfinancial commodity.¹⁵

- (3) The Proposal would clarify that the phrase “physical factors” should be interpreted broadly and would include facts or circumstances that could reasonably influence supply of or demand for the nonfinancial commodity. Such factors could include not only environmental factors but also relevant operational considerations and broader demographic and geopolitical factors; however, concerns about price risk will not satisfy the seventh element absent a regulatory requirement to obtain or provide the lowest price (e.g., cost-service regulation).¹⁶
- (4) The Proposal would clarify that curtailments of supply by electric utilities to support system reliability (i.e., *demand response agreements*), even if not mandated by a system operator, may be considered a product of a regulatory requirement and within the meaning of the seventh element.¹⁷

We note that under the Proposal, in determining whether a forward contract with embedded volumetric optionality would qualify for the forward exclusion, the Commission (in addition to clarifying other issues) would take a similar approach as it has in the context of forward contract exclusion in the futures context, i.e., whether the intention of the counterparties is to make and take delivery of a commodity and not to speculate on favorable market conditions.¹⁸

Interestingly, Commissioner Sharon Bowen’s concurrence recognizes the difficulty in applying these brightline tests and calls into question whether or not the Commission should be regulating forward contracts with embedded volumetric optionality as forward contracts. Her concurrence instead offers regulating such contracts as a commodity option as an alternative solution. She underscores the fact that regulating forward contracts with embedded volumetric optionality as a commodity option allows for exemptions (i.e., the Commission could carve out such contracts from regulation as it has with trade options), whereas scoping such contracts into the forward contract exclusion would wholesale exclude such contracts from regulation. Commissioner Bowen, while ultimately concurring with the Proposal, asks the industry for comment and insight to such an approach.

Below we highlight proposed changes to the seven-part test *which were adopted as proposed in the Final Interpretation*:

An agreement, contract, or transaction falls within the forward exclusion from the swap and future delivery definitions, notwithstanding that it contains embedded volumetric optionality, when:

- (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 with embedded volumetric optionality intends, at the time it enters into the agreement, contract, or transaction to deliver the underlying nonfinancial commodity if the **embedded volumetric** optionality is exercised;
- (5) The buyer of a nonfinancial commodity underlying the agreement, contract or transaction with embedded volumetric optionality intends, at the time it enters into the agreement, contract, or

transaction, to take delivery of the underlying nonfinancial commodity if ~~it exercises~~ the embedded volumetric optionality **is exercised**;

(6) Both parties are commercial parties; and

(7) The ~~exercise or non-exercise of the~~ embedded volumetric optionality is **primarily intended, at the time that the parties enter into the agreement, contract, or transaction, to address** ~~based primarily on~~ physical factors or regulatory requirements ~~that are outside the control of the parties and are influencing that reasonably influence~~ demand for, or supply of, the nonfinancial commodity.

Additional CFTC Guidance in the Final Interpretation

The CFTC provided further clarification in the Final Interpretation as to the practical application of the seven-factor test (and, specifically, the fourth, fifth and seventh elements) and how broadly such elements would be construed in determining whether a forward contract with embedded price optionality would fall within the forward contract exclusion.

In general the CFTC clarifies that its interpretation with respect to forward contracts with embedded volumetric optionality should not be read to alter or expand the standing interpretation of the forward contract.

Next, the CFTC states that bandwidth contracts (i.e., swing contracts), which provide for delivery of a nonfinancial commodity within a certain minimum and maximum range, are not precluded by the fourth and fifth element from falling within the forward contract exclusion. So long as all seven elements are satisfied, the fact that embedded volumetric optionality may change the quantity delivered under the underlying forward contract, would not remove the contract from the forward exclusion.¹⁹

Finally, the CFTC provided the following points of clarification in respect of the seventh element:

- **Reliance on Counterparty Representations:** *Though commercial parties may rely on counterparty representations regarding the intended purpose for embedding volumetric optionality in the contract provided they do not have information that would cause a reasonable person to question the accuracy of the representation, the CFTC clarified that such parties are **not** required to conduct due diligence in order to rely on such representations.*
- **Physical Factors:** *The seventh element's reference to "physical factors" are to be construed broadly and would include any fact or circumstance that could reasonably influence the supply of and demand for a nonfinancial commodity. Such factors include environmental factors (e.g. weather, location), operational considerations (e.g. transportation, technology), changes in demographics or geopolitics. The CFTC clarifies that having some influence over the physical factor would not be inconsistent with the seventh element.*
- **Price as a Consideration:** *Recognizing that price is likely to be a consideration, as with any contract, when entering into a forward contract, the CFTC clarified that, so long as the embedded volumetric optionality is primarily intended as a means of securing a supply source in the face of uncertainty regarding future supply and demand, taking price into consideration is not itself a bar to a contract qualifying for the forward exclusion.*

- *Characterization of Existing Contracts: When characterizing existing contracts (e.g., as an excluded forward contract with embedded volumetric optionality or a trade option), commercial parties may either (1) rely on their good faith characterization of such existing contract or (2) recharacterize it in accordance with the Final Interpretation.*²⁰

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Endnotes

- ¹ Forward Contracts with Embedded Volumetric Optionality, 80 FR 28239 (May 18, 2015) ([click here for release](#)) (the "Final Interpretation").
- ² Forward Contracts with Embedded Volumetric Optionality, Proposed Interpretation, 79 FR 69073 (November 20, 2014) ([click here for release](#)) (the "Proposal").
- ³ Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement"; Mixed Swaps; Security-Based Swap Agreement Recordkeeping, 77 FR 48208, 48238 (August 13, 2012) (hereafter, the "Final Products Rule").
- ⁴ See CEA, Section 1(a)(47).
- ⁵ See CFTC Division of Market Oversight Response to Frequently Asked Questions Regarding Commodity Options (*reissued* February 28, 2014).
- ⁶ See Final Products Rule at 48365.
- ⁷ See CEA, Section 1(a)(27), "the term 'future delivery' does not include any sale of any cash commodity for deferred shipment or delivery."
- ⁸ See CEA Section 1a(47)(B)(ii); Final Products Rule at 48238-39.
- ⁹ See Proposal, 79 FR at 69078 (concurring statement of Commissioner Bowen).
- ¹⁰ See Final Products Rule at 48227; Characteristics Distinguishing Cash and Forward Contracts and "Trade" Options, 50 FR 39656 (Sep. 30, 1985) ("1985 CFTC OGC Interpretation"). The CFTC states in the Final Products Rule that it is not providing that commodity options qualify as forward contracts in nonfinancial commodities, but rather providing an interpretation that certain forward contracts with embedded optionality would continue to qualify for the forward contract exclusion despite the embedded optionality. (Final Products Rule at 48237, citing 1985 CFTC OGC Interpretation) ("an option cannot be a forward under the CFTC's precedent, because under the terms of the contract the optionee has the right, but not the obligation, to make or take delivery, while under a forward contract, both parties must have a binding delivery obligation." Final Products Rule at note 321).
- ¹¹ The CFTC leaned heavily on the two-step analysis applied in *In re Wright* which looks first at whether the primary purpose of the optionality operates on the price or delivery and then turns to the secondary trading of the obligation and whether or not the option is severable from the delivery obligation. Under *Wright*, an embedded option in a forward contract is excluded from regulation if the primary purpose of the contract is physical delivery and the embedded option cannot be severed from the underlying commodity. See *id.* at 48228 (citing *In re Wright*, CFTC Docket No. 97-02, 2010 WL 4388247 (CFTC Oct. 25, 2010)).
- ¹² Forward contracts with embedded options (but not volumetric options) are considered excluded nonfinancial commodity forward contracts (and not swaps) so long as the embedded option: (1) may be used to adjust the forward contract price, but does not undermine the overall nature of the contract as a forward contract; (2) does not target the delivery term, so that the predominant feature of the contract is actual delivery; and (3) cannot be severed and marketed separately from the overall forward contract in which it is embedded. See Final Products Rule at 48237.
- ¹³ An agreement, contract, or transaction falls within the forward exclusion from the swap and future delivery definitions, notwithstanding that it contains embedded volumetric optionality, when:
 - (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 with embedded volumetric optionality intends, at the time it enters into the agreement, contract, or transaction to deliver the underlying nonfinancial commodity if the optionality is exercised;
 - (5) the buyer of a nonfinancial commodity underlying the agreement, contract or transaction with embedded volumetric optionality intends, at the time it enters into the agreement, contract, or transaction, to take delivery of the underlying nonfinancial commodity if it exercises the embedded volumetric optionality;
 - (6) both parties are commercial parties; and
 - (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 ("the seventh element") (collectively the "seven-part test").See Final Products Rule at 48238.
- ¹⁴ "For example, in choosing whether to obtain additional supply by exercising the embedded volumetric optionality under a given contract or turning to another supply source...commercial parties would be able to consider a variety of factors, including price, provided that the intended purpose for including the embedded volumetric optionality in the contract at contract initiation was to address physical factors or regulatory requirements influencing the demand for or supply of the commodity." Proposal, 79 FR at n.18.

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- ¹⁵ Under the Proposal the scheduling of plant maintenance or plans to expand the business would not cause the seventh element to fail despite the fact that such decisions are within the parties' control. See Proposal, 79 FR at 69075; Final Interpretation, 80 FR 28242.
- ¹⁶ Physical factors would include weather and location. See *id.*
- ¹⁷ System reliability issues that lead to voluntary curtailments (*i.e.*, other than by electric utilities) would be considered "physical factors" within the meaning of the seventh element. See Proposal, 79 FR at n.21 (citing 77 FR at n.345); Final Interpretation, 80 FR at 28242.
- ¹⁸ See 1985 OGC Interpretation; *Statutory Interpretation concerning Forward Transactions*, 55 FR 39188 (Sep. 25, 1990) ("Brent Interpretation").
- ¹⁹ Final Interpretation, 80 FR at 28241.
- ²⁰ Final Interpretation, 80 FR at 28242.