

## CFTC Hosts End-User Roundtable

### *The Commission responds to issues facing end-users as a result of derivatives reforms.*

Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act)<sup>1</sup> amended the Commodity Exchange Act<sup>2</sup> (CEA) to establish a comprehensive regulatory framework for swaps. Since 2010, the US Commodity Futures Trading Commission (CFTC) has issued numerous regulations, no-action letters and interpretations implementing the Dodd-Frank Act. Although many of these regulations are aimed specifically at new categories of registered entities, such as swap dealers, major swap participants and swap execution facilities (SEFs), the CFTC's rulemakings impose certain compliance obligations that affect all market participants, including commercial end-users and other unregistered entities. The CFTC has received numerous comments and requests for clarification from end-users and other non-registrants who have been impacted by the Dodd-Frank Act. Accordingly, the CFTC and its staff hosted a public roundtable<sup>3</sup> (Roundtable) on April 3, 2014 to discuss the issues end-users face as a result of the derivatives reforms the CFTC adopted pursuant to the Dodd-Frank Act, namely:

- The obligations of end-users and other non-registrants under CFTC Regulation 1.35 concerning recordkeeping requirements for commodity interest transactions and related cash or forward transactions<sup>4</sup>
- The appropriate regulatory treatment of forward contracts with embedded volumetric optionality<sup>5</sup>
- The appropriate regulatory treatment for purposes of the US\$25 million special entity *de minimis* threshold for swap dealing to government-owned electric utilities<sup>6</sup>

This *Client Alert* focuses narrowly on a brief overview of the discussions from the Roundtable as well as other issues that commercial end-users and other non-registrants should consider as they continue trading swaps in a newly regulated environment. Because this *Client Alert* offers only a brief summary of a select set of issues facing end-users, however, please contact the authors listed below for further clarification and guidance.

### CFTC Regulation 1.35 Recordkeeping

On December 17, 2012, the CFTC adopted final rules amending CFTC Regulation 1.35 to require that certain market participants, including SEF and Designated Contract Market (DCM) members, maintain certain records regarding the execution of commodity interest transactions and related cash or forward transactions.<sup>7</sup> Although amended CFTC Regulation 1.35 contains recordkeeping requirements for both written and oral records, the CFTC exempted most unregistered entities from the oral recordkeeping

requirements.<sup>8</sup> Nevertheless, under amended CFTC Regulation 1.35, all SEF and DCM members — including those that also qualify as commercial end-users — must maintain the following written records:

- Original source documents, or all documents on which trade information is originally recorded
- Written records in a form and manner identifiable and searchable by transaction
- All written communications provided or received concerning quotes, solicitations, bids, offers, instructions, trading and prices that lead to the execution of a transaction in a commodity interest and related cash or forward transactions<sup>9</sup>

As noted above, these recordkeeping requirements apply not only to a swap executed on a SEF or DCM but also to any related cash or forward transaction to which the swap relates.<sup>10</sup> Therefore, commercial end-users (and other non-registrants) that choose to transact on a SEF or DCM are subject to enhanced recordkeeping requirements for their cash commodity and forward contracts beyond those set forth under the CFTC's Part 45 (regulatory) recordkeeping requirements for swaps.<sup>11</sup>

At the Roundtable, numerous participants expressed concern that CFTC Regulation 1.35, as currently written, potentially captures every conversation in which their trading personnel engage because their business solely relates to entering into cash commodity and forward contracts. Participants also expressed concern regarding the requirement to maintain records of "related" cash or forward transactions because the participants do not necessarily tie their derivatives trades directly to a cash or forward transaction on a real-time basis and, thus, cannot identify the extent to which certain records must be kept for certain transactions.

The CFTC staff asked participants at the Roundtable about the scope of the rule and, in particular, its application to any "member" of a SEF or DCM. In response, a number of participants at the Roundtable argued that the CFTC defines the term "member" too expansively, covering more than what Congress intended and what CFTC Regulation 1.35 was designed to capture prior to the Dodd-Frank Act. Participants expressed frustration that the amendments to CFTC Regulation 1.35 went into effect prior to the CFTC finalizing its rules governing SEFs<sup>12</sup> and clarifying the meaning of a "member" of a SEF. In the participants' view, this ambiguity limited their ability to fully comment on the impact of the changes to CFTC Regulation 1.35 when initially proposed. Participants also claimed that CFTC Regulation 1.35 could create a disincentive for end-users to trade on SEFs, since the rule expressly applies to "members" of a SEF but would not apply to an end-user trading on a purely over-the-counter (OTC) basis. Finally, participants indicated that since CFTC Regulation 1.35 went into effect, many of them have ceased using written communications to execute forward and cash commodity transactions and have instead pushed all communications to the telephone because CFTC Regulation 1.35 exempts end-users from oral (but not written) recordkeeping requirements.

CFTC Acting Chairman Mark Wetjen suggested that the real purpose behind CFTC Regulation 1.35 is to enhance CFTC enforcement capabilities and, therefore, opponents would find difficulty arguing no public policy supports the rule. He further indicated, however, that the question the CFTC needs to consider is the scope of the rule and whether its costs are sufficiently weighed against its benefits. Additionally, on April 7, 2014, a bipartisan group of lawmakers introduced a bill (Proposed Bill)<sup>13</sup> entitled the Customer Protection and End-User Relief Act that would seemingly provide relief to end-users from certain CFTC Regulation 1.35 recordkeeping requirements. Under the Proposed Bill, end-users would only be required to maintain written records of the final material economic terms of an agreement.<sup>14</sup> However, whether or when the Proposed Bill will be adopted remains unclear.

## Commodity Options as Swaps

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 ....”<sup>15</sup> Therefore, all other things being equal, the CFTC has stated that the general rule is that commodity options are to be regulated as “swaps.”<sup>16</sup>

However, a commodity option involving a physical (as opposed to financial) commodity may avoid being fully regulated as a swap under the following three separate scenarios:

- **A Forward Contract with an Embedded Commodity Option:** A forward contract involving the actual delivery of a commodity that contains embedded optionality may be treated as an excluded forward contract (and not a swap) so long as: (i) the option may be used to adjust the forward price, but does not undermine the overall nature of the contract as a forward; (ii) the option does not target the delivery term, so that the predominant feature of the contract is actual delivery; and (iii) the option cannot be severed and marketed separately from the overall forward in which it is embedded.<sup>17</sup> A forward contract is not regulated as a swap.
- **A Forward Contract with Embedded Volumetric Optionality:** A forward contract that contains volumetric optionality (*i.e.*, that provides flexibility as to delivery amounts) may be treated as an excluded forward contract (and not a swap) where the forward contract meets a seven-part test:
  - (i) The embedded optionality does not undermine the overall nature of the contract as a forward.
  - (ii) The predominant feature of the contract is delivery.
  - (iii) The embedded optionality cannot be severed and marketed separately.
  - (iv) The seller intends to deliver the commodity if the option is exercised.
  - (v) The buyer intends to take delivery if the option is exercised.
  - (vi) Both parties are commercial parties.
  - (vii) 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.<sup>18</sup>

Again, a forward does not qualify as a swap.

- **Trade Options:** Trade options are options that, if exercised, would result in the sale of a non-financial commodity for immediate (*i.e.*, spot) or deferred (*i.e.*, forward) shipment or delivery. For an instrument to qualify as a trade option, the following conditions must be met:
  - (i) The offeror must be either:
    - (a) an eligible contract participant, as defined in Section 1a(18) of the CEA; or
    - (b) a producer, processor, or commercial user of, or a merchant handling the commodity that is the subject of the commodity option transaction, or the products or by-products thereof, and such offeror is offering or entering into the commodity option transaction solely for purposes related to its business as such;

- (ii) The offeree must be a producer, processor, or commercial user of, or a merchant handling the commodity that is the subject of the commodity option transaction, or the products or by-products thereof, and such offeree is offering or entering into the commodity option transaction solely for purposes related to its business as such; and the commodity option must be intended to be physically settled, so that, if exercised, the option would result in the sale of an exempt or agricultural commodity for immediate or deferred shipment or delivery.<sup>19</sup>

Like forward contracts, trade options are exempt from most of the CFTC's regulatory requirements, but remain subject to: (i) recordkeeping; (ii) regulatory reporting (subject to certain exemptions); and (iii) potentially, position limits.<sup>20</sup>

In practice, the application of these three exemptions has created uncertainty for numerous market participants, particularly in the energy markets. Among other things, end-users have struggled to decipher the CFTC's swap definition rules to determine whether and under what circumstances a forward contract with embedded volumetric optionality falls within the forward contract exclusion or should be treated instead as a swap or a trade option — each of which implicate different regulatory requirements. According to participants at the Roundtable, the seventh prong of the volumetric optionality test — *i.e.*, that the exercise or non-exercise of the embedded volumetric optionality be based primarily on physical factors or regulatory requirements that are outside the control of the parties — is inconsistent with market practice, where the inclusion of volumetric optionality in a contract for the physical delivery is often based on a combination of factors that may or may not be within the parties' control.

Given the difficulty in applying the seventh prong of the volumetric optionality test, the Roundtable participants explained counterparties often disagree with respect to classifying a contract as a forward contract, trade option or swap. In an abundance of caution, many Roundtable participants suggested that they typically treat contracts with volumetric optionality as trade options as opposed to excluded forward contracts. However, Roundtable participants noted that their counterparties may take the approach that their contracts with volumetric optionality should be treated as excluded forward contracts. Under that circumstance, then, one of the counterparties will report the transaction to the CFTC pursuant to the reporting requirements for trade options, generally by submitting a Form TO, and the other will not report the transaction at all, creating a discrepancy in data provided to the CFTC. Additionally, the Roundtable participants claimed that the need to classify a contract with volumetric optionality as either a forward contract, swap, or trade option and the arguments that may ensue from that determination have slowed down the commercial process, with certain market participants refusing to include volumetric optionality within their agreements.

Going forward, many Roundtable participants suggested that the CFTC should eliminate the seventh prong of the volumetric optionality test or should, at minimum, provide further guidance regarding the application of the seventh prong of the volumetric optionality test. Without signalling any action on the part of the CFTC, Acting Chairman Wetjen asked the Roundtable participants about the practical effect of clarifying that contracts with volumetric optionality are trade options instead of excluded forward contracts and that trade options are not subject to the CFTC's position limits rule. Although most Roundtable participants agreed such clarification would be helpful regarding the classification of certain instruments, they indicated that treating these instruments as excluded forward contracts would be more desirable to eliminate the continued reporting obligations with respect to trade options, which add costs. The Proposed Bill mentioned above would amend the CEA to clarify that forward contracts with volumetric optionality entered into between commercial market participants are excluded forward contracts (and not swaps) by, among other things, removing the conditions under the seventh prong of the current volumetric optionality test.<sup>21</sup> As stated above, however, whether or when the Proposed Bill will be adopted remains unclear.

## Special Entity *de minimis* Threshold

In May 2012, the CFTC issued its final rule further defining those entities required to register as “swap dealers” (the Entities Rule).<sup>22</sup> Under the Entities Rule, an entity will not be considered a swap dealer if it engages in a *de minimis* amount of swap dealing activities, with such amount limited to not more than US\$25 million notional amount in swap dealing transactions with “special entities” and not more than US\$8 billion in notional amount with other entities during an initial phase-in period.<sup>23</sup> Thus, if an entity engages in swap dealing transactions with special entities — e.g., government-owned utilities — that exceed the US\$25 million notional amount limit during a rolling 12-month period, then that entity will be required to register as a swap dealer and will be subject to additional registration, capital and margin, business conduct standards and reporting requirements.

Given the low threshold applicable to transactions with special entities, a number of market participants expressed concern that certain entities will avoid trading with government-owned electric utilities to avoid swap dealer registration and therefore filed a petition requesting that the CFTC exclude from the special entity *de minimis* threshold utility-related swaps with utility special entities. According to these requests, such an exclusion is necessary to increase the number of counterparties available to special entities that enter into swaps for the efficient conduct of a utility’s business and operations.

On October 12, 2012, the CFTC responded by issuing a no-action letter allowing an entity to deal in up to US\$800 million in swaps with government-owned utilities without being required to register as a swap dealer.<sup>24</sup> However, that no-action letter also included a number conditions and limitations that market participants claimed were unworkable and have inhibited counterparties’ willingness to enter into swap transactions with utility special entities, including a requirement that the counterparty to the utility special entity not be a “financial entity.”<sup>25</sup>

On March 21, 2014, the CFTC staff issued a separate no-action letter that provided further relief to market participants to enter into qualifying swaps with utility special entities subject to the ordinary US\$8 billion notional limit and removed certain conditions that market participants viewed as problematic in the October 2012 no-action letter.<sup>26</sup> At the Roundtable, Acting Chairman Wetjen suggested that the CFTC would be issuing a further rule proposal largely similar to this no-action letter but asked participants if there are areas for improvement. All of the Roundtable participants expressed appreciation for the March 2014 no-action letter and looked forward to seeing the CFTC’s proposal in this respect. The Proposed Bill also addresses these issues.<sup>27</sup>

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**Endnotes**

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- <sup>1</sup> See Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law 111–203, 124 Stat. 1376 (2010).
  - <sup>2</sup> 7 U.S.C. 1 *et seq.*
  - <sup>3</sup> See CFTC Staff to Host Public Roundtable to Discuss Dodd-Frank End-User Issues, CFTC Press Release 6872-14 (Mar. 15, 2014).
  - <sup>4</sup> See 17 C.F.R. 1.35.
  - <sup>5</sup> See Further Definition of “Swap,” “Security-Based Swap” and “Security-Based Swap Agreement,” Final Rule 77 Fed. Reg. 48208, 48238 (Aug. 13, 2012) (hereafter, the Final Products Rule).
  - <sup>6</sup> See Further Definition of “Swap Dealer,” “Security-Based Swap Dealer,” “Major Swap Participant,” “Major Security Based Swap Participant” and “Eligible Contract Participant,” Final Rule, 77 Fed. Reg. 30596, 30635 (May 23, 2012) (hereafter, the Entities Rule).
  - <sup>7</sup> See Adaptation of Regulations to Incorporate Swaps – Records of Transactions, Final Rules, 77 Fed. Reg. 75523, 75524 (Dec. 21, 2012).
  - <sup>8</sup> See 17 C.F.R. 1.35(a).
  - <sup>9</sup> See *id.*
  - <sup>10</sup> See *id.*
  - <sup>11</sup> See 17 C.F.R. 45.2.
  - <sup>12</sup> See Core Principles and Other Requirements for Swap Execution Facilities, Final Rule, 78 Fed. Reg. 33476 (June 4, 2013).
  - <sup>13</sup> See Customer Protection and End-User Relief Act (H.R. 4413) (hereafter, the Proposed Bill).
  - <sup>14</sup> See *id.* at Section 353.
  - <sup>15</sup> See CEA, Section 1(a)(47).
  - <sup>16</sup> See CFTC Division of Market Oversight Response to Frequently Asked Questions Regarding Commodity Options (*reissued* February 28, 2014).
  - <sup>17</sup> See Final Products Rule at 48237.
  - <sup>18</sup> See *id.* at 48238.
  - <sup>19</sup> See 17 C.F.R. 32.3.
  - <sup>20</sup> See *id.*
  - <sup>21</sup> See Proposed Bill Section 354.
  - <sup>22</sup> See Entities Rule, *supra* note 6.
  - <sup>23</sup> See *id.* at 30635.
  - <sup>24</sup> See CFTC No-Action Letter No. 12-18 (Oct. 12, 2012).
  - <sup>25</sup> See *id.*
  - <sup>26</sup> See CFTC No-Action Letter No. 14-34 (Mar. 21, 2014).
  - <sup>27</sup> See Proposed Bill Section 342.