

# Client Alert

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## CFTC and SEC Propose Interpretation Concerning Forward Contracts with Embedded Volumetric Optionality

By Julian Hammar and Michael Sorrell

On November 13, 2014, the Commodity Futures Trading Commission (CFTC) and the Securities and Exchange Commission (SEC) approved for publication in the Federal Register a proposed interpretation clarifying the CFTC's interpretation regarding forwards with embedded volumetric optionality contained in the Product Definitions Release.<sup>1</sup> The Proposed Interpretation is available [here](#).<sup>2</sup> The CFTC has requested comment on all aspects of the proposed interpretation, with the comment period ending on **December 22, 2014**.

### BACKGROUND

On August 12, 2012, the CFTC and SEC jointly published final rules and interpretations further defining the terms "swap" and "security-based swap" among other terms (the "Product Definitions Release"). The Product Definitions Release included an interim final interpretation and request for comment with respect to forward contracts that provide for optionality with respect to the amount of commodity to be delivered (*i.e.*, volumetric optionality). Forward contracts that meet the requirements of the interpretation are considered to be forward contracts excluded from the definition of the term "swap" contained in section 1a(47) of the Commodity Exchange Act (CEA), as well as the definition of the term "future delivery" contained in section 1a(27) of the CEA, notwithstanding that they contain embedded volumetric optionality.

Contracts that do not satisfy the elements of the test are considered to be commodity options. Commodity options are included in the definition of the term "swap," whether they are physically or financially settled, although they may qualify for the trade option exemption.<sup>3</sup> The interpretation included seven elements that were required to be satisfied in order for an agreement, contract, or transaction to satisfy the exclusions from the "swap" and "future delivery" definitions despite containing volumetric optionality.

A number of comments were received by the CFTC that, in particular, the seventh element of the test created uncertainty among industry participants about how to categorize certain transactions as excluded forward

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<sup>1</sup> Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement"; Mixed Swaps; Security-Based Swap Agreement Recordkeeping; Final Rule, 77 Fed. Reg. 48207 (Aug. 13, 2012).

<sup>2</sup> 79 Fed. Reg. 69073 (Nov. 20, 2014).

<sup>3</sup> Section 1a(47) of the CEA 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." In the Product Definitions Release, the CFTC reaffirmed that commodity options are swaps under the statutory definition. 77 Fed. Reg. at 48,236. In April 2012, the CFTC adopted a final rule on commodity options, which generally treats commodity options as subject to the same rules as other swaps, with the exception of physically settled commodity options that meet the requirements of the trade option exemption, adopted as an interim final rule in that rulemaking. See 77 Fed. Reg. 25320 (April 27, 2012). In general, trade options are subject to lighter regulation compared to swaps.

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contracts or trade options. Under the seventh element, an agreement, contract, or transaction falls within the forward exclusion if:

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.<sup>4</sup>

Some commenters expressed the view that they have been uncertain about how to characterize contracts at the time of execution under the seventh element, as they often do not know until the time of exercise the exact reasons why optionality will be exercised. In addition, the phrase “outside the control of the parties” has created problems during contract negotiations, according to some commenters, as counterparties may disagree about the degree of control they have over factors influencing their demand for or supply of the nonfinancial commodity.

## PROPOSED INTERPRETATION

The Proposed Interpretation provides that 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 (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.<sup>5</sup>

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<sup>4</sup> 77 Fed. Reg. at 48,238.

<sup>5</sup> 79 Fed. Reg. at 69,074.

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The first six elements of the Proposed Interpretation are largely unchanged from the interpretation in the Product Definitions Release other than slight modifications to the fourth and fifth elements to clarify that the interpretation applies to embedded volumetric optionality in the form of both calls and puts.

The key modification provided for in the Proposed Interpretation applies to the seventh element. The Proposed Interpretation removes the reference contained in the original interpretation to the “exercise or non-exercise” of the embedded volumetric optionality, thereby clarifying that the focus of the seventh element is intent with respect to the embedded volumetric optionality at the time of contract initiation. Thus, in choosing whether to obtain additional supply by exercising the embedded volumetric optionality under a given contract or turning to another supply source, the Proposed Interpretation states that 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. The Proposed Interpretation further clarifies that commercial parties may rely upon counterparty representations with respect to the intended purpose for embedding volumetric optionality in a contract, provided the parties were unaware, and should not reasonably have been aware, of facts indicating a contrary purpose.<sup>6</sup>

The Proposed Interpretation also removes the reference to physical factors or regulatory requirements being “outside the control of the parties” from the original interpretation. By removing this language, the CFTC intends to clarify that parties may have some influence over factors affecting their demand for or supply of the nonfinancial commodity (e.g., through the scheduling of plant maintenance, plans for business expansion), provided that the embedded volumetric optionality is included in the contract at initiation primarily to address potential variability in a party’s supply of or demand for the nonfinancial commodity.<sup>7</sup>

The CFTC also intends to clarify 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 nonfinancial commodity under the contract. Such facts and circumstances could include not only environmental factors, such as weather or location, but relevant “operational considerations” (e.g., the availability of reliable transportation or technology) and broader social forces such as changes in demographics or geopolitics. By contrast, concerns that are primarily about price risk (e.g., expectations that the cash market price will increase or decrease) would not satisfy the seventh element 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).<sup>8</sup>

In addition, the Proposed Interpretation would clarify 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 element.

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<sup>6</sup> 79 Fed. Reg. at 69,075.

<sup>7</sup> *Id.*

<sup>8</sup> *Id.* at 69,075-76.

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Notably, the Proposed Interpretation does not change the requirement of the seven-part test that a non-nominal amount of commodity must be delivered under the contract. Accordingly, peaking supply natural gas contracts with no firm delivery requirement (e.g., a contract that permits a party to call upon “up to” a certain quantity of natural gas) still fail the test even in its proposed modified form. Such contracts likely are eligible for the trade option exemption, and thus are subject to more limited Dodd-Frank requirements. The Proposed Interpretation also does not change the CFTC’s interpretation of “full requirements” and “full output” contracts, which are not subject to the seven-part test, but may qualify as forwards under the facts and circumstances.

If adopted, the Proposed Interpretation at a minimum signals that the CFTC is likely to take a more relaxed view of the seventh element, and the seven-part test in general.

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