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CFTC Fine-Tunes Rules, Emphasizing Relief for Commercial End-Users

On November 3, 2014, the Commodity Futures Trading Commission (CFTC or Commission) approved three proposals that Chairman Timothy Massad described as “fine tuning” certain of the CFTC’s rules “to make sure they do not impose undue burdens or unintended consequences, particularly for the nonfinancial commercial businesses” that use derivatives markets to hedge commercial risks. Comments on each proposal are due 60 days from the Federal Register publication date.

Limited Relief for DCM and SEF Members From Recordkeeping Requirements Related to Cash and Forward Delivery Contracts

By a vote of 3-1, the CFTC approved proposed amendments to certain recordkeeping requirements under Regulation 1.35(a).¹ Regulation 1.35(a) prescribes general recordkeeping requirements in connection with derivatives transactions and related cash or forward transactions that are applicable to certain CFTC-registered market participants or, if not registered (and not required to be registered), a member of a designated contract market (DCM) or swap execution facility (SEF) (non-registrants collectively, Unregistered Members). Many covered entities, particularly Unregistered Members, have expressed that Regulation 1.35(a) is overly burdensome and unworkable with respect to keeping records of physical commodity transactions, citing the rule’s requirements as a deterrent from gaining access to a SEF.

Most notably, this proposal would codify existing staff no-action relief that alleviates Unregistered Members from the requirements to keep records of text messages and to store all required records in a form and manner that is identifiable and searchable by transaction.² Additionally, this proposal seeks to clarify that the “identifiable and searchable by transaction” standard generally would mean that while required records must be kept in a form and manner that is searchable and allows for the identification of the particular transaction, records do not have to be searchable by transaction.

Commissioner Giancarlo, the lone dissenter, criticized the proposal for failing to define the term “searchable.” He noted that without a working definition, it will be difficult to comply with the rule’s searchability requirement for paper records such as canceled checks, signed account agreements, paper orders and wire transfers.

The proposal also clarified that oral and written records of communications that lead to the execution of a commodity interest or related cash or forward transaction would only have to be searchable, but not kept in a form and manner that allows for identification of a particular transaction. Practically, this means that there would be no requirement for an entity covered by

¹ A copy of the proposal to be published in the Federal Register is available at <http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/federalregister110314b.pdf>.

² See CFTC Letter No. 14-72 (May 22, 2014). The proposal also would codify existing staff no-action relief for CTAs who are members of a DCM or SEF from the requirement to keep oral records of any commodity interest transaction. This proposal is broader than the existing staff no-action position for CTAs, which applies only with respect to swaps. See CFTC Letter No. 14-60 (April 25, 2014).

Regulation 1.35(a) to link a record of a communication that leads to the execution of a transaction with a particular transaction.³

Clarification on the Seventh Factor of the Test for Treatment as a Forward Contract With Embedded Volumetric Optionality

The CFTC unanimously proposed interpretive guidance that would modify its guidance from 2012 regarding forward contracts with embedded volumetric optionality (EVO).⁴ The 2012 guidance includes a seven-part test to determine whether a transaction could qualify for treatment as a forward contract with EVO, as opposed to a swap or futures contract.⁵ For the past two years, commercial end-users have struggled to make sense of the test. In particular, the seventh prong arguably had redefined many unregulated physical supply contracts (used commercially for decades) to be regulated as swaps.⁶

The proposed guidance would clarify several aspects of the seventh prong.⁷ First, the proposed guidance would remove the phrase “outside the control of the parties” to clarify that parties may have some control, so long as at the outset of the agreement, EVO is included to address variability in supply or demand.⁸ Second, the proposed guidance would clarify that “physical factors” should be construed broadly to include any fact or circumstance that reasonably could influence the counterparties’ supply of, or demand for, the nonfinancial commodity. These facts and circumstances could include environmental factors, relevant operational considerations and broader social forces such as changes in demographics or geopolitics. However, the proposed guidance also would clarify that, absent an applicable regulatory requirement to obtain or provide the lowest price possible (*e.g.*, regulations that require utilities to enter into an electric demand response agreement), price risk alone would not satisfy the seventh prong of the test.

Deadline for Posting Residual Interest

The CFTC also unanimously approved a proposal to eliminate from Regulation 1.22 the automatic acceleration of the daily deadline by which a futures commission merchant (FCM) must post residual interest to a customer’s segregated account.⁹ The daily posting deadline under Regulation 1.22 became 6 p.m. Eastern Time as of November 14, 2014, and the CFTC is required to conduct a study of the feasibility for FCMs and their customers to comply with an accelerated residual interest posting deadline (*i.e.*, the morning daily clearing settlement cycle or time of settlement). While the proposal would not alter these requirements, it would eliminate the acceleration of the posting deadline that automatically will occur at the end of 2018 if the CFTC fails to take prior action.

3 The Commission also confirmed that the existing “searchable” and “identifiable” requirements under Regulation 1.35(a) do not require a market participant to link records of a derivatives position used for hedging purposes with records of the underlying physical position being hedged.

4 A copy of the proposal to be published in the Federal Register is *available at* <http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/federalregister111314.pdf>. After consulting with the Board of Governors of the Federal Reserve System, the CFTC issued this proposed clarification jointly with the Securities and Exchange Commission as required by the Dodd-Frank Act.

5 See Further Definition of “Swap,” “Security-Based Swap” and “Security-Based Swap Agreement”; “Mixed Swaps”; and “Security-Based Swap Agreement Recordkeeping,” 77 Fed. Reg. 48,207, 48,238-42 (Aug. 13, 2012). EVO allows for parties to the agreement, contract, or transaction to change the amount of physical commodity contemplated for delivery thereunder.

6 The seventh prong currently provides that “[t]he exercise or non-exercise of the [EVO] 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.” 77 Fed. Reg. at 48238. As revised by the proposed guidance, it would provide that “[t]he [EVO] 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 nonfinancial commodity.”

7 The proposed guidance also would clarify that the fourth and fifth prongs of the test apply to EVO in the form of either a put or a call option, such that the seller also could exercise the EVO. The fourth and fifth prongs currently provide that “[t]he [seller/buyer] of a nonfinancial commodity underlying the agreement, contract, or transaction with [EVO] intends, at the time it enters into the agreement, contract, or transaction [to deliver/to take delivery of] the underlying nonfinancial commodity if [the buyer exercises the EVO].” 77 Fed. Reg. at 48238.

8 Furthermore, the CFTC states that commercial parties may rely on each other’s representations with respect to determining their intent for embedding volumetric optionality into the contract.

9 A copy of the proposal to be published in the Federal Register is *available at* <http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/federalregister110314.pdf>.