

CFTC Issues Revised Embedded Volumetric Optionality Interpretation for Swaps

Skadden

05/15/15

If you have any questions regarding the matters discussed in this memorandum, please contact the following attorneys or call your regular Skadden contact.

Mark D. Young

Washington, D.C.
202.371.7680
mark.d.young@skadden.com

Maureen A. Donley

Washington, D.C.
202.371.7570
maureen.donley@skadden.com

Theodore M. Kneller

Washington, D.C.
202.371.7264
ted.kneller@skadden.com

W. Graham McCall

Washington, D.C.
202.371.7276
graham.mccall@skadden.com

Trevor A. Levine

Washington, D.C.
202.371.7577
trevor.levine@skadden.com

This memorandum is provided by Skadden, Arps, Slate, Meagher & Flom LLP and its affiliates for educational and informational purposes only and is not intended and should not be construed as legal advice. This memorandum is considered advertising under applicable state laws.

1440 New York Avenue, NW,
Washington, D.C. 20005
202.371.7000

Four Times Square
New York, NY 10036
212.735.3000

skadden.com

On May 12, 2015, the Commodity Futures Trading Commission (CFTC) issued revised interpretive guidance for forward contracts with embedded volumetric optionality (EVO).¹ In 2012, the CFTC and Securities and Exchange Commission (SEC) (collectively, the Commissions) jointly adopted interpretive guidance on forward contracts with EVO as part of the final rules to further define the term “swap.”² “Forward contracts” are commercial merchandizing transactions that the parties intend to result in actual delivery of the commodity at a future date and that are excluded from the definition of a “swap.”³ Options (not executed on an exchange) for the purchase or sale of a commodity, however, fall within the definition of a “swap.”⁴ Many commercial market participants enter into contracts that call for delivery of a commodity at a future date that include embedded optionality, and the optionality permits the volume of the commodity delivered under the contract to be adjusted up or down (*i.e.*, EVO). The 2012 guidance was intended to clarify whether such contracts would qualify for the forward contract exclusion from, or were options that fell within, the swap definition.

The 2012 guidance included a seven-part test that established a safe harbor for contracts with EVO.⁵ Contracts with EVO meeting all seven parts could rely on the forward contract exclusion from the swap definition, notwithstanding the embedded optionality. However, many market participants struggled to apply the test in general, and the seventh element in particular, to their contracts, resulting in regulatory uncertainty as to whether the transactions were swaps subject to federal regulation.

The 2015 revised interpretive guidance generally retains the first six elements of the seven-part test without significant changes. The Commissions slightly modified the fourth and fifth elements to clarify that its interpretation applies to both puts and calls,⁶ noting that the fourth and fifth elements do not prohibit “bandwidth contracts” from falling within the forward contract exclusion.⁷ The seventh element was substantially revised.

Under the revised test, an agreement, contract or transaction with EVO may still qualify as a forward contract that is excluded from the swap definition if it meets the following criteria:

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;

¹ A copy of the final interpretation to be published in the Federal Register is available at <http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/federalregister051215.pdf>. Even though the final interpretation is issued jointly by the CFTC and SEC, it does not apply to security forwards or to the distinction between security forwards and security futures products.

² Definition of “Swap,” “Security-Based Swap” and “Security-Based Swap Agreement”; “Mixed Swaps”; and “Security-Based Swap Agreement Recordkeeping,” 77 Fed. Reg. 48,207 (Aug. 13, 2012).

³ 7 U.S.C. § 1a(47)(B)(ii) (2012). The definition is limited to forwards on nonfinancial commodities.

⁴ 7 U.S.C. § 1a(47)(A)(i) (2012).

⁵ 77 Fed. Reg. at 48,238.

⁶ The fifth element was initially phrased, “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 deliver the underlying nonfinancial commodity if it exercises the embedded volumetric optionality.” *Id.*

⁷ A bandwidth contract, or “swing,” is a contract that provides for delivery of a nonfinancial commodity within a certain minimum and maximum range.

CFTC Issues Revised Embedded Volumetric Optionality Interpretation for Swaps

4. The seller 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 the underlying nonfinancial commodity if the EVO is exercised;
5. The 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 take delivery of the underlying nonfinancial commodity if the EVO is exercised;
6. Both parties are commercial parties; and
7. The 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.

The seventh element in the 2012 guidance required that the “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 or supply].” Many market participants had difficulty agreeing with their counterparties whether a contract met the seventh element. In response, the CFTC revised and explained that the seventh element is intended to ensure that contracts with EVO will meet the safe harbor only if the optionality is primarily intended as a means to assure a source of supply or provide delivery flexibility in the face of uncertainty regarding the quantity of the commodity that may be needed or produced in the future.

The CFTC confirmed that “physical factors” should be interpreted broadly to include “any fact or circumstance that could reasonably influence supply of or demand for the nonfinancial commodity under the contract.”⁸ The 2015 revised guidance clarifies that the parties can have some influence over physical factors without failing the seventh element, provided that when the contract was entered into, the EVO was primarily included to address potential variability in supply or demand.

Furthermore, the CFTC restated that if the EVO is primarily intended (as of the contract’s initiation) to address concerns about price risk rather than the ability to buy or sell the commodity, the contract would not satisfy the seventh element unless there is an applicable regulatory requirement to provide or obtain the lowest price. Notably, however, under the revised interpretive guidance, a market participant can consider a variety of factors, including price, in determining whether to exercise the EVO in a contract, provided that the intended purpose of including the

EVO at contract formation was to address physical factors or regulatory requirements influencing supply of, or demand for, the commodity.

Finally, the CFTC confirmed that to satisfy certain elements of the test, a party to a contract with EVO may rely on the representations of its counterparty as long as it does not have information that would cause a reasonable person to question the accuracy of the representation.⁹

⁸ This could include factors beyond environmental factors, such as the availability of transportation or technology, or broader social forces like geopolitics or changes in demographics.

⁹ In response to some comments, the CFTC clarified that a party is not required to conduct due diligence in order to rely on a counterparty’s representations.