

# Client Alert

May 20, 2015

## CFTC and SEC Issue Final Interpretation Regarding Forward Contracts with Embedded Volumetric Optionality

By Julian E. Hammar

On May 12, 2015, the Commodity Futures Trading Commission (“CFTC”) and Securities and Exchange Commission (“SEC”) jointly issued the CFTC’s final interpretation clarifying its interpretation concerning forward contracts with embedded volumetric optionality (“Final Interpretation”). The Final Interpretation appears to signal that, going forward, the CFTC will take a more relaxed view of which transactions constitute “forward contracts” that are not subject to regulation as swaps. This view should be helpful to many commercial parties entering into contracts that provide for volumetric optionality, which means the right to receive or deliver a commodity in an amount that is more or less than was originally contracted for, including many types of energy supply contracts. The Final Interpretation is available [here](#).<sup>1</sup>

### BACKGROUND

The Final Interpretation modifies the interpretation concerning forward contracts with embedded volumetric optionality contained in the CFTC’s and SEC’s product definitions release further defining the terms “swap” and “security-based swap,” published in 2012 (the “Product Definitions Release”).<sup>2</sup> It follows, with some minor clarifications, the CFTC’s and SEC’s proposed interpretation to amend the interpretation in the Product Definitions Release that was published in November 2014.<sup>3</sup> For more information about the proposed interpretation and further background, please see our client alert [here](#).

The Final Interpretation’s amendments to the interpretation contained in the Product Definitions Release focus primarily on the seventh element of the seven-element test intended to determine whether a transaction with embedded volumetric optionality falls within the forward contract exclusion.<sup>4</sup> That last element has proven controversial, with some commenters suggesting that it is difficult to apply in practice.

<sup>1</sup> Forward Contracts With Embedded Volumetric Optionality, 80 Fed. Reg. 28,239 (May 18, 2015).

<sup>2</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. 48,207 (Aug. 13, 2012).

<sup>3</sup> Forward Contracts With Embedded Volumetric Optionality, 79 Fed. Reg. 69,073 (Nov. 20, 2014).

<sup>4</sup> Contracts that meet the requirements of the seven-element test are considered to be forward contracts excluded from the definitions of the terms “swap” and “future delivery” in the Commodity Exchange Act (“CEA”). Contracts that do not satisfy the seven elements are considered to be “commodity options,” which are included in the definition of the term “swap,” although they may qualify for the trade option exemption, in which case they are subject to lighter regulation than other swaps. Section 1a(47) of the CEA, 7 U.S.C. 1a(47), 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. 25,320 (April 27, 2012).

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## FINAL INTERPRETATION

Under the Final Interpretation, an agreement, contract, or transaction that contains embedded volumetric optionality will fall within the forward contract exclusion from the swap and future delivery definitions (and thus not be a swap or futures contract) 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 the embedded volumetric 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 nonfinancial commodity.<sup>5</sup>

As set out in the Final Interpretation, the first six elements, in accordance with the proposed interpretation, are largely unchanged from the interpretation contained in the Product Definitions Release, although there are 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 relates to the seventh element.<sup>6</sup> The Final Interpretation contains the following modifications:

- The seventh element of the test now expressly refers to the intention of the parties “at the time that the parties enter into the agreement, contract, or transaction.” The key question is whether, at that time, the

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<sup>5</sup> 80 Fed. Reg. at 28,241.

<sup>6</sup> The seventh element of the original test contained in the Product Definitions provided that:

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>7</sup> 77 Fed. Reg. at 48,238.

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parties intended the embedded volumetric optionality to “address physical factors or regulatory requirements that reasonably influence demand for, or supply of, the nonfinancial commodity.”

- Following the proposed interpretation, the Final Interpretation also removes from the seventh element of the test the reference contained in the original interpretation to the “exercise or non-exercise” of the embedded volumetric optionality, thus further clarifying that the focus of the seventh element is the parties’ intent at the time of contract initiation, not when the volumetric optionality may be exercised. Accordingly, in choosing whether or not to obtain additional supply by exercising the embedded volumetric optionality under a given contract or turning to another supply source, the Final Interpretation states that commercial parties would be able to consider a variety of factors, including price, provided that the original intended purpose for the embedded volumetric optionality was to address physical factors or regulatory requirements influencing the demand for or supply of the commodity.<sup>7</sup>
- Also following the proposed interpretation, the Final Interpretation provides 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 not aware, and should not reasonably have been aware, of facts indicating a contrary purpose. The Final Interpretation further states, in a new clarification not contained in the proposal, that commercial parties are not required to conduct due diligence in order to rely upon such representations.<sup>8</sup>
- The Final Interpretation also removes, as proposed, the reference contained in the original interpretation to physical factors or regulatory requirements being “outside the control of the parties.” 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>9</sup>

The CFTC further clarifies, as proposed, that the phrase “physical factors” should be construed broadly to include any fact or circumstance that could reasonably influence the 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 (including formal or informal guidance) from a public utility commission or other similar body to obtain or provide the lowest price (e.g., the buyer is an energy company regulated on a cost-of-service basis). In addition, the Final Interpretation clarifies, as proposed, that

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<sup>7</sup> 80 Fed. Reg. at 28,242

<sup>8</sup> *Id.*

<sup>9</sup> *Id.*

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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.<sup>10</sup>

In an additional clarification to the proposed modification of the interpretation, the Final Interpretation provides that commercial parties may choose to either rely upon their good faith characterization of an existing contract (e.g., as an excluded forward contract with embedded volumetric optionality or an exempt trade option) or recharacterize it in accordance with the Final Interpretation.<sup>11</sup>

As was the case with the proposed interpretation, the Final Interpretation does not change the requirement of the seven-element test that a non-nominal amount of commodity must be delivered under a contract for it to be considered a forward 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 final modified form. Such contracts likely are eligible for the trade option exemption, however, and thus are subject to more limited Dodd-Frank requirements. The Final Interpretation also does not change the CFTC’s interpretation of “full requirements” and “full output” contracts, which are not subject to the seven-element test, but may qualify as forward contracts under the facts and circumstances.

## CONCLUSION

The Final Interpretation indicates that the CFTC will take a more relaxed view of the seventh element and the seven-element test in general. Coupled with the proposed rules regarding relief from Form TO reporting, which, if adopted, would eliminate Form TO and require a notice filing with CFTC staff if trade options exceed a notional threshold of \$1 billion during a calendar year (for more detail regarding the trade options proposal, please see our client alert [here](#)), the Final Interpretation will provide welcome relief for many commercial end users with respect to their transactions in forward contracts and trade options and should make the process of contract classification easier. However, some continued evaluation likely will be needed under the Final Interpretation, in particular for companies with high volumes of contracts that fail the seven-element test and are trade options that approach the reporting threshold, assuming the trade option proposal is finalized in its current form.

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<sup>10</sup> *Id.*  
<sup>11</sup> *Id.*

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