

COMMODITY FUTURES TRADING COMMISSION

RIN 3038-AE24

SECURITIES AND EXCHANGE COMMISSION

[Release No. 33-9681; 34-73584; File No. S7-16-11]

RIN 3235-AK65

Forward Contracts With Embedded Volumetric Optionality

AGENCY: Commodity Futures Trading Commission; Securities and Exchange Commission.

ACTION: Proposed Interpretation.

SUMMARY: In accordance with section 712(d)(4) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”), the Commodity Futures Trading Commission (the “CFTC”) and the Securities and Exchange Commission (“SEC”), after consultation with the Board of Governors of the Federal Reserve System (“Board of Governors”), are jointly issuing the CFTC’s proposed clarification of its interpretation concerning forward contracts with embedded volumetric optionality. The CFTC invites public comment on all aspects of its proposed interpretation.

DATES: Comments must be received on or before [insert date that is 30 days following publication in the Federal Register].

ADDRESSES: You may submit comments, identified by RIN number 3038-AE24, by any of the following methods:

- *CFTC Web site:* at <http://comments.cftc.gov>. Follow the instructions for submitting comments through the Web site.

• *Federal eRulemaking Portal*: [http:// www.regulations.gov](http://www.regulations.gov). Follow the instructions for submitting comments.

• *Mail*: Secretary of the Commission, Commodity Futures Trading Commission, Three Lafayette Centre, 1155 21st Street N.W., Washington, DC 20581.

• *Hand Delivery/Courier*: Same as Mail, above. Please submit your comments using only one method.

All comments must be submitted in English, or if not, accompanied by an English translation. Comments will be posted as received to www.cftc.gov. You should submit only information that you wish to make available publicly. If you wish the CFTC to consider information that you believe is exempt from disclosure under the Freedom of Information Act, a petition for confidential treatment of the exempt information may be submitted according to the procedures established in § 145.9 of the CFTC's regulations, 17 CFR 145.9.

The CFTC reserves the right, but shall have no obligation, to review, pre-screen, filter, redact, refuse or remove any or all of a submission from <http://www.cftc.gov> that it may deem to be inappropriate for publication, such as obscene language. All submissions that have been redacted or removed that contain comments on the merits of the notice will be retained in the public comment file and will be considered as required under all applicable laws, and may be accessible under the Freedom of Information Act.

FOR FURTHER INFORMATION CONTACT: CFTC: Elise Pallais, Attorney Advisor, (202) 418-5577, epallais@cftc.gov, Office of the General Counsel, Commodity Futures Trading Commission, 1155 21st Street, NW, Washington, DC 20581. SEC: Carol McGee, Assistant Director, (202) 551-5870, mcgeec@sec.gov, Office of

Derivatives Policy, Division of Trading and Markets, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549. **SUPPLEMENTARY**

INFORMATION:

I. Introduction

In *Further Definition of “Swap,” Security-Based Swap,” and “Security-Based Swap Agreement”*; *Mixed Swaps; Security-Based Swap Agreement Recordkeeping* (the “Products Release”), the CFTC provided an interpretation, in response to requests from commenters, with respect to forward contracts that provide for variations in delivery amount (*i.e.*, that contain “embedded volumetric optionality”).¹ Specifically, the CFTC identified when an agreement, contract, or transaction would fall within the forward contract exclusion from the “swap” and “future delivery” definitions in the Commodity Exchange Act (the “CEA”)² notwithstanding that it contains embedded volumetric optionality.³ In providing its interpretation, the CFTC was guided by and sought to reconcile agency precedent regarding forward contracts containing embedded optionality⁴ with the statutory definition of “swap” in section 1a(47) of the CEA, which provides, among other things, that commodity options are swaps, even if physically settled.⁵

¹ See 77 FR 48207, 48238-42 (Aug. 13, 2012).

² See 7 U.S.C. 1a(47)(B)(ii) (excluding from the definition of “swap” “any sale of a nonfinancial commodity or security for deferred shipment or delivery, so long as the transaction is intended to be physically settled”); 1a(27) (excluding from the definition of “future delivery” “any sale of any cash commodity for deferred shipment or delivery”).

³ See 77 FR at 48238-42 & n.335. See also *id.* at 48227-36 (providing the CFTC’s interpretation regarding the forward contract exclusion for nonfinancial commodities).

⁴ See *id.* at 48237-39 (citing *In re Wright*, CFTC Docket No. 97-02, 2010 WL 4388247 (CFTC Oct. 25, 2010), and *Characteristics Distinguishing Cash and Forward Contracts and “Trade” Options*, 50 FR 39656 (Sept. 30, 1985) (“1985 CFTC OGC Interpretation”).

⁵ See *id.* at 48236-37; 7 U.S.C. 1a(47)(A)(i) (defining “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 * * *”) (emphasis added). Part 32 of the CFTC’s regulations includes an exemption for certain physically settled options, termed “trade options.” See 17 C.F.R. 32.3. The trade option exemption is currently subject to CFTC staff no-action

The CFTC has received several comments from market participants requesting that it modify or further clarify its interpretation.⁶ According to commenters, uncertainty with regard to the meaning of certain language in the CFTC's interpretation, particularly the seventh element, has led to confusion among market participants with regard to how to characterize certain transactions, whether as excluded forward contracts with embedded volumetric optionality or regulated trade options.

II. Proposed Interpretation

In response to commenters, the CFTC is proposing to clarify its interpretation of when an agreement, contract, or transaction with embedded volumetric optionality would be considered a forward contract.⁷ Accordingly, the CFTC is proposing to provide 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;

relief. *See* CFTC Letter No. 13-08 (April 5, 2013), available at <http://www.cftc.gov/ucm/groups/public/@lrlettergeneral/documents/letter/13-08.pdf>.

⁶ The Products Release included a request for comment on the CFTC's interpretation. *See* 77 FR at 48241-42. CFTC staff also solicited comments in connection with a public roundtable to discuss issues concerning end users and the Dodd-Frank Act. These comments are available at <http://comments.cftc.gov/PublicComments/CommentList.aspx?id=1256> and <http://comments.cftc.gov/PublicComments/CommentList.aspx?id=1485>, respectively.

⁷ Section 712(d)(4) provides that "[a]ny interpretation of, or guidance by either Commission regarding, a provision of this title, shall be effective only if issued jointly by the Commodity Futures Trading Commission and the Securities and Exchange Commission, after consultation with the Board of Governors, if this title requires the Commodity Futures Trading Commission and the Securities and Exchange Commission to issue joint regulations to implement the provision." While the Dodd-Frank Act would require this interpretation to be issued jointly by the CFTC and the SEC, it would be an interpretation solely of the CFTC and would not apply to the exclusion from the swap and security-based swap definitions for security forwards or to the distinction between security forwards and security futures products.

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.

The first six elements are largely unchanged from the Products Release.⁸ Among them, the CFTC is proposing to modify only the fourth and fifth elements, to clarify that the CFTC's interpretation applies to embedded volumetric optionality in the form of both

⁸ See 77 FR at 48238.

puts and calls.⁹ Accordingly, the CFTC’s discussion of these six elements in the Products Release would remain relevant and applicable.¹⁰

The seventh element addresses the primary reason for including embedded volumetric optionality in a forward contract. As commenters have explained, commercial parties are often unable to accurately predict their exact delivery needs or production capacity for a given nonfinancial commodity at contract initiation due to a variety of factors, such as weather and certain other “operational considerations” (*e.g.*, transportation capacity).¹¹ The embedded volumetric optionality therefore offers commercial parties the flexibility to vary the amount of the nonfinancial commodity delivered during the life of the contract in response to uncertainty in the demand for or supply of the nonfinancial commodity.¹²

The seventh element ensures that this purpose, consistent with the historical interpretation of a forward contract,¹³ is the primary purpose for including embedded volumetric optionality in the contract. In other words, the embedded volumetric

⁹ As described in the Products Release, the fifth element did not appear to contemplate circumstances where the seller of the nonfinancial commodity might exercise the embedded volumetric optionality. *See* 77 FR at 48238 (“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 *it exercises* the embedded volumetric optionality.”) (emphasis added).

¹⁰ *See* 77 FR at 48238-39.

¹¹ *See, e.g.*, Letter from ONEOK, Inc. (July 22, 2011) at 4 (stating that “day-to-day changes in demand” for natural gas “may be caused by variation in weather, operational considerations, or other factors”); Letter from the American Gas Association (Oct. 12, 2012) at 9 (stating that “weather-sensitive demands” for natural gas “cannot be accurately predicted in advance”).

¹² *See, e.g.*, Letter from the Commodity Markets Council, the National Corn Growers Association, and the Natural Gas Supply Association (April 17, 2014) at 2 (“Physical end-users need these contracts to address supply input or production output uncertainty associated with the operation of a physical business.”); Letter from the Plains All American Pipeline, L.P. (April 17, 2014) at 2 (“Such contracts provide us with the ability to allow our customers flexibility to increase or decrease the amount of purchase or sale of a commodity in response to prevailing market conditions.”).

¹³ *See* 77 FR 48228 (describing a forward contract as a “commercial merchandising transaction” in which delivery is delayed for “commercial convenience or necessity”).

optionality must primarily be intended as a means of assuring a supply source or providing delivery flexibility in the face of uncertainty regarding the quantity of the nonfinancial commodity that may be needed or produced in the future, consistent with the purposes of a forward contract.¹⁴

In response to commenters, the CFTC is proposing to modify the seventh element to further clarify its interpretation.¹⁵ To begin, the CFTC is proposing to remove reference to the “exercise or non-exercise” of the embedded volumetric optionality. This language was included to embody the longstanding principle, recognized by commenters, that intent may be ascertained by the relevant facts and circumstances surrounding the contract, including the parties’ course of performance thereunder.¹⁶ According to commenters, however, this language has created problems during contract negotiations, because certain parties feel pressure to specify the exact factors that could lead to the

¹⁴ See 77 FR at 48228 (“The primary purpose of a forward contract is to transfer ownership of the commodity and not to transfer solely its price risk.”). See also Letter from the Commodity Markets Council, the National Corn Growers Association, and the Natural Gas Supply Association (April 17, 2014) at 2 (“[Contracts with volumetric optionality] exist to permit end-users to have agreements in place so that they can effectively and economically manage the purchase or sale of commodities related to their commercial businesses, not as a substitute for a financially settled contract or for speculative purposes.”); Letter from ONEOK, Inc. (July 22, 2011) at 7 (“Although the amounts that can be taken on delivery may vary, the primary intent of the contracts is not to provide price protection, which is clearly the intent of the contracts described in the [1985 CFTC] OGC Interpretation as trade options.”).

¹⁵ As stated in the Products Release, the seventh element reads as follows:

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.

77 FR at 48238 (footnotes omitted).

¹⁶ See 77 FR 48228 (“In assessing the parties’ expectations or intent regarding delivery, the CFTC consistently has applied a ‘facts and circumstances’ test.”); Letter from ONEOK, Inc. (July 22, 2011) at 6 (“The intent of the parties to defer delivery of a varying amount can be ascertained based on objective criteria, such as the pattern of deliveries in relation to variation in weather, customer demand, or other similar factors.”).

exercise or non-exercise of the volumetric optionality.¹⁷ By removing this language, the CFTC intends to clarify that the focus of the seventh element is intent with respect to the embedded volumetric optionality at the time of contract initiation.¹⁸ The CFTC would further advise commercial parties that they may rely on counterparty representations with respect to the intended purpose for embedding volumetric optionality in the contract, provided they are unaware, and should not reasonably have been aware, of facts indicating a contrary purpose.

The CFTC is also proposing to remove reference to physical factors or regulatory requirements being “outside the control of the parties.” This phrase was taken from commenter letters¹⁹ but has also apparently created problems during contract negotiations, as counterparties often disagree about the degree of control they have over factors influencing their demand for or supply of the nonfinancial commodity.²⁰ By

¹⁷ See, e.g., Letter from the Commodity Markets Council, the National Corn Growers Association, and the Natural Gas Supply Association (April 17, 2014) at 2 & n.3 (stating that commercial parties are “being asked for vague (and, therefore, potentially unenforceable) representations” because “the question of the reason for exercise of volumetric optionality can vary from transaction to transaction and is not known until the time of exercise”); Letter from the American Gas Association (April 17, 2014) at 10 (citing “widespread confusion as to whether counterparties must demonstrate forward contract status as of the time of entering into an agreement, or as of the time of exercise or non-exercise of delivery rights under the agreement.”).

¹⁸ For example, in choosing whether to obtain additional supply by exercising the embedded volumetric optionality under a given contract or turning to another supply source – whether storage, the spot market, or another forward contract with embedded volumetric optionality – 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.

¹⁹ See Letter from BG Americas & Global LNG (July 22, 2011) at 4 (“Variability associated with an energy customer’s physical demand is influenced by factors *outside the control of the energy suppliers (and sometimes the consumers)* . . .”); Letter from the Working Group of Commercial Energy Firms (July 22, 2011) at 8 (“Availability of production and requirements for consumption are often influenced by factors *outside the control of the parties* to an energy commodity transaction and can change on an hourly or daily basis.”) (emphasis added).

²⁰ Letter from the Plains All American Pipeline, L.P. (April 17, 2014) at 3 (“[M]any counterparties understand the [seventh element] to have failed when a counterparty has more than one alternative to meet its physical commodity needs, therefore making the choice of supply ‘within its control.’”); Letter from the Commodity Markets Council, the National Corn Growers Association, and the Natural Gas Supply

removing this language, the CFTC intends to clarify that whether the parties have some influence over factors affecting their demand for or supply of the nonfinancial commodity (*e.g.*, the scheduling of plant maintenance, plans for business expansion) would not be inconsistent with the seventh element of the CFTC's interpretation, 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.

The CFTC is also proposing 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.²¹ Concerns that are primarily about price risk (*e.g.*, expectations that the cash market price will increase or decrease), however, 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).²²

Association (April 17, 2014) at 2-3 (listing as an issue stemming from the ambiguity in the seventh element "uncertainty as to whether end-users with more than one supply choice are always exercising optionality within their control").

²¹ The CFTC reiterates that, as stated in the Products Release, system reliability issues that lead to voluntary supply curtailments would be considered "physical factors" within the scope of the seventh element. *See* 77 FR at 48239 n.345.

²² *See* Letter from the Office of the General Counsel, Federal Energy Regulatory Commission (Oct. 12, 2012) at 4. The CFTC confirms that, as stated in the Products Release, the deliverable quantities allowable under embedded volumetric optionality may be justified by a combination of regulatory requirements and physical factors, such that the quantity provided for by the embedded volumetric optionality may reasonably exceed quantities required by regulation. *See* 77 FR 48238 n.340.

The CFTC understands that in certain retail electric market demand-response programs, electric utilities have the right to interrupt or curtail service to a customer to support system reliability.²³ The CFTC is proposing to clarify that, given that a key function of an electricity system operator is to ensure grid reliability, 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.²⁴

III. Request for Comment

The CFTC believes that it would benefit from public comment about its proposed interpretation, and therefore requests public comment on all aspects of its proposed interpretation regarding forwards with embedded volumetric optionality, and on the following questions:

1. Market participants have expressed concerns about whether various types of volumetric optionality fit within the CFTC's interpretation. The CFTC recognizes that, since the interpretation is not intended to provide relief for all forms of embedded volumetric optionality, there are likely to remain concerns within the industry about the treatment of embedded volumetric optionality within forward contracts.

²³ See Letter from the National Rural Electric Cooperative Association, the American Public Power Association, the Large Public Power Association, and the Transmission Access Policy Study Group (Oct. 12, 2012) at 9.

²⁴ The CFTC clarifies that its interpretations regarding full requirements and output contracts, as provided in the Products Release, would be unaffected by the discussion herein. See 77 FR at 48239-40. Similarly, the CFTC reiterates that, depending on the relevant facts and circumstances, capacity contracts, transmission (or transportation) service agreements, tolling agreements, and peaking supply contracts, as discussed in the Products Release, may qualify as forward contracts with embedded volumetric optionality provided they meet the elements of the CFTC's proposed interpretation. See 77 FR 48240.

The CFTC notes that, in April, 2012, the CFTC adopted an Interim Final Rule for Commodity Options (the “IFR”).²⁵ Even if a contract with volumetric optionality does not fit within the seven elements of the interpretation, the CFTC believes there is widespread agreement that contracts that fail one or more of the seven elements of the CFTC’s interpretation would fall within the exemption from most swaps regulation provided by the IFR. Therefore, it appears that the IFR provides a clear and well-understood mechanism through which contracts with volumetric optionality can be exempted that avoids many of the difficulties of determining whether a particular contract with volumetric optionality would satisfy the seven elements of the CFTC’s interpretation.

The CFTC invites comment on whether the IFR’s approach to defining the universe of swaps subject to its exemption may provide a clearer and easier mechanism for providing relief from swaps requirements than the CFTC’s interpretation of forwards with embedded volumetric optionality and whether the IFR currently provides sufficient relief for such contracts.

2. Market participants have argued that the lack of clarity around the seventh element of the CFTC’s interpretation has led to costs to end-users. Conceivably, since contracts that fail one or more of the seven elements would be regulated as exempt commodity trade options under the IFR, these costs are attributable to complying with the IFR. The CFTC invites comment on whether or not this is the case, and invites the submission of data quantifying those costs.

²⁵ See 77 FR 25320 (April 27, 2012).

3. What factors should the CFTC consider in determining whether the proposed modifications and clarifications to the CFTC's interpretation are appropriate in view of CFTC precedent regarding the interpretation of the CEA's forward contract exclusion? Do the proposed changes provide sufficient clarity on how contracts with embedded volumetric optionality may satisfy all seven elements of the interpretation, particularly the first and second elements? Are there reasons why trying to provide further relief through the swap definition's forward contract exclusion would not be in the public interest?

By the Securities and Exchange Commission.

Brent J. Fields
Secretary

Date: November 13, 2014

Issued in Washington, DC, on November 13, 2014, by the Commodity Futures Trading Commission.

Christopher J. Kirkpatrick,
Secretary of the Commission.

Commodity Futures Trading Commission (CFTC) Appendices to Forward Contracts With Embedded Volumetric Optionality – Commission Voting Summary, Chairman’s Statement, and Commissioners’ Statements

Appendix 1 – Commodity Futures Trading Commission Voting Summary

On this matter, Chairman Massad and Commissioners Wetjen, Bowen, and Giancarlo voted in the affirmative. No Commissioner voted in the negative.

Appendix 2 – Statement of CFTC Chairman Timothy G. Massad

I support the Staff’s proposed interpretation regarding forward contracts that have what is known as embedded volumetric optionality – generally speaking, contracts to buy or sell a nonfinancial commodity for deferred delivery that provide for variations in delivery amount.

One of my priorities has been to fine-tune our rules to make sure they work as intended and do not impose undue burdens or unintended consequences, particularly for the nonfinancial commercial businesses that use these markets to hedge commercial risks. We must make sure these businesses – whether they are manufacturers, farmers, ranchers or other companies – can continue to use these markets efficiently and effectively.

This proposal is part of that effort. In certain situations, commercial parties are unable to predict at the time a contract is entered into the exact quantities of the commodity that they may need or be able to supply, and the embedded volumetric optionality offers them the flexibility to vary the quantities delivered accordingly. The CFTC put out an interpretation, consisting of seven factors, to provide clarity as to when such contracts would fall within the forward contract exclusion from the swap definition, but some market participants have felt this interpretation, in particular the seventh factor, was hard to apply. In some cases, the two parties would reach different conclusions about the same contract.

Today we are proposing clarifications to the interpretation that I believe will alleviate this ambiguity and allow contracts with volumetric optionality that truly are intended to address uncertainty with respect to the parties' future production capacity or delivery needs, and not for speculative purposes or as a means to obtain one-way price protection, to fall within the exclusion.

Appendix 3 – Statement of CFTC Commissioner Mark P. Wetjen

This proposal further clarifying the definition of forward contracts with embedded volumetric optionality, or EVO, is intended to provide commercial firms the regulatory clarity they have sought since the original release of the seven-part test in August 2012.

The definition of a swap in the Commodity Exchange Act includes commodity options, but excludes from that definition forward contracts.¹ There was a policy reason for this, and at its root was a desire to ensure that Dodd-Frank captured many swaps, and swap-like contracts, that were structured to be similar to options, while also ensuring that

¹ 7 U.S.C. 1a(47).

a new regulatory regime was not inadvertently and inappropriately extended into certain physical markets.

The broad definitional language in question was designed to ensure that financial – as opposed to physical – contracts could not be structured or re-characterized to avoid the new market structure. While the swap definition does not expressly exclude options on energy and agricultural commodities, it does exclude both futures and forwards. I am confident Congress did not intend to pull contracts that historically have been treated as forwards into the new swap regime solely because of optionality in the amount of the physical commodity delivered under the contract.

As a policy matter, Congress surely recognized that the swap definition had to reflect a long-held Commission belief that contracts that are physically settled, and where delivery is required, do not pose the same systemic threats to the financial system as contracts used for speculative purposes. Moreover, Congress expanded the Commission’s fraud² and anti-manipulation authority³ over markets where forward contracts are traded, and left intact the Commission’s surveillance authority to issue special calls to market participants for all positions and transactions related to a commodity.⁴

² 7 U.S.C. 9(c)(1) (“It shall be unlawful for any person, directly or indirectly, to use or employ, or attempt to use or employ, in connection with . . . a contract of sale of any commodity in interstate commerce . . . any manipulative or deceptive device or contrivance, in contravention of such rules and regulations as the Commission shall promulgate. . . .”). See also 17 CFR Part 180.

³ 7 U.S.C. 9(c)(3) (“[I]t shall be unlawful for any person, directly or indirectly, to manipulate or attempt to manipulate the price . . . of any commodity in interstate commerce. . .”).

⁴ 17 CFR 18.05(b) (maintenance of books and records concerning positions and transactions in the cash commodity); 17 CFR 1.31 (pursuant to § 1.31(2), the authority to request information required to be kept in accordance with the Act or Commission regulations); 17 CFR 1.35 (pursuant to § 1.35(3), the authority to request from a futures commission merchant, retail foreign exchange dealer, introducing broker or member of a designated contract market or swap execution facility records required to be kept by § 1.35 in accordance with the requirements of § 1.31); 17 CFR 23.203 (pursuant to § 23.203(a), the authority to request and receive within 72 hours any records required to be kept by a swap dealer or major swap

As mentioned, in resolving to adopt the appropriate regulatory treatment of forward contracts with EVO, the Commission also must weigh the operational and compliance consequences of that treatment. Indeed, the Commission should bring a heightened sensitivity to these considerations in the context of the power sector because affordable electricity and heat are such fundamental needs of modern life.

The Commission's 2012 interpretation, while intended to be helpful, contained certain ambiguities in the seven-part test that created confusion among commercial end-users.

Last spring, the Commission learned at a public roundtable that some market participants may have withdrawn from the market due to those ambiguities, resulting in inferior execution for commercial firms. It is difficult to measure the exact impact of this phenomenon, but apparently it has not been a positive one for consumers of electricity and gas.

A. Ambiguity in the Seven-Part Test

In discussing the seven-part test, commentators zeroed in on two primary issues. First, many of the roundtable participants noted that the exercise or non-exercise of volumetric optionality depends on a number of factors,⁵ some of which will be outside of the control of the parties, and some that will not.

participant by the Act and by Commission regulations and pursuant to § 23.203(2), the authority to request records of any swap or related cash or forward transaction); 17 CFR 23.606 (pursuant to § 23.606(c), the authority to request information that a swap dealer or major swap participant is required to maintain under § 23.606(a)(1)); 17 CFR 45.2 (pursuant to § 45.2(h), the authority to request from swap execution facilities, designated contract markets, derivatives clearing organizations, swap dealers, and major swap participants records required to be kept pursuant to § 45.2.); 17 CFR 46.2 (the authority, pursuant to § 46.2(e), to request records relating to pre-enactment and transition swaps in existence on or after April 25, 2011).

⁵ Letter from The Edison Electric Institute ("EEI") and the Electric Power Supply Association ("EPSA") (April 17, 2014) ("EEI/EPSA Letter") at 3 ("The exercise or non-exercise of volumetric optionality under a forward energy contract depends on a number of factors, including but not limited to, any or all of the following: (1) the level of demand as affected by weather or market conditions; (2) the amount of

Many also noted that parties could reasonably disagree on whether, and the degree to which, a factor is outside of the control of the parties. For example, having choice among more than one source of supply, or selecting from those choices the lowest-priced contract, to some commercial firms caused the contract to fail the seventh prong.

This ambiguity contributed to a second issue – market participants stated that they often do not know the exact reasons that optionality will be exercised until the time of exercise. In other words, parties are uncertain how to characterize contracts at the time of execution, and how intent at the time of exercise or non-exercise might affect that analysis.⁶

The seventh factor's ambiguity has caused a host of problems. For instance, parties have been asked to provide vague and possibly unenforceable representations in agreements.⁷ Parties also often disagree about the proper categorization of a transaction, resulting in them “agreeing to disagree” and considering the same transaction to be, at the same time, a swap, trade option, or a forward with EVO.⁸ This has had the unintended consequence of distorting transaction data reported to the Commission.⁹

unexercised volume remaining under the contract; (3) the time of the change in the level of demand relative to delivery scheduling capabilities, (4) anticipated future weather conditions, (5) the delivery location under the contract relative to the demand location; (6) the price and availability of transportation capacity (e.g. pipeline capacity) to move natural gas; (7) the price of alternative sources of supply; (8) the availability of natural gas or electricity in the spot market; and/or (9) the remaining inventory of the commodity in storage.”).

⁶ Letter from the American Gas Association (April 17, 2014) (“AGA Letter”) at 10 (citing “widespread confusion as to whether counterparties must demonstrate forward contract status as of the time of entering into an agreement, or as of the time of exercise or non-exercise of delivery rights under the agreement.”).

⁷ AGA Letter at 2; EEI/EPSC letter at 3.

⁸ NFP Electric Associations Letter at 3.

⁹ EEI/EPSC letter at 3.

The bottom line is that such uncertainty in the seven-part test increased transaction costs for commercial firms and limited their access to an effective risk-management tool.

B. Proposed Clarifications

This proposal appropriately modifies and clarifies the interpretation of the seventh prong. First, it clarifies that concluding whether the seventh prong is met should be determined by looking to the intent of the parties at the outset of contract initiation.

Second, the new proposal also deletes language referring to physical or regulatory factors being “outside of the control of the parties.” Deleting this ambiguous language helps clarify that parties having some influence over factors affecting their demand for a nonfinancial commodity will not per se cause a contract to fail the seventh prong.

In that vein, the proposal also notes that parties may take a variety of factors into consideration when determining whether to exercise volumetric optionality, so long as the intended purpose was to address physical factors or regulatory requirements influencing the demand for, or supply of, the commodity.

Prongs one through six of the test are also appropriately crafted to ensure that the EVO does not undermine the forward contract’s overall purpose. Prongs two and three help achieve those purposes by requiring the predominant factor to be actual delivery, and prohibiting the embedded optionality from being severed and marketed separately from the overall agreement.

Prongs four and five also help deter the potential for abuse of these contracts by requiring that the seller under the contract intends to deliver, and the buyer intends to receive, the underlying commodity.

This proposal should go a long way towards providing commercial firms adequate guidance, but I look forward to comments on whether it is adequate enough.

Appendix 4 – Concurring Statement of CFTC Commissioner Sharon Y. Bowen

This is a proposal that, I am concerned, will neither provide the clarity industry is seeking regarding the treatment of embedded volumetric options nor the safeguards that Congress intended when it passed the Dodd-Frank Wall Street Reform and Customer Protection Act.

I do not oppose the Commission's trying to better tailor our regulations to address concerns of end-users. In fact, I commend the Chairman and my fellow Commissioners for trying to address the issues that have arisen from our existing guidance and rules on embedded volumetric options. After many meetings with stakeholders and much analysis of this subject, I am convinced that the Commission should address concerns that industry has raised regarding the treatment of embedded volumetric options.

However, the proposed interpretation may not resolve the issues industry has raised. Options, even physical options, have never been interpreted by the Commission to be forward contracts. They lack the central characteristic that is critical to being a forward contract under the Commodity Exchange Act: a binding obligation to deliver at some time in the future. The history on this is clear, if there is no binding obligation to deliver, there is no forward contract.

The seventh factor was intended, essentially, as a "safe-harbor" provision. Notwithstanding the fact there is no obligation to make or take delivery for the optional portion of the specified commodity, the seventh factor was designed to allow a party's transaction to receive the forward exclusion if that party can demonstrate that it

determined the specified, optional amount was necessary based upon commercial and physical factors, and exercised the option based upon those factors. In other words, this seventh factor was designed to allow embedded volumetric options to receive the forward contract exclusion treatment where their exercise was driven largely by external commercial and physical factors central to the party's commercial business, but largely beyond the control of the party. Through its conduct then, the party was demonstrating its intent to be “bound” to exercise the option if its estimate, based on the factors it used, proved to be accurate.

The Commission was trying to distinguish such a situation from a situation where the party enters into the embedded volumetric option intending to exercise the volumetric option based upon whether, at the time of exercise, it still makes economic sense to use the option. In other words, it was trying to distinguish a situation where the motivation for exercising the option was primarily or substantially based on price. In the latter case, the embedded volumetric option is hard to distinguish, in usage, from any other commodity option. There is no demonstration in the party's course of conduct that it intended to be “bound” to exercise the option at all.

While this test is far from perfect, and I can see the difficulty industry would have in administering it, the Commission was clearly trying to find a rationale for allowing some volumetric optionality that was consistent with the Commission's historic treatment of forward contracts, while avoiding completely erasing the line between options and futures on the one hand, and cash and forward contracts on the other.

This current proposal, however, in possibly broadening the universe of options that would fit within the seventh factor, seems to depart from that rationale, and in doing

so, loses that vital element of demonstrating the parties intended to be “bound” in some sense to exercise the option and consequently that the option was similar, in usage, to a forward contract. Without that, it is not clear to me how such an option can be considered consistent with a forward contract. If it cannot be considered at least similar to a forward contract, I am not sure how a party would determine that embedding such an option in a forward contract would not undermine its nature as a forward contract and thus fail the first factor of the seven-factor test.

There is nothing in the Commodity Exchange Act or Dodd-Frank that contemplates options can be deemed forward contracts simply by being associated with a forward contract. In fact, the opposite seems true: Congress specifically determined that commodity options are swaps and removed the Commission's ability to provide exemptions from the definition of swap.

Interestingly though, Congress did maintain the Commission's authority to determine how swaps that are commodity options should be regulated since Congress did not repeal the Commission's plenary authority over options, including options that are swaps. It was that plenary authority that the Commission utilized to exempt trade options from most of the regulations applicable to swaps in April 2012. It is that authority that the Commission should use here to address embedded volumetric options.

By seeking to broaden an exclusion for volumetric options embedded in forward contracts, the proposed interpretation does try to achieve a goal that industry apparently wants—they would like these options to be outside the Commission's jurisdiction rather than just exempted from regulation. However, history has shown that as the circle of

exclusion widens for industry, too often the circle of protection narrows for investors and consumers.

In 1993, one Commissioner cast the lone dissenting vote against exempting over-the-counter energy derivatives from Commission regulation. She argued that exempting energy derivatives from regulation would set a dangerous precedent and would leave the public unprotected. Today's proposal seems to go farther. It excludes embedded volumetric options from the Commission's authority. Whereas with an exemption, there is the ability to later tailor it to fit the precise needs of the market and the public, there is no turning back from an exclusion.

Congress said, quite clearly, that commodity options are swaps, not forwards. Embedded volumetric options should be exempted as options, not excluded as forwards. I know many in industry have spoken for the need for further clarity regarding the regulation of embedded volumetric options. I don't know what clarity is achieved by trying to call something what it is not. If it looks like an option, is used like an option, and works like an option, it is most likely, an option.

I think the objective of providing for clear regulatory treatment of embedded volumetric options will be far easier to implement, and far more complete, if done through fixing the trade option exemption. Regardless, this proposal is the vehicle before the Commission at present. I want us to get this interpretation right, and therefore support getting public comment on these changes. I do not believe we should contemplate such a significant change to our jurisdiction without receiving the public's views on it first. I invite all interested stakeholders to respond to this proposal and look forward to reviewing their comments.