Commodity Futures Trading Commission
Office of Public Affairs
Three Lafayette Centre
1155 21st Street, NW
Washington, DC 20581
www.cftc.gov

May 12, 2015

Forward Contracts with Embedded Volumetric Optionality

In accordance with section 712(d)(4) of the Dodd-Frank Wall Street Reform and Consumer Protection Act, the Commodity Futures Trading Commission (the "CFTC") and the Securities and Exchange Commission, after consultation with the Board of Governors of the Federal Reserve System, are jointly issuing the CFTC's interpretation concerning forward contracts with embedded volumetric optionality.

Overview

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 interpretation, which consists of seven elements, identified when an agreement, contract, or transaction would fall within the forward contract exclusions from the "swap" and "future delivery" definitions in the Commodity Exchange Act notwithstanding that it contains embedded volumetric optionality.

In response to requests from market participants, the CFTC proposed in November 2014 to clarify its interpretation of when an agreement, contract, or transaction with embedded volumetric optionality would be considered a forward contract, and invited comment on all aspects of its proposal.[2]

After a careful review of the comments received, the CFTC is finalizing its interpretation as proposed with some additional clarifications.

The Fourth and Fifth Elements

As proposed, the CFTC is modifying the fourth and fifth elements of the interpretation to clarify that it applies to embedded volumetric optionality in the form of both puts and calls. In response to commenters, the CFTC is also clarifying that the fourth and fifth elements do not preclude bandwidth (a.k.a. "swing") contracts from falling within the forward contract exclusion.

The Seventh Element

As proposed, the CFTC is also modifying the seventh element to clarify that the embedded volumetric optionality must be 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 CFTC is clarifying that the phrase "physical factors" should be construed broadly to include any fact or circumstance that could reasonably influence the parties' supply of or demand for the nonfinancial commodity under the contract, including environmental factors, relevant "operational considerations," and broader social forces, such as changes in demographics or geopolitics.

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

[2] *See Forward Contracts With Embedded Volumetric Optionality*, 79 FR 69073 (Nov. 20, 2014) (the "Proposed Interpretation").

Although the CFTC recognizes that price is likely to be a consideration when entering into any contract, the CFTC is reiterating that if the embedded volumetric optionality is primarily intended at contract initiation to address concerns about price risk, the seventh element would not be satisfied absent an applicable regulatory requirement (including guidance from a public utility commission or other similar governing body) to obtain or provide the lowest price.

As proposed, the CFTC is clarifying that electric demand response agreements may be properly characterized as the product of a regulatory requirement within the meaning of the seventh element. The CFTC is also clarifying that commercial parties are not required to conduct any due diligence in order to rely on counterparty representations with respect to the seventh element.

Finally, in response to commenters, the CFTC is clarifying that commercial parties may choose to either rely on their good faith characterization of an existing contract or recharacterize it in accordance with the CFTC's interpretation.