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DODD–FRANK

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CLIENT ALERT: CFTC ISSUES FINAL SWAP DEFINITION

The Commodity Futures Trading Commission ("CFTC"), in conjunction with the Securities and Exchange Commission, has finalized its key rule defining "Swap" and related terms. As you are aware, the Dodd-Frank Act subjects energy commodities to the reach of the Commodity Exchange Act ("CEA"), including the mandatory clearing requirement[1] for Swaps. However, the Act excludes forward contracts[2] from the clearing requirement. The CFTC's final rulemaking defining Swap outlines standards that will be used to determine whether a transaction involving energy, or energy-related commodities such as emissions allowances, falls into this exclusion and therefore will not be regulated as a Swap (though such transactions will still be subject to other CFTC jurisdiction including its market manipulation authority, for example). The Swaps definition rule has not yet been published in the Federal Register but is available on the CFTC's website here.[3] The memorandum below provides a brief overview of key parts of the rule.

Swaps, Energy Contracts, and the Forward Contract Exclusion

In this rulemaking, the CFTC describes the terms of its forward contract exclusion. The forward contract exclusion is an exclusion from the Swap definition for contracts that meet a "facts and circumstances" test to establish that they are true forward purchases or sales of a commodity. Transactions that meet this case-by-case test will not be subject to the Swaps clearing requirement.

The facts and circumstances test will emphasize "[i]ntent to make or take delivery."[4] The Dodd-Frank Act's definition of Swap excludes "any sale of a nonfinancial commodity . . . for deferred shipment or delivery, so long as the transaction is intended to be physically settled"[5] – i.e. forward contracts where

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[1] Clearing is the requirement that a Swap be "cleared" through an exchange or trading platform.

[2] As discussed below, a forward contract is buying a commodity now for future physical delivery (such as March gas), while a Swap or futures contract contemplates financial, rather than physical, settlement.

[3] A CFTC fact sheet summarizing the rule can be found here.

[4] Prepublication Copy at 80.

[5] CEA § 1a(47)(B)(ii), 7 U.S.C. § 1a(47)(B)(ii).

physical delivery is intended. Under the rule, a “nonfinancial commodity” is a commodity that can be physically delivered, but this can include intangible commodities such as emissions allowances. It does not include transactions such as credit default Swaps or “fixed for floating” energy transactions, that only settle financially.

Although in this rulemaking the CFTC has not made any categorical exclusions for energy contracts, it has specified that various types of energy contracts may be eligible for the exclusion under one or another test, most commonly the facts and circumstances test that applies to all forward contracts. Energy-related contracts that the CFTC has stated may be eligible for exclusion from regulation as Swaps, depending on the facts and circumstances, include:

- Physical transactions settled through book-out transactions,
- EEI form contracts with netting agreements,
- Contracts for environmental commodities including RECs and emission allowances,
- Fuel delivery agreements,
- Full requirements contracts,
- Output contracts,
- Capacity contracts,
- Transmission services agreements,
- Tolling agreements,
- Evergreen contracts or extension terms,
- Peaking supply natural gas contracts, and
- Power or gas transaction contracts containing liquidated damages provisions.

Even if the contracts described above are true forward transactions, they may still fall within the Swap definition if they include embedded options. Forward contracts with embedded optionality will still qualify under the forward contract exclusion if the options: 1) may be used to adjust the forward contract price but do not undermine the overall nature of the contract as a forward contract where physical delivery is intended; 2) do not target delivery terms, so that the predominant feature of the contracts is actual delivery; and 3) cannot be severed or marketed separately from the overall forward contract in which they are embedded. Forward contracts can include embedded volumetric optionality, e.g., requirements contracts where the load may vary according to time of day or weather.

The CFTC makes clear that it intends to retain the so-called "Brent Interpretation"[6] for forward contracts settled through book-out[7] transactions, and that it also will retain all other prior precedent related to forward contracts. The Brent Interpretation applies to commercial participants in connection with their business where the parties intend to make or take delivery at the time that they enter into the contract, regardless of whether the parties later book-out. According to the CFTC, "[i]ntent to make or take delivery can be inferred from the binding delivery obligation for the commodity referenced in the contract and the fact that the parties to the contract do, in fact, regularly make or take delivery of the referenced commodity in the ordinary course of their business."[8] Other factors include: demonstrable commercial need for the product, underlying purpose of the contract, regular practices of the entity with respect to its commercial business, or whether the absence of physical settlement is based on a change in commercial circumstances. Contracts that have renewal options or optionality with regard to delivery points or delivery dates will meet the forward exclusion if their provisions are in line with the Brent Interpretation—for example, because they require delivery.

The bottom line is that intent for actual delivery is key for a transaction to avoid the "Swap" label. There is an additional multi-factor test for transactions where the volume to be delivered may vary, such as with requirements transactions that would vary with load. Such a contract is analyzed under seven factors:

1. The embedded optionality does not undermine the overall nature of the contract as a forward contract;
2. The predominant feature of the contract is actual delivery;
3. The embedded optionality cannot be severed and marketed separately from the overall agreement;
4. The seller of the nonfinancial commodity intends to deliver the commodity if the option is exercised;
5. The buyer of the nonfinancial commodity intends to take delivery if it exercises the option;
6. Both parties are commercial parties; and

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[6] The Brent Interpretation has been used by the CFTC to distinguish a forward contract from a futures contract (or Swap). Prepublication Copy at 78. Key to classifying book-outs as forwards rather than futures has been that "[a]t any point in the chain, one of the parties could refuse to enter into a new contract to book-out the transaction and, instead, insist upon delivery pursuant to the parties' obligations under their contract." *Id.* at 79. Also relevant "is that the [book-out] occur through a subsequent, separately negotiated agreement." *Id.* at 85. While in the past, the Brent Interpretation applied only to oil, the CFTC will now apply it to all nonfinancial commodities. *Id.* at 81.

[7] A "book-out" transaction occurs when two parties with a contract for physical delivery enter into a new agreement to settle the old agreement financially instead of through physical delivery.

[8] *Id.* at 80.

7. 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 commodity (for example, the weather as it affects actual load).

The CFTC requests public comment on one part of the rule—its interpretation regarding forward contracts with volumetric optionality. The agency asks whether its distinctions are appropriate; whether its interpretation lacks any factors; whether it is sufficiently clear with respect to capacity contracts, transmission services agreements, and other contracts, and whether such contracts evidence embedded optionality to begin with; and requests other related feedback. Comments will be due 60 days after the rule is published in the Federal Register.

> **If you are engaged in transactions that may be considered Swaps, the information contained here should not be relied upon to the exclusion of specific and detailed legal advice. If you have any questions about these or other CFTC actions that may affect your utility, please contact the Spiegel attorney with whom you regularly work, or a member of our CFTC compliance team listed below.**

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