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In this issue:

CLIENT ALERT:

New CFTC Proposed Rule Could Provide Relief from Special Entity \$25 Million Sub-Threshold for Government Utilities and Seeks Comment on the Embedded Volumetric Optionality Test

The Commodity Futures Trading Commission (“CFTC”) has announced a [proposed rule](#) that would provide permanent relief for government-owned utilities from the \$25 million “special entity” sub-threshold. The proposed rule offers an opportunity to lock in the fix for the low sub-threshold, which caused counterparties to avoid doing business with special entities, lest they be forced to register as swap dealers with all the regulatory obligations that status entails.

As part of the rulemaking docket, the CFTC also seeks comment on its [current interpretation](#) of “volumetric optionality,” a concept that has bedeviled many smaller utilities seeking to determine whether particular commodity contracts were or were not subject to regulation as swaps.

The rulemaking offers an opportunity for entities concerned with the effects of CFTC regulation to support the relief from the special entity sub-threshold and potentially to seek favorable changes in the volumetric optionality test, at least as applied to special entities. The comment date will be 30 days after publication in the Federal Register, which we expect will happen soon.

Proposed Rule on Special Entity Sub-Threshold

In response to a July 12, 2012 [Petition for Rulemaking](#) of APPA, TAPS, and others, as well as subsequent urging from various groups, the CFTC has proposed to amend its regulations establishing the special entity sub-threshold for swap transactions. The rule, if enacted, would eliminate certain transactions from consideration in calculating whether counterparties have met the \$25 million sub-threshold that would trigger a requirement for them to register as swap dealers. This is expected to benefit utility special entities by increasing the number of willing counterparties with whom they can contract.

As utility special entities know all too well, the Dodd-Frank Act imposed new requirements on “swap dealers and major market participants” who transact with “special entities.” Special entities are governmental entities, including municipal utilities and joint action agencies, deemed by Congress to be in need of special protection in swap transactions. However, the CFTC determined that it would provide that protection by requiring anyone entering into more than \$25 million in annual transactions with special entities to register as a swap dealer. Because registration as a swap dealer is expensive and burdensome, this rule served as a major disincentive to counterparties to enter into transactions with government-owned utilities, in case those transactions might be considered swaps.

On March 21, 2014, the CFTC issued a “no-action” letter stating that the CFTC staff would not recommend enforcement action against a person for failure to register as a swap dealer if the person does not include “utility operations-related swaps” with special entity utilities in calculating whether it has exceeded \$25 million sub-threshold.

The proposed amendments would change the regulation for utility operations-related swaps that are used to hedge or mitigate commercial risk for special entity utilities. All swaps would still count against the \$8 billion threshold applicable to any dealings in swaps with any type of entity, but this would at least place special entities engaged in utility operations-related swaps on the same footing as everyone else.

In order to rely on the exclusion provided by this rule, a counterparty would be required to file a one-time notice with the National Futures Association. In addition to basic information, that notice would contain a representation that the special entity with which it is transacting meets the criteria of the exclusion for utility operations-related swaps with special entities. The CFTC proposes to permit counterparties to rely upon your representation that you are a utility special entity and that the swap is a utility operations-related swap.

Request for Comments on Volumetric Optionality

The proposed rule also seeks comment on an important issue that is not necessarily exclusive to special entities, though the CFTC has asked how it affects special entities. These questions ask about the CFTC’s current test for embedded volumetric optionality in forward contracts. As many of you are aware, the seven factor balancing test for detecting optionality in non-price contractual terms is sufficiently vague and difficult to apply that it becomes very difficult to conclude with confidence that any given contract is or is not a swap. The uncertainty influenced some entities to report contracts to the CFTC as possible swaps even where it seemed unlikely that they qualified, just in case the CFTC might view them differently. Improvements to the CFTC volumetric optionality test could provide important clarity and benefit many municipal utilities.

The CFTC solicits input on questions including: the appropriateness of the CFTC’s current seven-factor test for determining whether a transaction that contains embedded volumetric optionality is a forward contract or a swap; what interpretation the CFTC should adopt, if not the current seven-factor test; and how entities such as municipal utilities would benefit if the CFTC revised or replaced the seven-factor test.

Given the desirability of regulatory relief from the special entity sub-threshold and the problems caused by the volumetric optionality test, some of you might be interested in filing comments on these issues. Please contact us if you require any assistance in this regard.

Hedging of Physical Commodities and Certain No Action Relief

On the same date, the CFTC [announced](#) that it would accept additional comments on issues related to position limits and the hedging of physical commodities, and hold a roundtable discussion on those issues. While position limit rules would tend to affect only larger entities, please let us know if you believe that comments on this pending rule would be a useful exercise.

FOR ADDITIONAL INFORMATION, PLEASE CONTACT THE FOLLOWING SPIEGEL ATTORNEYS:

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| Lisa Dowden | 202.879.2046 | lisa.dowden@spiegelmc.com |
| Melissa Birchard | 202.879.4015 | melissa.birchard@spiegelmc.com |

www.spiegelmc.com