THOMSON REUTERS PRACTICAL LAW

Certain Forward Contracts with Embedded Volumetric Optionality (EVO) to Be Excluded from Dodd-Frank Swaps Rules

by Practical Law Finance

Published on 25 Nov 2014 • USA (National/Federal)

Related Content

The CFTC and the SEC issued a joint proposal that would exempt certain forward contracts with embedded volumetric optionality (EVO) from the application of Dodd-Frank swaps rules.

On November 20, 2014, the CFTC and the SEC issued a joint *proposed interpretation* intended to clarify the agencies' interpretation of when an agreement, contract or transaction with EVO would be considered a forward contract for purposes of the application of Dodd-Frank swaps rules.

Under the proposal, an agreement, contract or transaction that includes EVO would fall within the "forward" exclusion from the "swap" and "future delivery" definitions found in sections 1a(27) and 1a(47) of the CEA (which provide that commodity options are swaps, even if physically settled) if the following criteria are met:

- The embedded optionality does not undermine the overall nature of the agreement, contract or transaction as a forward contract.
- The predominant feature of the agreement, contract or transaction is actual delivery.
- The embedded optionality cannot be severed and marketed separately from the overall agreement, contract or transaction in which it is embedded.
- The seller of a nonfinancial commodity underlying the agreement, contract or transaction with EVO intends, at the time it enters into the agreement, contract or transaction, to deliver the underlying nonfinancial commodity if the EVO is exercised.
- The buyer of a nonfinancial commodity underlying the agreement, contract or transaction with EVO intends, at the time it enters into the agreement, contract or transaction, to take delivery of the underlying nonfinancial commodity if the EVO is exercised.
- Both parties are commercial parties.
- The EVO 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 from the list above are largely unchanged from the interpretation that the agencies previously issued in their July 2012 *definitional release* (see *Legal Update, Regulators Define Key Dodd-Frank Terms "Swap" and "Security-based Swap" Triggering Title VII Compliance*). Among the first six elements, the agencies are proposing to modify the fourth and fifth elements to clarify that their interpretation applies to EVO in the form of both ***puts*** and ***calls***. The CFTC's discussion of these six elements in the definitional release would therefore remain applicable.

The seventh element above addresses the primary reason for including EVO in a forward contract. It demonstrates that the EVO 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. The agencies are proposing to remove reference from the seventh element to the "exercise or non-exercise" of the EVO. (According to the agencies, this language has created problems during contract negotiations, because certain parties feel pressure to specify the exact factors that could lead to the exercise or non-exercise of the volumetric optionality.) By removing the language "exercise of non-exercise," the agencies intend to clarify that the focus of the seventh element from the above list is on intent with respect to the EVO at the time of contract initiation.

Under the "Forward Contract Exclusion" (p. 73 of the *final definitional rules*), the final definitions of the terms "swap" and "security-based swap" under Title VII exclude "any sale of a nonfinancial commodity or security for deferred shipment or delivery, so long as the transaction is intended to be physically settled." Therefore, most physically settled commodity contracts that contemplate the delivery and/or receipt of physical commodities in connection with a business purpose are exempt from many Title VII rules, including mandatory clearing and exchange trading, subject to certain conditions (see *Legal Updates, CFTC Clarifies: Most Commodity Options Are Swaps Subject to Dodd-Frank*). Non-deliverable forwards (NDFs) are not excluded from these definitions and are therefore subject to Title VII swaps rules.

The agencies are proposing the changes in response to industry demand that EVO forwards entered into for the supply of physical commodities would not be treated as swaps for purposes of the application of Title VII swaps rules under the Dodd-Frank Act. This would subjecting these contracts to mandatory clearing, exchange trading and other rules that would add to the expense of conducting their commercial operations.

The CFTC requests that comments on the rule be submitted on or before December 22, 2014.

PRODUCTS

PLC US Finance, PLC US Financial Services, PLC US Law Department