Corporations and Hedging: Distinguishing Forwards from Swaps Under the Commodity Exchange Act Post-Dodd–Frank

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I. INTRODUCTION

Many authors have offered explanations for what caused the 2008 financial crisis.[1]

1. *See generally, e.g.*, Steven L. Schwarcz, Keynote Address, *Understanding the Subprime Financial Crisis*, 60 S.C. L. Rev. 549 (2009); Anthony Faiola et al., *What Went Wrong*, WASH. POST, Oct. 15, 2008, (outlining the debate about whether to regulate derivatives, including swaps, and asserting that although

Some of these authors point a finger at the careless way in which some companies used derivatives.[2] There are several types of derivatives, but the distinguishing feature of a derivative is that its value is derived from something else's value.[3] This could be anything, including, for example, natural gas, coal, or even weather conditions.[4] The contract price for some amount of electricity to be delivered in two years could depend on the market price for coal in two years. In other words, the contract price for electricity would derive from the future market price of coal.

Derivatives are used either to hedge or to speculate.[5] Hedging is a way of managing risk by taking offsetting positions in the market.[6] When an electricity-generating corporation buys coal, it might hedge the risk that the price of coal will rise by purchasing an option to sell coal. By taking this offsetting position, it will be able to sell coal at a higher price if it winds up having to buy coal at a higher price. This allows it both to guarantee itself an adequate supply of inputs while at the same time lowering its vulnerability in the event that market prices fluctuate.[7]

Speculating, on the other hand, is placing a bet that the market price will move one way or the other.[8] Like the generating corporation in the previous paragraph, a speculator who thought the price of coal would go up could purchase an option to sell at that higher price. Unlike the generating corporation, however, which is seeking to smooth things out, the speculator would probably choose to hedge less, if at all. The speculator is not seeking to break even on its investment but to turn a profit. Speculators, in this way, are trying to beat the market.[9] Both hedging and speculating involve a certain amount of risk, which is why some authors blame derivatives markets not only for the most recent financial crisis but for others as well, including the Enron collapse in 2001.[10]

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derivatives did not cause the 2007–08 financial crisis, they "accelerated" it); *cf. Dodd-Frank Act*, U.S. COMMODITY FUTURES TRADING COMM'N, http://www.cftc.gov/LawRegulation/DoddFrankAct /index.htm (last visited Apr. 9, 2014) ("[Swaps], which have not previously been regulated in the United States, were at the center of the 2008 financial crisis.").

2. *See* ROBERT W. HAMILTON & RICHARD A. BOOTH, BUSINESS BASICS FOR LAW STUDENTS 509 (Vicki Been et al. eds., 4th ed. 2006) ("Perhaps the most serious derivatives-induced problem is that of Orange County, [California] which declared bankruptcy as a result of losses primarily in [collateralized mortgage obligations, or] CMOs."). For a general description of what a derivative is, see *infra* Part II.A.

3. R. GLENN HUBBARD, MONEY, THE FINANCIAL SYSTEM, AND THE ECONOMY 186 (Denise Clinton et al., eds. 6th ed. 2008).

4. These all affect the price of electricity. Coal and natural gas are inputs, and weather affects demand for electricity. For a useful overview of electricity generation, see *Virtual Tours*, MIDAMERICAN ENERGY, http://www.midamericanenergy.com/aboutus3.aspx (last visited Apr. 9, 2014) (visually showing how plants generate electricity).

5. Paul K. Connolly, Jr., Presentation to the Harvard Electricity Policy Group, *To Hedge or Not To Hedge*, HARVARD KENNEDY SCHOOL OF GOV'T 4 (Sept. 21, 2006), www.hks.harvard.edu/hepg/Papers/ Connolly_Hedging_0906.pdf (discussing how state regulation of energy companies affects energy companies' decision whether to hedge or not).

6. HUBBARD, *supra* note 3, at 190.

7. *Id.*

8. *Id.*

9. *Id.*

10. HAMILTON & BOOTH, *supra* note 2, at 510. However, that is not to say that derivatives markets are universally well-understood. "As a result of numerous scandals," according to Hamilton and Booth, "the risks of derivatives are often overestimated and mischaracterized." *Id.* at 508.

After the 2008 financial crisis, people demanded that something be done about the use of these somewhat mysterious yet blameworthy financial products.[11] President Barack Obama urged Congress to pass legislation increasing regulation of financial markets.[12] Congress responded with the Dodd–Frank Wall Street Reform and Consumer Protection Act (Dodd–Frank Act),[13] which is the most comprehensive legislation concerning financial markets since the Great Depression.[14]

This Note examines one small aspect of the complex regulatory scheme that Congress set forth in the Dodd–Frank Act: its amendment to the Commodity Exchange Act (CEA).[15] Congress amended the CEA to include a definition of the term swap, which is one type of derivative.[16] In addition, Congress authorized the Commodity Futures Trading Commission (CFTC) to regulate certain swaps.[17] In its definition of the term swap, Congress expressly excluded certain types of contracts, including forwards.[18] This safe harbor matters for corporations that must comply with the new regulations.

This Note focuses on the term swap as it applies to corporations that use derivatives for hedging. Particularly, this Note focuses on corporations in the electricity industry because it offers concrete and specific examples. Electricity cannot be stored, so it is common in this industry to hedge because these corporations cannot leave their commodity in a warehouse and wait to sell under more favorable market conditions.[19] Despite this relatively narrow focus, the principles this Note discusses apply beyond the electricity industry.

Part II describes in more detail some of the common types of derivative instruments, how they are used, and how the Dodd–Frank Act applies.[20] It also introduces the so-called Product Definitions Rule, which excludes from the swap definition certain types of

11. *See* Faiola et al., *supra* note 1 (discussing how regulators recognized the need for regulating swaps and derivatives after the 2008 crisis).

12. The White House, Office of the Press Secretary, President Barack Obama, Remarks by the President on 21st Century Financial Regulatory Reform (June 17, 2009), http://www.whitehouse.gov/the_press_office/Remarks-of-the-President-on-Regulatory-Reform ("We are also proposing comprehensive regulation of credit default swaps . . .") [hereinafter Remarks by the President].

13. Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified at 12 U.S.C. § 5301) [hereinafter Dodd–Frank Act].

14. Margaret E. Tahyar, *Summary and Implementation Schedule of the Dodd–Frank Act*, THE HARV. L. SCH. FORUM ON CORP. GOVERNANCE & FIN. REG. (July 15, 2010, 9:17 AM), blogs.law.harvard.edu/corpgov/2010/07/15/summary-and-implementation-schedule-of-the-dodd-frank-act/ ("[T]he bill will mark the greatest legislative change to financial supervision since the 1930s.").

15. Commodity Exchange Act, 7 U.S.C. § 1a (2006) [hereinafter CEA].

16. CEA § 1a(47)(A) (2006) (defining swap); CEA § 1a(47)(B) (2006) (setting forth the forward contract exclusion).

17. Dodd–Frank Act § 712.

18. CEA, § 1a(47)(B) (setting forth the forward contract exclusion).

19. NPRM Comment Letter, NFP Electric Ass'ns, Comments on Joint Final Rule and Interpretations on Further Definition of "Swap," "Security-Based Swap," "Security-Based Swap Agreement"; Mixed Swaps; Security-Based Swap Agreement Recordkeeping, 6 (17 C.F.R. Part 1) RIN No. 3038-AD46 (Oct. 12, 2012), *available at* http://comments.cftc.gov/PublicComments/ViewComment.aspx?id=59235&SearchText= [hereinafter NFP Electric Ass'ns Letter].

20. *Infra* Part II.

contracts that are of interest to corporations that hedge.[21] Part III analyzes the way in which the CFTC and courts distinguish between forwards—which are beyond the scope of the swap definition—and swaps, which are now subject to regulatory oversight.[22] The fact that forwards are excluded is critical to the analysis.

This Note recommends three things.[23] First, the CFTC wisely incorporated into the swap context the same principles it already uses for distinguishing forwards from futures.[24] Second, courts should continue to follow the same path, applying the law to swaps the same way it has applied the law to forwards.[25] In addition, Part IV argues that the courts should defer to the CFTC to the extent possible, allowing the agency adequate flexibility to regulate swaps, especially because swaps have never been regulated before.[26] That is to say, the court should leave the CFTC some wiggle room.[27]

Lastly, and most importantly, Part IV recommends corporations familiarize themselves with the new regulatory definitions and safe harbors.[28] Corporations that have a choice in the matter ought to privately negotiate forward contracts that fall outside the scope of the Dodd–Frank changes to the CEA. In any event, this Note aims to provide a framework for determining how the CFTC distinguishes between forwards and swaps. Using this framework, companies can structure their transactions in the most advantageous way.

II. BACKGROUND

Congress passed Dodd–Frank in 2010, in which it authorized the CFTC to regulate certain swaps. The CFTC, along with the Securities Exchange Commission (SEC), issued the Product Definitions Rule in the summer of 2012.[29] In both, consistent with historical practice, Congress and the CFTC excluded nonfinancial commodity forwards from regulation. In order to understand what this means and why they did so, an explanation of derivatives is necessary.

A. Derivative Instruments

According to Steven L. Schwarcz, one of the leading scholars on the financial crisis, "[d]erivatives are chameleon-like, in that they easily can change form and appearance."[30] This variety not only makes it difficult to determine what transactions ought to be regulated; it also makes it hard for the general reader to understand what derivatives are

21. *Infra* Part II.C.
22. *Infra* Part III.
23. *Infra* Part IV.A.
24. *Infra* Part IV.
25. *Infra* Part IV.B.
26. *Infra* Part IV.B.
27. *Infra* Part IV.B.
28. *Infra* Part IV.C.
29. Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement"; Mixed Swaps; Security-Based Swap Agreement Recordkeeping, 77 Fed. Reg. 48207, 48227–45 (Aug. 13, 2012) [hereinafter Product Definitions Rule] (to be codified at 17 C.F.R. pt. 1).
30. Schwarcz, *supra* note 1, at 567.

in the first place. Yet, derivatives seem to be involved in many of the economic scandals that make headline news.[31] Derivatives, for example, have played a role in several scandals ranging from Enron in 2001[32] to the Orange County bankruptcy during the 2008 financial crisis.[33] But what are these financial instruments exactly? This Part will discuss just three derivative instruments—forwards, futures, and swaps—in order to provide a foundation for understanding the context in which administrative agencies, including the CFTC, regulate them.

1. Forwards

In the financial world, a "spot transaction" is one that is settled immediately, or on the spot.[34] The parties might exchange, for example, cash for some quantity of an asset. It applies in the context of a commodities market the same way it applies at the gas station: you pay whatever price is posted that day. If you were in the electricity generation business, you might pay the spot market price for coal or natural gas. (Ultimately, the price of these inputs gets reflected in the retail price that households pay.)

A "forward transaction," in contrast, is one in which the parties reach an agreement to settle the transaction at some time in the future.[35] In a forward contract for a nonfinancial commodity like coal,[36] settling would include delivery and payment. Unlike a spot transaction, the parties negotiate a mutually acceptable price so that rather than later paying the market price or "spot" price, the purchasing party pays the negotiated price.[37]

Such contracts have traditionally proven useful in agricultural commodity markets because of the timing involved. It allows, for example, a corn farmer to lock in a price for his corn before he plants it, rather than hoping that the market price will be acceptable after he harvests and is ready to sell.[38] Otherwise, he takes a risk that the price will fall, and he will have to sell his corn at a loss. Conversely, a corn buyer could enter a forward contract to minimize the risk that the price of corn will skyrocket, forcing him to buy at a premium.

This economic principle applies to electricity markets as well. Suppose, as another example, that a utility company expecting the next summer to be very hot entered into a

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31. *E.g.*, Faiola et al., *supra* note 1 (discussing derivatives and their role in the 2008 financial crisis).

32. BETHANY MCLEAN & PETER ELKIND, THE SMARTEST GUYS IN THE ROOM: THE AMAZING RISE AND SCANDALOUS FALL OF ENRON 27–43 (Penguin Grp, 2003).

33. HAMILTON & BOOTH, *supra* note 2, at 509 ("Perhaps the most serious derivatives-induced problem [was] that of Orange County, which declared bankruptcy as a result of losses primarily in [collateralized mortgage obligations]."); HUBBARD, *supra* note 3, at 200; Maura Webber Sadovi, *Orange County Comeback*, THE WALL ST. J. ONLINE (Sept. 18, 2012, 8:42 PM), http://online.wsj.com/article/SB1000087239639 04437202045780024836885552230.html.

34. HUBBARD, *supra* note 3, at 187.

35. *Id.*

36. Financial commodities include, for example, securities, which are not treated the same way as physical, nonfinancial commodities. CEA, 7 U.S.C. § 1a (47)(B)(ii) (2006).

37. HUBBARD, *supra* note 3, at 187.

38. *Id.*

forward contract with a generation and transmission company to make sure that it had sufficient electricity to meet its load, or demand. (When it is hot, consumers use electricity to cool buildings.) The utility can negotiate a price for the electricity it thinks it will need next summer, and in doing so, remove the uncertainty involved if it waits and buys electricity on the spot market. That is, it can hedge against the risk of unfavorable weather conditions.[39]

2. Futures

Like forwards, futures are contracts in which the price and delivery date are set up front.[40] Forwards are privately negotiated, though. Unlike forwards, futures are standardized and traded on exchanges.[41] Futures traders, rather than agreeing to take delivery of the underlying asset (whether it be a nonfinancial commodity like electricity or a financial commodity, such as a quantity of foreign currency) agree to settle the obligation *financially*. Thus, in a simplified example, a corn futures trader would enter into two contracts: one to purchase X amount of corn at price Y, and one to sell X amount of corn at price Z.[42] If price Z is greater than price Y, then the trader earns a profit without ever seeing the corn.[43]

3. Swaps

Swap transactions are different than both forwards and futures. In a swap transaction, parties agree to trade income streams over a period of time.[44] Ordinarily, one party will exchange a fixed-income stream for a variable-income stream.[45] The idea is for one party to acquire a defined, predictable stream of income, while the other party agrees, for a price, to bear the risk that the variable stream will not pay off.[46]

To illustrate, take the credit default swap (CDS), which played a role in the 2008 financial crisis.[47] Every day creditors loan money to borrowers who agree to repay the debt periodically over time. Some of these borrowers inevitably default, so the creditor might seek to lower its exposure. To do this, the creditor could purchase what is known as a credit default swap (CDS).[48]

Under this CDS arrangement, the creditor makes periodic payments to a CDS-seller (usually a bank or some other entity with large pools of money), which guarantees to pay

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39. Here, the utility company does not make two offsetting investments, but it takes a position that hedges against what it expects the weather to cause the market price to do; namely, that hotter weather will increase demand, which will raise the market price.

40. HUBBARD, *supra* note 3, at 187–88.

41. *Id.* at 187.

42. HAMILTON & BOOTH, *supra* note 2, at 496.

43. *Id.* This is consistent with the widely-understood maxim, "Buy low and sell high."

44. HAMILTON & BOOTH, *supra* note 2, at 505–06.

45. *Id.* at 506.

46. *Id.*

47. Remarks by the President, *supra* note 12 ("We're also proposing comprehensive regulation of credit default swaps . . . .").

48. Janet Morrissey, *Credit Default Swaps: The Next Crisis?*, TIME (Mar. 17, 2008), http://www.time.com/time/business/article/0,8599,1723152,00.html.

the creditor the loan amount should the borrower default. The creditor knows that some debtors will default, but by entering into a swap agreement with the CDS-seller, the creditor swaps its uncertain income stream for a guaranteed income stream, assuming the CDS-seller or its assignee has sufficient funds.[49] The CDS-seller, on the other hand, bears the risk that it will have to pay the amount in default; in return, however, the CDS-seller keeps the premiums without paying the creditor if the borrower indeed satisfies the debt.[50]

This insurance-like system works well for both the creditor and the CDS-seller unless an unexpectedly high number of borrowers default in a short period of time.[51] This becomes more likely if creditors loan money to less credit-worthy borrowers, knowing the CDS-seller will repay the debt. If borrowers default in unexpectedly high numbers, the CDS-seller could run out of money to pay the creditors, and the system breaks down altogether.[52]

This all illustrates that derivative instruments are inherently risky. This is primarily because they deal in future events, which are inherently unpredictable. In order to rein in actual and potential misuse of derivatives, Congress passed the Dodd–Frank Act.[53]

B. The Dodd–Frank Act

Given the role of derivatives in the 2008 financial crisis and given the risk they entail, Congress naturally sought to add swaps to the list of derivatives that are regulated.[54] This comprehensive legislation was aimed at eliminating as much structural risk as possible and protecting the integrity of the financial system as a whole.[55] In Title VII of the Dodd–Frank Act, Congress added a definition of the term "swap" to the CEA, and it authorized the CFTC and SEC to further define and administer the Act's terms.[56] This Part goes over these provisions in more detail.

The CEA swap definition includes a wide variety of contract forms:

> Swap.
> (A) In general. Except as provided in subparagraph (B), the term "swap" means any agreement, contract, or transaction—
> (i) that is a put, call, cap, floor, collar, or similar option of any kind that is for the purchase or sale, or based on the value, of 1 or more interest or other rates, currencies, commodities, securities, instruments of indebtedness, indices, quantitative measures, or other financial or economic interests or property of

49. *Id.*
50. *Id.*
51. *Id.*
52. *Id.*
53. *See generally* Dodd–Frank Act, Pub. L. No. 111-203, 124 Stat. 1375 (2010) (regulating some types of derivatives and creating safe harbors for others).
54. Jeremy Gogel, *"Shifting Risk to the Dumbest Guy in the Room"—Derivatives Regulation After the Wall Street Reform and Consumer Protection Act*, 11 J. BUS. & SEC. L. 1, 32 (2010); David A. Skeel, Jr., et al., *Inside-Out Corporate Governance*, 37 J. CORP. L. 147, 185 (2011) ("[D]erivatives magnified the 2008 financial crisis . . . .").
55. Skeel, *supra* note 54, at 194–95.
56. Dodd–Frank Act § 712(a).

> any kind;
> (ii) that provides for any purchase, sale, payment, or delivery (other than a dividend on an equity security) that is dependent on the occurrence, nonoccurrence, or the extent of the occurrence of an event or contingency associated with a potential financial, economic, or commercial consequence;
> (iii) that provides on an executory basis for the exchange, on a fixed or contingent basis, of 1 or more payments based on the value or level of 1 or more interest or other rates, currencies, commodities, securities, instruments of indebtedness, indices, quantitative measures, or other financial or economic interests or property of any kind, or any interest therein or based on the value thereof, and that transfers, as between the parties to the transaction, in whole or in part, the financial risk associated with a future change in any such value or level without also conveying a current or future direct or indirect ownership interest in an asset (including any enterprise or investment pool) or liability that incorporates the financial risk so transferred, including any agreement, contract, or transaction commonly known as—
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> . . .
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> (XVIII) an energy swap;
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> . . . and
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> (XXII) a commodity swap;
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> (iv) that is an agreement, contract, or transaction that is, or in the future becomes, commonly known to the trade as a swap;
> (v) including any security-based swap agreement which meets the definition of "swap agreement" as defined in section 206A of the Gramm-Leach-Bliley Act (15 U.S.C. 78c note) of which a material term is based on the price, yield, value, or volatility of any security or any group or index of securities, or any interest therein; or
> (vi) that is any combination or permutation of, or option on, any agreement, contract, or transaction described in any of clauses (i) through (v).[57]

Notice how widely Congress cast its net. In subsection (i), for example, except as otherwise provided, "swap" includes any option contract or derivative based on not just the enumerated list but also any financial or economic property of any kind.[58] Likewise, subsection (ii) covers contingent agreements.[59] Subsection (iv) even extends the definition to cover all agreements that become known among people in the business as a swap.[60]

Companies that hedge their risk using such agreements would appear to fall well within the scope of the Act's definition. Congress provided some safe harbors, however. After all, the mischief Congress sought to eliminate was the misuse of derivatives, not

57. CEA, 7 U.S.C. §1a(47)(A) (2006).
58. 7 U.S.C. § 1a(47)(A)(i) (2006).
59. 7 U.S.C. § 1a(47)(A)(ii) (2006).
60. 7 U.S.C. § 1a(47)(A)(iv) (2006).

conservative hedging. As a result, "[t]he term 'swap' does not include . . . any sale of a nonfinancial commodity or security for deferred shipment or delivery, so long as the transaction is intended to be physically settled . . . ."[61] This is where nonfinancial commodity forwards come in.[62] Distinguishing swaps from non-swaps, therefore, is important to companies that want to hedge.

C. Product Definitions Rule

Although Congress provided the regulatory framework, it assigned the CFTC and the SEC the task of further defining the Act's terms.[63] In July 2012, after going through notice and comment rulemaking procedures, the CFTC and SEC jointly issued the Product Definitions Rule.[64] This rule defined several products, including swaps, security-based swaps, mixed swaps and more. Only the first category, swaps, is within this Note's scope, and the CFTC has exclusive authority to regulate these.[65] In further defining these terms, the agencies kept Congress' language and stated how it would apply the new definitions.[66]

Under the CEA, a nonfinancial commodity forward transaction is not a swap and is therefore not subject to CFTC regulation under Dodd–Frank.[67] The issue then becomes what types of agreements qualify for the exclusion. Inquiring companies want to know.

1. Nonfinancial Commodity Forwards

The CFTC has never regulated forwards.[68] It has regulated futures, however. Part III will discuss the CFTC's analysis when it comes to distinguishing forwards from futures.[69] This is the same analysis the CFTC will use in distinguishing forwards from swaps under the CEA.[70] This distinction is of particular concern to electricity companies that use forwards to hedge commercial risk. Further concern arises when companies use forwards with embedded options. That is, the forward itself is for the future delivery of a nonfinancial commodity and the parties intend to settle physically, but the contract also includes, for example, an option for more or less of a commodity based on whether a contingency occurs. These seem to fall within the scope of the swap definition set forth above.[71] Will they be subject to regulation, or does the CEA swap definition exclude them?

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61. 7 U.S.C. § 1a(47)(B)(ii) (2006).

62. For a discussion of forwards, generally, *see supra* Part II.A.1 (contrasting forwards, where parties agree to settle the transaction in the future, with spot transactions, where the transaction is settled immediately).

63. Dodd–Frank Act § 712(d)(2).

64. Product Definitions Rule, *supra* note 29.

65. Dodd–Frank Act § 712(a).

66. Product Definitions Rule, *supra* note 29.

67. "The term 'swap' does not include— . . . (ii) any sale of a nonfinancial commodity or security for deferred shipment or delivery, so long as the transaction is intended to be physically settled . . . ." 7 U.S.C. § 1a(47)(B)(2006).

68. *Dodd-Frank Act*, U.S. COMMODITY FUTURES TRADING COMM'N, *supra* note 1.

69. *Infra* Part III.

70. Product Definitions Rule, *supra* note 29.

71. *Supra* Part II.B (quoting 7 U.S.C. § 1a(47)(A) (2006)).

2. Embedded Options

Pure forwards, described above,[72] are not subject to CFTC regulation.[73] As the CEA makes clear, a contract for future delivery is a forward as long as the parties intend, at the time they make the contract, to settle or deliver physically.[74] In other words, they must not intend at the outset to settle financially.[75]

However, some forward contracts for electricity contain options that provide for financial settlement. Recall the previously posited situation, where the electric utility entered into a forward agreement with the supplier to make sure it had enough electricity for next summer, which it expected to be hot. Electricity cannot be stored like rice or corn. If the following summer turns out to be much cooler than expected and the utility does not need as much electricity as it contracted for, the utility may wish to financially settle, or "book-out" the contract as opposed to taking delivery.

The potential problem from the CFTC's perspective is that if the underlying forward contract contains an option to settle financially, the contract could be treated like a swap. That is, it will be regulated such that the company will have to comply with record-keeping and reporting requirements. From the utility's perspective, on the other hand, it makes sense to settle the contract financially (it cannot just place the leftover electricity in a warehouse), and the fact that it did not need a certain amount at the margin should not affect the nature of its contract for regulatory purposes.

This is the problem that the CFTC had to deal with as part of its Product Definitions Rule. How should it treat these contracts that fall in the gray areas? It has said that it will interpret the scope of the term swap consistent with its precedents in distinguishing forwards from futures. What does that mean and how will it go about sorting which forwards are swaps and which are not?

III. ANALYSIS

Given that the CFTC will distinguish between forwards and swaps the same way it has distinguished between forwards and futures, this Part analyzes the agency decisions and court opinions that give meaning to and apply the broad, general statutory language. Next, it discusses the effect that the post-Dodd–Frank Act regulations will have on corporations in the electric industry. This discussion will hopefully serve as a useful example of how these regulations will generally affect companies that use forwards for hedging purposes.

A. Statutory Framework and the Product Definitions Rule

Title VII of the Dodd–Frank Act amended the CEA to include a definition of the term swap.[76] Under this section, the term swap does not include futures, which are defined as "any contract of sale of any commodity for *future delivery* (or option on such a

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72. *See supra* Part II.A.1 (explaining forward transactions).
73. Product Definitions Rule, *supra* note 29.
74. 7 U.S.C. § 1a(47)(B) (2006).
75. *Id.*
76. Dodd–Frank Act, Pub. L. No. 111-203, 124 Stat. 1375 (2010); 7 U.S.C. § 1a(47) (2006).

contract)."[77] Nor does it include forwards, which are defined as "any sale of a nonfinancial commodity or security for deferred shipment or delivery, so long as the transaction is intended to be physically settled."[78] The scope of this latter exclusion—the nonfinancial commodity forwards exclusion—is what electric corporations are worried about in terms of CFTC enforcement, particularly because the language of the CEA is so broad that the distinction is not always clear.[79]

In addition to defining the term swap, Congress authorized the CFTC and SEC jointly to define its scope further.[80] It also divided up the jurisdiction between the CFTC, which will regulate swaps, and the SEC, which will regulate security-based swaps.[81] Both parties will regulate certain mixed-swaps.[82] Pursuant to this congressional grant of authority, the administrative agencies jointly issued the so-called Product Definitions Rule.[83] In it, the agencies did not change Congress' definition of the term swap in the CEA, but they did offer some final interpretations.[84] Of relevance to this Note was the CFTC's statement that it would distinguish forwards from swaps the same way it has historically distinguished forwards from futures.[85]

B. Distinguishing Forwards from Futures

Given the broad statutory language described in Part III.A, the CFTC and the courts have had to look at legislative intent to determine the scope of the definitions and boundaries of the safe harbor for nonfinancial commodity forwards under the CEA.[86] It is this set of precedents that the CFTC plans to apply in cases arising under the new swap definition.

1. Defining the Scope of the Forward Exclusion

In determining whether a contract falls within the scope of the forward exclusion, courts consider the legislative purpose.[87] When President Obama proposed that Congress overhaul financial regulation in the wake of the 2008 financial crisis, he outlined several

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77. 7 U.S.C. § 1a(47)(B)(i) (emphasis added). Future delivery is a term of art in the regulatory context; both forwards and futures contemplate delivery at some point in the future, but the term applies to futures, in this case, and not to forwards.

78. 7 U.S.C. § 1a(47)(B)(ii) (2006).

79. NFP Electric Ass'ns Letter, *supra* note 19. Additional derivative instruments like credit default swaps, interest rate swaps, and foreign currency swaps are beyond the scope of this Note.

80. Dodd-Frank Act, Pub. L. No. 111-203, 124 Stat. 1375 (2010).

81. *Id.*

82. *Id.*

83. Product Definitions Rule, *supra* note 29.

84. *Id.* The fact that the CFTC issued interpretations rather than final rules irked some comment authors, who would like a surer statement of policy to rely on in conducting business. *E.g.*, NFP Electric Ass'ns Letter, *supra* note 19.

85. Product Definitions Rule, *supra* note 29.

86. CEA, 7 U.S.C. § 1 (2006).

87. *See, e.g.*, CFTC v. Co Petro Mktg. Grp., 680 F.2d 573, 577–79 (9th Cir. 1982) ("Where the statute is, as here, ambiguous on its face, it is necessary to look to legislative history to ascertain the intent of Congress.").

goals,[88] which are reflected in the preamble to the Act itself.[89] The thrust of these aims was to promote structural stability by imposing record-keeping and reporting obligations.[90]

From the time futures were first regulated in the 1930s, forwards have been excluded from the scope of regulation.[91] Under the CFTC's interpretation, this will not change going forward under Dodd–Frank. Thus, the CFTC decided, and the courts have held, that Congress clearly did not intend for the CFTC to regulate forwards. The more difficult problem is determining what a forward is and what it is not under the statutory framework.

2. Determining Whether a Contract Falls in the Safe Harbor for Nonfinancial Commodity Forwards

The critical factor in determining whether a contract falls within the forward exclusion is whether the parties intended, when they entered the agreement, to settle the contract physically; that is, to make or accept actual delivery.[92] In determining the parties' intent, the courts and the CFTC use a facts-and-circumstances approach.[93] Courts can infer intent from subsequent conduct, but the fact that the parties ultimately do not physically settle is not dispositive.[94] Intent may also be inferred from a party's ordinary course of business.[95] In addition, courts can infer intent from the terms of the agreement, but again, they can look beyond the four corners of the contract in determining the parties' intent. The CFTC has the burden of proving by a preponderance of the evidence whether the contract falls beyond the borders of the forward exclusion.[96]

In *CFTC v. Wright*, the enforcement division of the CFTC brought an action against a grain elevator operator, alleging that a hedge-to-arrive[97] agreement between the elevator operator and some grain-producing farmers violated the CEA as an off-market futures agreement.[98] Originally, the grain elevator operator entered into a contract with a

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88. Remarks by the President, *supra* note 12 ("We're also proposing comprehensive regulation of . . . swaps . . .").

89. Dodd–Frank Act, Pub. L. No. 111-203, preamble, 124 Stat. 1376 (2010) ("To promote the financial stability of the United States by improving accountability and transparency in the financial system . . .").

90. *See generally* Dodd–Frank Act, Pub. L. No. 111-203, Title VII, §§ 701-774, 124 Stat. 1376 (2010) (detailing new reporting and record-keeping requirements, as well as oversight functions, for the CFTC).

91. *Dodd–Frank Act*, U.S. COMMODITY FUTURES TRADING COMM'N, *supra* note 1.

92. *In re* Wright, CFTC Docket No. 97-02 (Oct. 25, 2010), *available at* http://www.cftc.gov/ucm/groups/public/@lropinionsandadjudicaryorders/documents/legalpleading/ogcwright102510.pdf.

93. CFTC v. Co Petro Mktg. Grp., 680 F.2d 573, 581 (9th Cir. 1982) ("The transaction must be viewed as a whole with a critical eye toward its underlying purpose."); *In* re *Wright*, CFTC Docket No. 97-02 (Oct. 25, 2010), *available at* http://www.cftc.gov/ucm/groups/public/@lropinionsandadjudicaryorders/documents/legalpleading/ogcwright102510.pdf; *In re* Stovall, CCH ¶20,941 at 23 (Dec. 6, 1979).

94. *In re* Wright, CFTC Docket No. 97-02 (Oct. 25, 2010), *available at* http://www.cftc.gov/ucm/groups/public/@lropinionsandadjudjcaryorders/documents/legalpleading/ogcwright102510.pdf.

95. *Id.*

96. *Id.* at 5.

97. Jayashree B. Gokhalé, *Hedge to Arrive Contracts: Futures or Forwards*, 53 DRAKE L. REV. 55, 61–63 (2004) (describing hedge-to-arrive contracts, which like forwards contemplate future delivery but unlike forwards do not specify the exact delivery date; parties can roll over the delivery obligation to a future date).

98. *In re* Wright, CFTC Docket No. 97-02 (Oct. 25, 2010), *available at* http://www.cftc.gov/ucm/groups/

middleman to obtain and deliver grain.[99] When the middleman failed to perform, the elevator operator entered into what the Commission referred to as a substitute agreement whereby the farmers stepped into the shoes of the middleman.[100] Not only did the contract provide for cancellation, but the elevator operator offered the farmers cash-settled put options.[101] The parties never actually settled, and the elevator eventually went under, but the parties never cancelled or rolled over their contracts either: they simply failed to perform. Thus, the Commission could not infer that the parties did not intend to settle, mainly because the agency presumes the farmers intended to settle physically and the testimony of the farmers that the enforcement division called to testify did not overcome the presumption.[102]

Predicting the outcome in any given case is not easy because the facts and circumstances can vary. Moreover, forward contracts may contain additional provisions beyond merely price, commodity, and delivery date.[103] Also, even though Dodd–Frank prohibits the use of forwards as tools for evading regulation, it can be difficult to spot the wolves in sheep's clothing.[104] The CFTC has set forth interpretations regarding common provisions that companies use in forward transactions.

3. *Forwards with Embedded Options and Other Provisions*

Under the facts and circumstances test, one question for electric corporations will be how the rules affect their regulatory obligations if they structure their transactions as forwards, but use other common provisions, such as for book-outs,[105] liquidated damages, volume options, and renewal terms (also known as "evergreen provisions").[106] Consistent with the CFTC's functional approach in the facts-and-circumstances analysis, embedded options will be fine as long as they are not severable and they go to the price term and not the delivery term.[107] That is, as long as the parties intend to settle

public/@lropinionsandadjudicaryorders/documents/legalpleading/ogcwright102510.pdf.

99. *Id.*

100. *Id.*

101. *Id.* at 2. That is, in exercising this put option, the farmers would be financially settling rather than physically settling. However, the key issue remains the parties' subjective intent at the beginning of the agreement.

102. *Id.* at 3.

103. *CFTC and SEC Finalize Key Dodd–Frank Product Definitions, Ushering in Implementation Phase of U.S. OTC Derivatives Regulatory Reforms, Dodd–Frank Product Definitions Update,* SIDLEY AUSTIN, LLP (Aug. 7, 2012), http://www.sidley.com/CFTC-and-SEC-Finalize-Key-Dodd-Frank-Product-Definitions-Ushering-in-Implementation-Phase-of-US-OTC-Derivatives-Regulatory-Reforms-08-07-2012/ ("Used as a hedge against future uncertainty . . . a forward contract with embedded volumetric optionality could include, for example, a gas supply contract entered into by an electric utility where the amount of gas the utility receives on a future date varies depending on weather conditions.").

104. This metaphor is borrowed from the commerce clause lectures of Professor Barry Matsumoto, University of Iowa College of Law.

105. A bookout provision might allow the parties to close their position early by settling for cash. *Bookout*, INVESTOPEDIA (2014), http://www.investopedia.com/terms/b/bookout.asp.

106. NFP Electric Ass'ns, *supra* note 19.

107. Product Definitions Rule, *supra* note 29.

physically, contract terms that provide one party a put or call option should be fine.[108] The CFTC does not want these terms to be severable so that a counterparty can turn around and trade these options on secondary markets.[109] After all, that would defeat the purpose of using a forward merely to hedge.

C. Effect on Corporations in the Electric Industry

In passing the Dodd–Frank Act in 2010, Congress settled a long-standing debate about whether the CFTC should regulate swaps.[110] One of the chief ongoing criticisms leveled against such regulation is that the statutory language and agency interpretations are ambiguous.[111] Corporations understandably want to know whether their contracts are going to be subject to regulatory obligations.[112] As a result, parties that have commented on the CFTC's Product Definitions Rule have asked the CFTC to draw a clearer boundary for the forward exclusion from the swap definition—a more workable standard for companies to rely on.[113]

The way a company structures its transactions will determine whether it falls within the scope of the CFTC's interpretations. By way of illustration, consider a corporation that produces electricity. To guarantee itself a satisfactory return on its electricity-producing investment, it might enter a forward contract with a buyer that wants to secure an adequate supply of electricity at some point down the road. The parties would negotiate three things: a price, some unit of the underlying commodity, and a future date of delivery. By entering a forward contract, the seller is able to hedge against the risk that the market price of electricity will fall when the producer wants to sell. This is not new. It is the same scenario described in Part II of this Note.[114]

Alternatively, however, the producer could enter into a swap agreement. This arrangement especially makes sense if the parties are going to transact repeatedly over a period of time because rather than enter into a series of forward contracts, they can enter into one swap agreement.[115] Recall from Part II that a swap agreement is one in which the parties agree to swap income streams; ordinarily, the parties exchange a fixed stream for a variable stream.[116] As in a forward contract, swap counterparties negotiate a price for an amount of a commodity over each period for the life of the deal.[117]

Unlike a traditional forward, however, the parties may not intend to settle

108. *Id.*

109. *Id.*

110. *See, e.g.*, Mark D. Young & William L. Stein, *Swap Transactions Under the Commodity Exchange Act: Is Congressional Action Needed?*, 76 GEO. L.J. 1917, 1943–45 (1988) (recommending that Congress should amend the CEA to include swaps, which it ultimately did with Dodd–Frank); *see also* Morrissey, *supra* note 48 (suggesting that the CDS market could contribute to the next economic downturn if system safeguards are ineffective).

111. Young & Stein, *supra* note 110 at 1945–47; NFP Electric Ass'ns Letter, *supra* note 19.

112. *Id.*

113. NFP Electric Ass'ns Letter, *supra* note 19.

114. *Supra* Part II.A.1.

115. Young & Stein, *supra* note 110 at 1928 (providing an excellent description of how swaps work and how parties use them).

116. *See supra* Part II.A.3 (explaining swap transactions).

117. Young & Stein, *supra* note 110, at 1928.

physically. The producer agrees to pay the buyer the variable, market value of the commodity. The buyer takes that money and turns around to buy its electricity from the spot market. In return, the producer receives the negotiated price and then sells its electricity to a stranger on the spot market.

Whether the price rises or falls, both parties transact at the agreed upon price. Suppose the market price rises. The seller is obligated to pay the buyer a higher price, but the seller is actually going to be able to sell the electricity at a higher price, cancelling out the market risk because the seller receives the negotiated price no matter what (assuming the buyer does not default). Thus, from an economic standpoint, the two transactions are the same.[118]

Seller	$	Buyer
Receives fixed price	←	Pays fixed price
Pays market price ↕	→	Receives market price ↕
Sells on spot market		Buys on spot market

Figure 1. Net Economic Effect of a Swap Transaction[119]

From a legal standpoint, however, the consequences of structuring a transaction as a swap or a forward are very different. In the real world, dealers facilitate swap transactions.[120] Swaps can be standardized and marketed to buyers and sellers who never have any direct contact with one another.[121] Unlike the sorts of commodity forwards that Congress did not intend to reach, Dodd–Frank was aimed at these sorts of transactions. The new regulatory scheme allows the CFTC (and the SEC in the context of security-based swaps) to monitor and assess the risks of the swap market.

The structure of the contract, agreement, or transaction, matters. How a company does it affects how it will be regulated. That is why the next Part recommends, among other things, that electric corporations structure their transactions in ways that keep them within the safe harbor for nonfinancial commodity forwards while not evading regulation or taking advantage of Congress' intent not to regulate forwards.

118. *Id.*

119. Notice that both parties buy and sell, respectively, on the spot market. The market price gets factored out, however, because the price the buyer has to pay on the spot market and the price the seller is going to be able to sell at are equal. When the seller gives the buyer that variable price in return for the fixed, negotiated price, you have the fixed for variable stream, the hallmark of a swap transaction.

120. Young & Stein, *supra* note 110, at 1928.

121. *Id.*

IV. RECOMMENDATION

A few major players stand out in the derivatives regulation game. First, several administrative agencies are responsible for making and enforcing the rules as well as conducting adjudicative proceedings. For purposes of this Note, however, the CFTC is the only relevant agency.[122] Second, courts play a role as well, and they participate either by reviewing administrative decisions or by applying the established principles for distinguishing nonfinancial commodity forwards from swaps, borrowed from the futures-regulation context, that Congress set forth and the CFTC has fine-tuned. Third, there are corporations and other business entities that conduct their various commercial activities according to these rules.[123]

This final Part offers some recommendations and observations concerning each of the players in turn. It points out what each of these players has done well. It also recommends how corporations should react.

A. CFTC

There had been a debate for years about whether swaps should be regulated.[124] Until 2010, when the President signed the Dodd–Frank Act into law, they had never been regulated. The CFTC deserves praise for wading carefully into the waters of this never-before-regulated area of the derivatives market. It is clear from the CFTC Commissioners' comments in June 2012, during the meeting in which the agency approved the Product Definitions Rule, that they were proud of the agency's hard work.[125] It is also clear that the CFTC was mindful of the various interests involved and sensitive to the comments it received.[126] That is, the CFTC deliberately made sure that it did not step on toes where it did not need to.

For example, even after approving the Product Definitions Rule, the CFTC opened a notice and comment period about how it should deal with nonfinancial commodity

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122. Security-based swaps, mixed swaps, and other swap-related derivative instruments are beyond the scope of this Note. In Title VII of the Dodd–Frank Act, Congress granted the CFTC exclusive jurisdiction over swaps. Dodd–Frank Act, Pub. L. 111-203, § 712, 124 Stat. 1376 (2010).

123. To simplify the analysis, this Note deliberately narrows the universe of relevant actors when it comes to financial markets in swaps and other derivatives. That is to say, in real life, intermediaries, such as swap dealers, play a significant role in facilitating liquidity, spreading risk, and gathering information. HUBBARD, *supra* note 3, at 157–229.

124. *See* Young & Stein, *supra* note 110, at 1937–45 (outlining a debate about whether swaps are futures, in which some argued that all swaps are futures; others argued that only some swaps are futures; and still others took the position that swaps were not futures at all). The debate that Young and Stein describe, now essentially moot in the wake of the Dodd–Frank Act's passage because both swaps and futures are regulated, demonstrates how slippery these distinctions between and among financial instruments (and also commercial contracts) can be when trying to categorize them for regulatory purposes.

125. Gary Gensler, Chairman, U.S. Commodity Futures Trading Comm'n, Open Meeting to Consider Final Rule on Further Definition of the Term "Swap," Final Rule on the End-User Exception to Clearing, and Proposed Rule to Exempt from Clearing Certain Swaps by Cooperatives (July 10, 2012), http://www.cftc.gov/ucm/groups/public/@swaps/documents/dfsubmission/dfsubmission11_071012-trans.pdf [hereinafter Open Meeting].

126. *Id.*

forward contracts with volumetric optionality.[127] The agency already stated (in its interpretations issued along with the Product Definitions Rule) that it would not treat a forward contract as a swap or future just because it contains, for example, embedded terms affecting only the contract price. The potential problem with volume options, from the CFTC's perspective, is that parties could abuse the safe harbor for forwards by including terms that give the other party something it can turn around and sell on a secondary market. Such contracts are within the scope of what Congress intended to regulate with the Dodd–Frank Act.

However, the CFTC also recognizes that potential problems are not actual problems. Some volume terms are harmless and actually serve a valid commercial purpose, particularly in the electricity industry. As Part II mentioned, a hedging contract could include terms for volume options simply because it is difficult to predict how much electricity a customer will actually need at some point in the future.[128] In requesting comments, the CFTC showed that it was aware that there are fine lines, and it has done a good job of respecting diverse interests.

One way the CFTC could improve the existing framework is to issue rules rather than interpretations. The CFTC is still in the process of implementing the Dodd–Frank Act and is continuing to adapt the scope of the term swap under the CEA to deal with this complex area of the economy and the law. For administrative agencies, rules have the force and effect of law until they are changed.[129] Interpretations, on the other hand, are more malleable.

Electric corporations have requested that the CFTC issue more permanent norms concerning the forward safe harbor.[130] Although it is more expensive to make rules than it is to issue interpretations because of the procedures involved in notice and comment rulemaking, the CFTC should eventually do so. It is understandable that the CFTC would issue interpretations alone because it allows the agency to preserve its flexibility to adjust as the market responds to the new regulations. The analysis in Part III demonstrates that there is an endless variety of possible contracts. Just as electricity takes the most efficient path to the ground, businesses will take advantage of the most efficient means. Flexibility is important at this stage in the process, and at any stage in the process for that matter.

Overall, the CFTC has done a good job of drawing clear lines where it can without recklessly covering contracts that Congress did not intend to include under the Dodd–Frank Act. The CFTC should focus on providing clear standards while maintaining a level of responsiveness and flexibility.[131] That is, it should stay the course.

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127. Product Definitions Rule, *supra* note 29, at 112, § II.B.2(b)(ii), n.335 (2012). By volumetric optionality, the agency is referring to contract provisions that provide one party an option to either take or deliver some additional volume of (in the context of this Note) electricity at the negotiated time for a negotiated price, based on varying levels of customer demand. *Id.*

128. *Supra* Part II.C.2.

129. Accardi v. Shaughnessy, 347 U.S. 260, 265 (1954).

130. NFP Electric Ass'ns Letter, *supra* note 19.

131. To its credit, Dodd–Frank creates an Energy and Environmental Markets Advisory Committee, which will be a nine-member committee including hedgers and consumers that will report on "matters of concern to exchanges, firms, end users, and regulators regarding energy and environmental markets and their regulation by the Commission." Dodd–Frank Act, Pub. L. 111-203, § 751, 124 Stat. 1378 (2010).

B. Courts

The courts play a smaller role in administering the new regulations than the CFTC. They should apply the legal distinctions even-handedly, in a manner that remains true to the way that the CFTC and the courts have historically interpreted the future-forward distinction. In doing so, the courts will make predictable decisions that corporations can rely on.

Courts' primary goal should be to give effect to the legislative purpose of the Dodd–Frank Act. This Note explains in several places that electric companies use forwards for hedging and that Congress did not intend or propose to require these contracts to be openly traded on exchanges the way Congress requires parties to trade futures and now swaps. Though as Part III suggests, courts should look past the form of a transaction to the parties' purpose. In applying Congress' intent, courts should be equally as flexible as the CFTC.

C. Corporations

Complying with regulations can be expensive and time-consuming. In order to avoid these new regulations lawfully—which were not actually aimed at hedging—corporations in the electricity industry should do a couple of things. Specifically, they should privately negotiate forward contracts to the extent they are able. As described toward the end of Part III, a forward and a swap can have identical economic outcomes in any given transaction, but they may have different regulatory outcomes. Likewise, standardized futures contracts on exchanges are subject to regulation. Thus, corporations ought to use forwards if they can.

Also, corporations should manifest a clear intent to settle physically, both in drafting the provisions of their contracts and in conducting their business activities. In doing so, they will have a greater chance of falling within the safe harbor rather than meeting the swap definition. Recall that the paramount consideration is the parties' intent to settle physically.[132]

Because the primary concern for the courts and the CFTC is that the parties intend to settle financially, the parties have to walk the walk, not just talk the talk. The agency will not turn a blind eye to form and ignore the function of a new contract. Accordingly, corporations should be mindful of the fact that there always remains a potential for abuse and to steer clear of overly gray areas.

Whatever they choose to do, corporations should not purposely evade regulation. The Dodd–Frank Act contains anti-evasion provisions,[133] and the CFTC Commissioners were careful to point out in their statements when issuing the rule that the agency would look past the form to the function of any agreement.[134] That is, a party that structures its contract as a forward but includes a provision that grants, for example, the other party an option to purchase ten times the electricity such that the other party can turn around and sell that option to someone else will not benefit from the safe harbor.

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132. *Supra* Part III.B.

133. Dodd–Frank Act, Pub. L. 111-203, § 753, 124 Stat. 1376 (2010).

134. Open Meeting, *supra* note 125.

This Note has primarily focused on electric corporations as a way to contextualize the analysis. It has also relied on examples from the electricity industry because derivative instruments are a particularly relevant financial instrument for electric companies seeking to hedge commercial risk. That said, there is no reason that the same considerations would not apply in other contexts.

It remains to be seen what effect the new rules will have on companies' level of participation in swap markets.[135] It may be that companies try to avoid using them altogether if the regulatory obligations turn out to be more burdensome than achieving the same risk-lowering benefits with other financial instruments. It is too soon to say.

Overall, as with any regulation, corporations will have incentives to change certain behaviors. It remains to be seen what they will do. This Note recommends that electric corporations, and others that use forwards for hedging, become aware of both the established and developing law about the scope of the term swap, so that they can plan and conduct businesses according to their best interests.

V. CONCLUSION

The misuse of derivatives at least exacerbated, if not partly caused, the 2008 financial crisis that set off a global economic downturn, the effects of which are still felt today. In response, Congress passed the Dodd–Frank Act, which established a new regulatory framework for derivatives, including swaps. Complying with these regulations costs corporations time and money. It is important for some corporations to understand the distinction between swaps and nonfinancial commodity forwards. This Note serves as a starting point for corporations in determining how to comply with one small part of the Dodd–Frank Act. Flexibility and adaptation are crucial. Corporations will adjust; the CFTC will fine-tune the regulations already in place; and the courts will follow as the dust eventually settles around this small piece of the Dodd–Frank Act.

135. The CFTC is in the process of gathering market data from regulated entities. One could do an interesting empirical analysis of whether new swap regulations change when and how companies use swaps.

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