**COMPLIANCE TOOL RE CERTAIN EXEMPTIONS FROM CEA REQUIREMENTS, EXCLUSIONS FROM THE DEFINITION OF “SWAP,” AND THE COMMODITY TRADE OPTION (“SWAP”) EXEMPTION FROM CEA REQUIREMENTS**

# **Introduction**:

This compliance tool has been prepared by Reed Smith LLP and is intended to provide guidance with respect to certain 4(c)(b) exemptions from compliance with the Commodity Exchange Act (the “CEA”), certain exclusions from the term “swap” promulgated under the U.S. Commodities Futures Trading Commission’s (the “CFTC”) Product Definitions Release, 77 Fed. Reg. 48,208 (August 13, 2012) (“PDR”) and the Non-financial Commodity Trade Option Interim Final Rule (“IFR”) provided in the Commodity Options Release, 77 Fed. Reg. 25,320 (April 27, 2012) (“COR”). Please note that the CFTC changes and updates its regulations and interpretations periodically, so readers are advised to check the CFTC’s website and other authoritative sources to obtain current and complete regulations, interpretations and other regulatory guidance[[1]](#footnote-1).

Further, the various summaries contained herein, including observations or recommendations expressed by the authors, do not constitute legal advice in respect of any particular agreement, contract or transaction. For specific guidance on particular matters, including regulatory and legal advice on the application of the PDR, COR or the Dodd Frank Wall Street Reform and Consumer Protection Act (the “DFA”) to particular issues and products, you should seek further advice and counsel from Reed Smith LLP or other lawyers and professionals who are familiar and experienced with the relevant laws, regulations and CFTC precedent. In all cases, the CFTC reserves the right to consider the facts and circumstances involving any particular agreement, contract or transaction.

# **The Proposed Not-For-Profit Electrics Order**.[[2]](#footnote-2)

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| **Acceptable Parties** | 1. Government-owned electric utilities described by Section 201(f) of the Federal Power Act (the “FPA”) NFP Order at 51003.  2. Electric utilities owned by Native American tribes recognized by the Federal Government, otherwise subject to regulation as public utilities under the FPA. NFP Order at 51003.  3. Cooperatively-owned electric utilities, regardless of whether such utilities are described by FPA section 201(f), so long as (a) they are treated as cooperative organizations under the Internal Revenue Code and (b) exist for the primary purpose of providing electric energy service to its member/owner customers at the lowest cost possible. NFP Order at 51003.  4. Any not-for-profit wholly owned, directly or indirectly, subsidiary of one or more of the foregoing. NFP Order at 51003. |
| **Exempted Transactions** | Note that an exempt transaction must be “between or amongst” NFP Electric Entities.  Non- Financial Energy Transactions that are: (a) based upon a commodity (as defined by the CEA) where (b) the primary purpose of the transaction is to satisfy existing or anticipated contractual obligations to facilitate the generation, transmission, and/or delivery of electric energy service to customers at the lowest cost possible and (c) such transaction is intended for making or taking physical delivery of the commodity upon which the transaction is based are exempt. NFP Order at 51012. |
| **Non-exempt transactions** | 1. Transactions derived from any interest rate, credit, equity or currency asset class, or any grade of a metal, agricultural product, crude oil or gasoline that is not used as fuel for electric energy generation. NFP Order at 51001.  2. Environmental rights contracts, allowances or attributes. Note, however, that these arrangements are nonetheless exempt from many requirements of the CEA because they would be covered under by the forward exclusion from the swap definition. NFP Order at 51003. |

# **Proposed RTO Order**.[[3]](#footnote-3)

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| **Acceptable Parties** | Each party to the applicable agreement, contract or transaction must be an “appropriate person,” as defined in Sections 4(c)(3)(A) through (J) of the CEA or an “eligible contract participant,” as defined in section 1a(18)(A) of the CEA and in CFTC regulation 1.3(m). RTO Order at 52318. |
| **Exempted Transactions** | 1. Financial Transmission Rights (“FTR”) provided that the following conditions are met: (a) each FTR is linked to, and the aggregate volume of FTRs for any period of time is limited by, the physical capability of the electricity transmission system operated by the RTO offering the contract for such period, (b) a RTO serves as the market administrator for the market on which the FTR is transacted, (c) each party to the transaction is a member of the RTO, is the RTO itself, and the transaction is executed on a market administered by the RTO and (d) The transaction does not require any party to make or take physical delivery of electricity. RTO Order at 52141.  2. Energy Transactions in the day-ahead market or real-time market for the purchase or sale of a specified quantity of electricity at a specified location where the price of electricity is established at the time it he transaction is executed. RTO Order at 52142.  3. Forward Capacity Transactions that fall in to one of the following categories: (a) generation capacity contractwhereby a RTO has the right to require certain sellers to maintain the interconnection of electric generation facilities to physical locations in the electric power transmission system during a future time period (Such general capacity contracts also requires a seller, subject to applicable tariff provisions, to interject electric energy into the electric power transmission system operated by the RTO), (b) Demand Response Right that provides a RTO the right to require that certain sellers of such rights curtail their consumption of electricity from the RTO electricity transmission system during a future period of time and (c) Energy Efficiency Rights providing the RTO with the right to require specific performance of an action on the part of the other party that will reduce the need for General Capacity or Demand Response Rights over the duration of a future period of time. RTO Order at 52142.  4. Reserve Regulation Transactionsthat allow a RTOto purchase through auction the right to require the seller to operate electric facilities in a physical state such that the facilities can increase or decrease the rate of injection or withdrawal of electricity to the electric power transmission system operated by the RTO with physical performance by the seller’s facilities within a response interval specified in the RTO’s tariff, or prompt physical performance by the seller’s facilities. RTO Order at 52142. |
| **Non-exempt transactions** | Only the transactions described above are exempt under the RTO Order. It should be noted that the CFTC expressly declined to exempt “the purchase and sale of a product or service that is directly related to, and a logical outgrowth of, any of an applicable RTO’s core functions. Additionally, convergence and virtual bids and transactions would not be exempt unless such transactions fall within the scope of one of the transactions described above. RTO Order at 52163. |
| **Conditions Precedent to Exemption** | The CFTC retains general antifraud, anti-manipulation and enforcement authority over contracts subject to the RTO Order. RTO Order at 52166.  The Exemptions in the RTO Order are contingent upon the existence of information sharing arrangements between the CFTC and FERC. RTO Order at 52166.  Finally, the RTO Order would require that neither the tariffs nor any other governing documents of a particular RTO include any requirement that the RTO notify its members prior to providing information to the CFTC in response to a subpoena or other requests for information or documentation. RTO Order at 52166. |

# **Nonfinancial Commodity Forward Contract**[[4]](#footnote-4)

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| **Key Definition** | The CFTC interprets the term “nonfinancial commodity” to mean a commodity that can be physically delivered and that is either (a) an “exempt commodity” (which is a commodity that is not an “excluded commodity” under pre-DFA CEA) or (b) an “agricultural commodity.” PDR at 48232.  The CFTC provides a “safe harbor” interpretation that an intangible commodity (that is not an “excluded commodity”) ***is*** a nonfinancial commodity ***if*** ownership of the commodity can be conveyed in some manner ***and if*** the commodity can be consumed (*e.g*., it is of limited quantity, and the purchaser needs the commodity, not cash, to fulfill its requirements). PDR at 48233.  KEY POINT FOR ENERGY INDUSTRY: Examples given of nonfinancial commodities in the PDR are environmental commodities, such as emissions allowances, and renewable energy credits. See PDR at 48233 and 48316. |
| **Acceptable Parties** | “Commercial market participants”  Commercial: must be “related to the business of a producer, processor, fabricator, refiner or merchandiser.” PDR at 48229. Clarification requested that commercial users of commodity (or products or byproducts) are also included.  The business activity in which a market participant makes or takes delivery of the commodity must be “commercial activity” for the entity to be a commercial market participant. PDR at 48229.  Clarification request that nonprofits and government entities have “commercial” activity, and so can be “commercial” market participants. Although this interpretation is provided in other places in the CFTC’s rulemakings, it is not in this “safe harbor.” |
| **Acceptable Contract Provisions** | Enforceable obligation to deliver, but delivery is deferred for reasons of commercial convenience or necessity. PDR at 48229 FN 213.  Bona fide termination rights, including, *e.g.*, force majeure provisions and termination rights triggered by events of default, such as counterparty insolvency, default or other inability to perform. PDR at ­­­­­­­­­­­48230.  Alternative settlement methods: (a) seller’s passage of title and buyer’s payment and acceptance of the underlying commodity; (b) taking delivery of the commodity in some instances and in others instead passing title to another intermediate purchaser in a chain; and (c) physically exchanging (*i.e.*, delivering) one quality, grade or type of physical commodity for another quality, grade or type of physical commodity. PDR at 48230.  Liquidated damages (or cover damages) provision does not render such a contract ineligible for the forward exclusion, BUT cannot mask a lack of intent to deliver. PDR at 48244.  Payment trigger under a performance guarantee would not preclude a contract from being covered by the forward exclusion, BUT a guarantee of a swap may be considered a swap. PDR at 48244 FN 394. CFTC plans to propose rules or interpretations on swap guarantees PDR at 48,226. |
| **Unacceptable Contract Provisions** | Termination rights that are not “bona fide,” but for the purpose of evasion. PDR at 48230.  [Other contextual factors that the CFTC will consider in its facts and circumstances analysis: contract size; demonstrable commercial need for the product; underlying purpose of the contract; the regular practices of the commercial entity with respect to its general commercial business and forward/swap transactions, or whether the absence of physical settlement is based on a change in commercial circumstances. PDR at 48231.] |
| **Acceptable Intent** | The transaction is intended to be physically settled (Key-see statute). PDR at 48227.  Intent is to transfer ownership of the commodity, and not solely transfer price risk of the commodity. PDR at 48228. |
| **Unacceptable Intent** | Solely to transfer price risk of the commodity. Speculation. PDR at 48228. |
| **Post-Contract Events that Affect Safe Harbor** | “Book-outs” (either bilateral or multi-lateral) must meet the requirements specified in the Brent Interpretation*, i.e.,* must be effectuated through a subsequent, separately negotiated agreement. PDR at 48,230.[[5]](#footnote-5) Although the Product Definitions Release is not clear as to what the ramifications would be should this not be the case. Presumably, if the “book-out” were in the original agreement or anticipated or negotiated earlier, the parties’ “intent to physically settle” would be called into question. However, whether the transaction would then be a non-forward “swap” (DFA) or a non-forward “futures contract” (pre-DFA) is not clear.  In the event of an oral “book out,” such book out must be followed in a commercially reasonable timeframe by a “confirmation[[6]](#footnote-6)” in some type of written or electronic form. PDR at 48,230. Comments were submitted on this issue, as well as challenge in OMB proceeding, along with request for “no action.”  If a “non-commercial market participant” is an intermediate purchaser in a delivery chain, then the transaction may not be a commercial merchandising transaction, and the parties cannot rely on the Brent Interpretation safe harbor. PDR at 48230, see footnote 235. Commented on this issue. |
| **Contract Examples Cited as Consistent with this Safe Harbor** | Physical netting agreements, or clauses in the base agreement (*e.g.,* Edison Electric Institute Master Power Purchase and Sale Agreement), that contain provisions contemplating the reduction to a net delivery amount of future, unintentionally offsetting delivery obligations; provided that the parties had a bona fide intent, when entering into the transactions, to make or take delivery of the commodity. PDR at 48230.  Physical exchange transactions (described in II.B.2(a)(iv)). PDR at 48235.  Fuel Delivery Agreements (described in II.B.2(a)(v)) –PDR at 48236. |

# **Nonfinancial Commodity Forward Contract, *with* Embedded Option(s) Affecting Price and Other Terms But Not Delivery Term** [[7]](#footnote-7)

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| **Key Definition** | Assume same as above. |
| **Acceptable Parties** | Assume same as above. |
| **Acceptable Contract Provisions** | “Embedded options:” PDR at 48237.  1. May be used to adjust the forward contract price, but do not undermine the overall nature of the contract as a forward contract;  2. Do not target the delivery term, so that the predominant feature of the contract is actual delivery; and  3. Cannot be severed and marketed separately from the overall forward contract in which they are embedded. Clarification requested.  4. Examples of permissible forward contract price adjustments at FN 331. PDR at 48237. |
| **Unacceptable Contract Provisions** | Assume same as above. |
| **Acceptable Intent** | Assume same as above. |
| **Unacceptable Intent** | Assume same as above. |
| **Post-Contract Events that Affect Safe Harbor** | Assume same as above. |
| **Acceptable Contract Examples** | Assume same as above. |

# **Nonfinancial Commodity Forward, *with* Embedded Volumetric Optionality**[[8]](#footnote-8)

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| **Key Definition** | Assume same as above. |
| **Acceptable Parties** | Both parties must be “commercial” parties (see element 6 below, PDR at 48238). Clarification requested re “commercial market participant.” |
| **Acceptable Contract Provisions** | Seven elements: PDR at 48238.  1. Embedded optionality does not undermine the overall nature of the contract as a forward contract;  2. Predominant feature of the agreement, contract, or transaction is actual delivery;  3. Embedded optionality cannot be severed and marketed separately from the overall agreement, contract, or transaction in which it is embedded;  4. Seller of a nonfinancial commodity intends, at the time it enters into the contract, to deliver the underlying nonfinancial commodity if the option is exercised;  5. Buyer of nonfinancial commodity intends, at the time it enters into the contract, to take delivery if it exercises the option;  6. Both parties are commercial parties; and  7. 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 re influencing demand for, or supply of, the nonfinancial commodity. Comments requested withdrawal of this regulatory safe harbor. |
| **Unacceptable Contract Provisions** |  |
| **Acceptable Intent** | See #4 and #5 in the “Acceptable Contract Provisions.” |
| **Unacceptable Intent** |  |
| **Post-Contract Events that Affect Safe Harbor** | See #7 in the “Acceptable Contract Provisions.” Footnotes say ***predominant*** basis for failing to exercise the option would be that the demand or supply that the optionality was intended to satisfy, if needed, never materialized, materialized at a level below that for which the parties contracted or changed due to physical factors or regulatory requirements outside the parties’ control e.g., colder than expected weather driving down energy demand. FN 341. PDR at 48238.  To the extent a business has a ***business need*** to procure additional capacity resources beyond the regulatory requirements; it may be covered under the interpretation if the additional capacity is required due to physical factors beyond the control of the parties (i.e., unscheduled outages). FN 340. PDR at 48238. |
| **Examples of Contract Provisions and Analysis in PDR** | Gas supply curtailment due to a pipeline outage and power generation curtailment by an ISO for operational reasons, while volume curtailment is within control of power buyers based on a physical constraint. FN 345. PDR at 48239.  Safe harbor may apply to capacity contracts, transmission (or transportation) services agreements, tolling agreements and peaking supply contracts. If these are not nonfinancial commodity forwards with embedded volumetric optionality, they may fall within the forward exclusions from the swap definition. PDR at 48240. Issue presented if references a specified facility and contains two-tiered pricing. See Section I hereof.  Contracts with evergreen or extension terms (in a commercial contract?) are not ineligible for the forward exclusions from the definition of swap. Using extension or evergreen provisions to avoid delivery, as was the case with “rolling spot” contracts could [per agricultural hedge-to-arrive or retail foreign exchange precedent from pre-DFA CEA] constitute evasion or violate other provisions of the CEA. FN 359. PDR 48240.  Embedded optionality as to delivery points and delivery dates will ***not*** cause a transaction that otherwise qualifies as a forward contract to be considered a swap. PDR at 48240. |

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| **Generally** | Full requirements contracts or output of the unit or system contracts qualify as an excluded forward contract (not a “swap”) because the PDR notes that these contracts do not have embedded volumetric optionality. See PDR at 48239-48240. |
| **Key Definition** | A contract where the seller agrees to provide all requirements for a specific customer’s location or delivery point; the purchaser deals exclusively with one supplier, the seller; there is an obligation under the UCC for the purchaser to act in good faith with respect to securing from the single supplier the varying amount that is called for delivery. See PDR at 48239-48240. |
| **Acceptable Parties** | The purchaser must deal exclusively with one supplier. See PDR at 48239-48240. |
| **Acceptable Contract Provisions** | Any instance where nominal or zero delivery occurs would have to be because the commercial requirements changed or did not materialize. Any variability in delivery amounts under the contract is driven directly by the buyer’s commercial requirements and is not dependent upon the exercise of any commodity option by the contracting parties. This is the case even if the recipient owns generation and the “full” requirements is full in excess of owned generation. See PDR at 48239-48240. |

# **Full Requirement Contracts[[9]](#footnote-9)**:

# **Customary Commercial Agreements, Contracts or Transactions, Entered Into As Part of Operations**[[10]](#footnote-10)

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| **Key Definition** | The term “commercial” is not defined in this safe harbor.[[11]](#footnote-11) However, the additional phrase “as part of operations” seems to distinguish these operations-related contracts from other contracts entered into as part of financing or investment activities. |
| **Acceptable Parties** | Commercial or non-profit entities as principals (or by agents). PDR at 48247. |
| **Acceptable Contract Provisions** | Escalation clauses linked to an underlying “commodity” such as an interest rate or CPI. PDR at 48247.  Assignment provision alone does not mean that it is “traded.” PDR at 48248. (See below) |
| **Unacceptable Contract Provisions** | Payment obligations that are severable from the agreement, contract or transaction. PDR at 48250.  Agreement, contract or transaction is traded on an organized market or over-the-counter. PDR at 48247-48248. No context is provided for the term “traded” or “organized market” or “over-the-counter.” No indication whether the parties have a due diligence requirement to verify if traded in some venue. Requested clarification. |
| **Acceptable Intent** | To serve an independent commercial, business or non-profit purpose. No indication of the meaning of “independent.” PDR at 48247. |
| **Unacceptable Intent** | Speculative, **hedging** or investment purpose. PDR at 48247 and 48249. No definition of “hedging” in this context, but requested clarification. |
| **Acceptable Contract Examples** | “Safe harbor” is expressly a non-exhaustive list that includes: (a) sales, servicing or distribution arrangements; (b) purchase, sale, lease or transfer of…equipment or inventory. PDR at 48247. Safe harbor also includes other commercial agreements, contracts and transaction with characteristics and terms identified above. PDR at 48247. |

# **Certain Physical Commercial Agreements, Contracts or Transactions for the Supply and Consumption of Energy**[[12]](#footnote-12)

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| **Key Definition** | Certain physical commercial agreements, contracts or transactions for the supply and consumption of energy that provide flexibility . . . may have option-like features. PDR 4824. |
| **Acceptable Parties** | No guidance provided. |
| **Acceptable Contract Provisions** | Regulatory safe harbor says a contract is not ***an option*** if:[[13]](#footnote-13)  1. The subject of the contract is usage of a specified facility or part thereof rather than the purchase or sale of the commodity that is to be created, transported, processed or stored using the specified facility;  2. The contract grants the buyer the exclusive use of the specified facility or part thereof during its term and provides for an unconditional obligation on the part of the seller to grant the buyer the exclusive use of the specified facility or part thereof; and  3. The payment for the use of the specified facility or part thereof represents a payment for its use rather than the option to use it. |
| **Unacceptable Contract Provisions** | Overselling transmission or transportation capacity of the power grid or gas pipelines would be per se inconsistent with the interpretation. FN 377 PDR at 48242  “However, if the right to use the specified facility is only obtained via the payment of a demand charge or reservation fee, and the exercise of the right (or use of the specified facility or part thereof) entails the further payment of actual storage fees, usage fees, rents or other analogous service charges not included in the demand charge or reservation fee, such contract is a commodity option subject to the swap definition.” PDR at 48242.[[14]](#footnote-14)  Notwithstanding the foregoing language in the PDR, the CFTC, OCG has said it, will not interpret two-tiered pricing to indicate a commodity option (“swap”) if the four additional steps listed below are met:  1. the right to use the specified portion of the facility for the term of the agreement, contract or transaction is legally established upon entering into the agreement, contract or transaction;  2. the party who has legally established the right to use the specified portion of the facility for the term of the agreement, contract or transaction pays the Demand Charge/Reservation Fee in a commercially reasonable timeframe’  3. the use of the facility does not depend on the further exercise of an option; and  4. the Usage Fee is in the nature of a reimbursement for the variable costs incurred by the operator of the facility in rendering the service. |
| **Acceptable Intent** | No guidance provided. |
| **Unacceptable Intent** | No guidance provided. |
| **Post-Contract Events that Affect Safe Harbor** | No guidance provided. |
| **Questioned Contract Examples** | Tolls on power plants, transportation agreements on gas pipelines, natural gas storage agreements. PDR at 48242. |

# **Trade Option Exemption for Commodity Options. Exemption is not from the Definition of “Swap,” but from Many of the Regulatory Requirements Applicable to Swaps.**[[15]](#footnote-15)

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| **Key Definition** | Pursuant to the trade option interim final rule, if the offeror, the offeree, and the option transaction meet the conditions of IFR 32.3 (below), such option transaction is a “swap,” but will be exempt from the general Dodd-Frank swaps regime and subject to specified ongoing conditions and compliance requirements discussed below, as applicable. See COR at 25326. |
| **Acceptable Parties** | Offeror must be either: (a) an eligible contract participant or (b) a producer, processor, or commercial user of, or a merchant handling the commodity that is the subject of the commodity option transaction, or the products or by-products thereof, and such offeror is offering or entering into the commodity option transaction solely for purposes related to its business as such. Offeror must have a reasonable basis to believe that the transaction is offered to any offeree that meets the requirements below. § 32.3(a)(1). See COR at 25338.  Offeree must be a producer, processor or commercial user of, or a merchant handling the commodity that is the subject of the commodity option transaction, or the products or by-products thereof, and such offeree is offered or entering into the commodity option transaction solely for purposes related to its business as such. § 32.3(a)(2). See COR at 25338. |
| **Acceptable Contract Provisions** | The commodity option must be intended to be physically settled, so that, if exercised, the option would result in the sale of an exempt or agricultural commodity for immediate or deferred shipment or delivery. § 32.3(a)(3). See COR at 25338.  Note that the interpretation in the PDR that an intangible commodity can be a nonfinancial commodity (which the PDR interpretation characterizes as an exempt or agricultural commodity –not an excluded commodity), is not expressly available for this Interim Final Rule.  Historically, the trade option exemption has not been available for intangible commodities. This may call into question whether capacity or ancillary services transactions or other similar intangible commodities, or transactions which have option-like characteristics, may be “swaps.” Clarification sought in the PDR comment letter. |
| **Unacceptable Contract Provisions** | See preceding row re acceptable contact provisions for comparison. |
| **Acceptable Intent** | A party must intend the commodity option to be physically settled. A party must enter into the commodity option transaction solely for purposes related to its business as such. See Commodity Option Release at 25338 |
| **Unacceptable Intent** | See preceding row re acceptable intent for comparison. |
| **Post-Contract Events that Affect Safe Harbor** | There are various recordkeeping and reporting requirements with respect to trade options. It is not clear how the CFTC will decide to address inadequate recordkeeping/reporting and whether such inadequate recordkeeping/reporting could affect the safe harbor. Commodity Option Release at 25327. |
| **Acceptable Contract Examples** | No examples provided. |

# **Spot transactions in physical commodities for immediate delivery are not “swaps” due to 1a(47)(A)(iii). Conveys current ownership interest in asset or liability–Consider PDR FN 236 re a physical exchange. Spot transactions usually settle (go to delivery) within a few days of the trade date. However, the CFTC acknowledges that under prevailing cash market practices, [spot] transactions in crude oil and sugar called for delivery in 30 and 75 days, respectively, while foreign currency spot transactions settle in 2 days. See FN 41, COR at 25326.**

# **Futures contracts or options on futures contracts are not “swaps” (CEA 1a(47)(B)(i).**

# **Note that commodity options, in general, are swaps under CEA 1a(47)(A). For example, options where the intention of the parties is to settle financially, or where one party or the other has an option to settle financially (or “cash settle”) rather than perform by physical settlement or delivery. The CFTC characterizes this as “optionality as to delivery” or “optionality targeting the delivery term.” Essentially, if delivery is optional and both parties would be indifferent as to whether the person delivering delivers cash or a futures contract rather than the nonfinancial commodity, such a “financial” commodity option is a “swap.” PDR at 48240.**

1. See, for example, footnote 14, which references a CFTC Office of General Counsel publication on November 14, 2012. [↑](#footnote-ref-1)
2. Not-For-Profit Electric Utilities Order 77 Fed. Reg. 50998 (August 23, 2012) (the “Electrics NFP Order”). Note that the Proposed NFP Electrics Order is to be finalized by the CFTC. In the interim period, a no-action letter has been issued based on the Application for a 4(c)(6) Exemption Order, not based on the Proposed Order. [↑](#footnote-ref-2)
3. RTO Exemption Order 77 Fed. Reg. 52138 (August 28, 2012) (the “Proposed RTO Order”). Note that the Proposed RTO Order is being finalized by the CFTC. In the interim, a no-action letter has been issued based on the Proposed Order, without the conditions precedent having been met. [↑](#footnote-ref-3)
4. Note that the statute provides an exclusion from the term “swap” for a “sale of a nonfinancial commodity…for deferred shipment or delivery, so long as the transaction is intended to be physically settled.” *See* Section 1a(47)(B)(ii) of the Commodity Exchange Act, enacted as Section 721(a)(21) of the Dodd-Frank Act.

   II.B.2(a) and (b) of Products Definition Release. [↑](#footnote-ref-4)
5. The PDR does not contain a definition of the term “book-out” but the implication is that, after the forward contract is executed, the parties agree in a subsequent, separately- negotiated agreement to cancel or extinguish or otherwise waive or forego physical delivery and receipt of the commodity. Note that in the energy industry, market participants in certain regions may use the term colloquially, or in tariffs or agreements, to mean something different. See WSPP Agreement. [↑](#footnote-ref-5)
6. The term “confirmation” is not defined in the PDR. However, in a rule published subsequent to the PDR (the final Adaption Rules, 77 Fed Reg. 66288 (November 2, 2012), a new definition of “confirmation” may raise additional issues if a “swap dealer” or “major swap participant” is a party to a non -financial commodity forward that is subject to a “book out.” [↑](#footnote-ref-6)
7. II.B.2(b)(ii) of Products Definition Release. [↑](#footnote-ref-7)
8. II.B.2(b)(ii) of Products Definition Release. Note: no definition of the term “embedded volumetric optionality.” This regulatory “safe harbor” is of limited value due to ambiguities pointed out in energy industry comments on PDR. [↑](#footnote-ref-8)
9. This is not identified in the CFTC’s PDR as a separate regulatory “safe harbor.” Rather, these contracts are discussed within the PDR’s interpretation on commodity options embedded in forward contracts. However, the interpretation in effect creates a regulatory interpretation “safe harbor”— that these types of contracts are not “swaps.” [↑](#footnote-ref-9)
10. II.B.3 of the Products Definition Release. [↑](#footnote-ref-10)
11. “Commercial” may mean“related to the business of a producer, processor, fabricator, refiner or merchandiser.” This definition is from the “safe harbor” for nonfinancial commodity forward contracts (see chart H). [↑](#footnote-ref-11)
12. II.B.2(b)(iii) of Products Definition Release. [↑](#footnote-ref-12)
13. Unclear why the interpretation is referencing an option as compared to a “swap,” except that the CFTC has interpreted all commodity options as “swaps.” [↑](#footnote-ref-13)
14. On November 14, 2012 the CFTC of General Counsel posted its response to FAQ’s on this regulatory safe harbor. This regulatory “safe harbor” is of limited value due to the ambiguities pointed out in energy industry documents on the PDR, and due to further ambiguities in the “clarifications” issued by the OCG. [↑](#footnote-ref-14)
15. Interim Final Rule, 77 Fed. Reg. 25320 (April 27, 2012). The definition of “swap” in CEA 1a(47)(A) expressly includes “commodity options.” The CFTC has not provided an interpretation that a nonfinancial commodity option (where the parties intend to physically settle) is excluded from the definition of “swap” under CEA 1a(47)(B)(ii). Request made for reconsideration of statutory construction. While the trade option exemption operates as a general exemption from the Dodd-Frank “swaps” regime, the exemption is still subject to certain compliance obligations, including recordkeeping under Part 45, reporting pursuant to Part 45 (or, alternatively, annual notice filing pursuant to Part 45), large trader reporting and position limits, SD/MSP conditions, and anti-fraud and anti-manipulation rules. § 32.3(b) – (d). Moreover it is unclear whether certain other provisions of either the CFTC’s regulations or other regulators’ rulemakings that incorporate by reference the CFTC’s definition of “swap,” would include or exclude trade options. On August 14, 2012 the CFTC issued a no-action letter in respect of trade options until December 31, 2012. [↑](#footnote-ref-15)