

CFTC OPEN MEETING TO CONSIDER THE RESIDUAL INTEREST DEADLINE, FORWARD CONTRACTS WITH EMBEDDED VOLUMETRIC OPTIONALITY, AND CFTC REGULATION 1.35

OVERVIEW

For questions on the note below, please contact Kwon Park or Kevin Batteh at (202) 547-3035. Please click the following for more information:

[Fact Sheet: Proposed Amendments to Rules Regarding Records of Commodity Interest and Related Cash or Forward Transactions](#)

[Questions and Answers: Rules Regarding Records of Commodity Interest and Related Cash or Forward Transactions](#)

[Fact Sheet: Forward Contracts with Embedded Volumetric Optionality](#)

[Chairman Tim Massad Opening Statement](#)

[Commissioner Mark Wetjen Opening Statement](#)

[Commissioner Sharon Bowen Opening Statement](#)

[Commissioner Chris Giancarlo Opening Statement](#)

Key Takeaways

- The Commission, by a unanimous vote of 4-0, approved the proposed rule on the residual interest deadline for FCMs. The proposed rule clarifies that the deadline for posting residual interest will not be moved earlier than 6PM without formal CFTC action.
- The Commission, by an unanimous vote of 4-0, approved the proposed interpretation for forward contracts with embedded volumetric optionality (EVO). The proposed interpretation will clarify when an agreement, contract, or transaction with EVO would be considered a forward contract by modifying the 4th, 5th and 7th elements of the 7-factor test under the current rule.
- The Commission approved by a vote of 3-1, with Commissioner Giancarlo dissenting, the proposed amendments to rules regarding records of commodity interest and related cash or forward contracts. The proposed amendments will codify previous no-action relief to certain market participants from recordkeeping requirements under CFTC Regulation 1.35.

Opening Statements

- **Chairman Massad** said the proposed change to CFTC Regulation 1.22 will help ensure funds deposited to FCMs remain safe. Additionally, the proposal will remove the automatic adjustments of the phased-in compliance schedule on December 21, 2018. He declared that staff will conduct a costs and benefits analysis to consider moving the residual interest deadline from 6PM to an earlier time in the day, and will review industry feedback before an amendment to the deadline is implemented. As for the written and oral recordkeeping requirements of CFTC Regulation 1.35, the proposed amendments will revise the rules to be consistent with previously issued no-action letters and the identifiable and searchable by transaction language of the rule will be interpreted to provide clarity to the industry. Finally, as for forward contracts with EVO the Commission will coordinate with the SEC in relieving uncertainty regarding the 7-factor test to provide market participants with clarity.
- **Commissioner Wetjen** stressed that commercial end users were not responsible for the financial crisis, and the three considerations today will try to address their concerns. He noted market participants concerns about the uncertainty on how to categorize contracts at the time of execution under the 7-factor test for forward contracts with EVO.
- **Commissioner Bowen** said that in these considerations, staff aims to provide relief to smaller end users while balancing the needs of enforcement. As for forward contracts with EVO, while she expressed sympathy to industry concerns, she raised concerns that the current proposal will cause too many contracts to be incorrectly included as forwards and hopes the Commission can revise this.
- **Commissioner Giancarlo** withheld his remarks for the question and answer sessions.

Residual Interest Deadline

Staff Presentation:

· **Thomas Smith, Division of Swap Dealer and Intermediary Oversight (DSIO):**

In the proposed rule, staff recommended removal of the December 31, 2018 automatic termination date for the phased-in compliance schedule for FCMs. He provided assurance that the residual interest deadline would only be revised through a separate rulemaking, which provides the Commission time to analyze a staff analysis on costs and benefits, review comments from industry participants, and evaluate all the issues through an open meeting.

Chairman Massad

· Q) Will the staff costs and benefits analysis address technological adjustments to what FCMs are or will be able to achieve in the future through technology advancements? A) Yes.

Commissioner Wetjen said he hopes technological innovation will help solve issues to receive and maintain collateral which will encourage FCMs to maintain proper risk management practices.

· Q) What sorts of impediments might make the T+1 at 9AM settlement residual interest deadline requirement difficult to pull off in the future? A) In discussions with FCMs and market participants, the ability to move funds may pose problems down the road. Many small entities do not want to hold sufficient margin with FCMs and cannot monitor the markets on a real time basis because of the nature of their own personal business. In order to meet the residual interest deadline, they have to be able to access liquidity from financial institutions and move money within the specified time.

· Q) Do you see issues with time zones for FCMS located all over the world? A) A margin call by a US based FCM to a party located in another country may face a delay in receiving margin and it may take more than 1-2 business days for funds to be netted.

Commissioner Giancarlo expressed concerns on the costs to farmers and ranchers in their ability to prefund margin accounts as the rule currently stands, but was supportive of the proposed rule changes. He said the Commission should take a deliberative approach to fix other rules that contain automatic adjustments such as the *de minimis* adjustment for the swap dealer registration threshold.

CFTC Regulation 1.35

Staff Presentation:

· Katherine Driscoll, DSIO:

Proposed amendment to CFTC Regulation 1.35 will provide that all required records must be searchable and clarify that all records be kept in a form and manner that allows for identification of a particular transaction, except records of oral and written communications leading to the execution of a transaction (pre-execution). The amendments will codify and expand current noaction relief. Specifically, [CFTC no-action letter 14-72](#), which exempts unregistered members of designated contract markets (DCMs) and swap execution facilities (SEFs) from the requirements to retain text messages and to maintain records in a particular form and manner, and [CFTC noaction letter 14-60](#), which excludes commodity trading advisors (CTAs) from oral recordkeeping requirements for all transactions, not just swaps transactions.

Commissioner Wetjen pointed out an ongoing problem with the consolidation of FCMs in the derivatives marketplace from the impact of increased regulation. He stated that there are fewer FCMs in the market than a few years ago because it is more expensive to profitably run an FCM, which as a result makes it more difficult for hedgers to access these markets.

Commissioner Giancarlo expressed disappointment and said the revised rule and carve out to oral recordkeeping requirements are unworkable, and that the proposal does not go far enough. He believes the proposal is still overly burdensome to covered entities, because of the ambiguity in the way “searchable and identifiable” is construed. Giancarlo indicated that FCMs are vital to functioning commodity markets and without healthy FCMs, everyday costs for commodities will rise for American consumers. He said the low interest rate environment and regulatory burdens have reduced the number of surviving FCMs to just half of what remained a few years ago. Finally, he stated that getting the rules clear and precise was critical. It is his view that the lack of clarity in the current rule will result in senseless costs, and CFTC regulations 1.35 and 1.31 should be reviewed as it applies in the actual marketplace.

Forward Contracts with Embedded Volumetric Optionality

Staff Presentation:

· Elise Pallais, Office of General Counsel:

The proposed interpretation will clarify when an agreement, contract, or transaction with EVO would be considered a forward contract. First, the interpretation will modify the 4th and 5th elements of the interpretation to clarify that it applies to EVO in the form of both puts and calls. Second, the 7th element will be modified to clarify that the EVO must be primarily intended, at the time of agreement, to address physical factors or regulatory requirements that reasonably influence demand for, or supply of, the nonfinancial commodity. In addition, the phrase “physical factors” is interpreted to include any fact or circumstance that could reasonable influence the parties’ supply or demand for the nonfinancial commodity under the contract, including environmental factors, operational considerations, and social forces. Finally, electric demand response agreements may be properly characterized as the product of a regulatory requirement within the 7th element. The CFTC will work jointly with the SEC in adopting this proposed interpretation.

Commissioner Giancarlo said the CFTC Guidance under the 7-factor test has been burdensome, unnecessary and duplicative. He suggested that forwards with EVO should not be included as swaps

because it will increase the costs for companies, curtail market activity, and consolidate risk into the market, eventually passing costs onto consumers. He was optimistic about the short term relief provided, but said he would prefer to see a change to the product definition.

Commissioner Bowen

· Q) Would the proposal's text exclude these instruments from our jurisdiction? A) In the proposed interpretation, to the degree these contracts are not included as forwards, they could be included as options within the Commission's definition.