



CFTC Final Interpretation on Forward Contracts with EVO

Overview

For questions please contact [Kevin Batteh](#) or [Kwon Park](#) at (202) 547-3035.

On May 12, the CFTC released its final interpretation on forward contracts with embedded volumetric optionality (EVO). The interpretation identifies when an agreement, contract, or transaction (ACT) would fall within the forward contract exclusions from the “swap” and “future delivery” definitions in the Commodity Exchange Act (CEA), notwithstanding that it allows for variations in the delivery amount. Although the interpretation was issued jointly with the SEC, it applies solely to the CFTC and does not apply to the exclusion from the swap and security-based swap definition for security forwards or to the distinction between security forwards and security futures products.

Please see below for additional information:

[Final Interpretation on Forward Contracts with Embedded Volumetric Optionality](#)

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

[Chairman Massad Statement of Support](#)

[Commissioner Bowen Concurring Statement](#)

Key Takeaways

- The Commission approved the final interpretation unanimously via seriatim.
- The final interpretation is substantially similar to the [November 2014 interpretation](#).
- The final interpretation clarifies the fourth, fifth, and seventh elements in response to [commenters concerns](#) regarding the seven element test for forward contracts with EVO.
- The final interpretation is open for [comment](#), which concludes **June 8, 2015**.

Summary

Seven Element Test for Forward Contracts with EVO

An ACT falls within the forward exclusion from the swap and future delivery definitions, notwithstanding that it contains EVO, when:

1. The embedded optionality (EO) does not undermine the overall nature of the ACT as a forward contract;
2. The predominant feature of the ACT is actual delivery;
3. The EO cannot be severed and marketed separately from the overall ACT in which it is embedded;
4. The seller of a nonfinancial commodity (NC) underlying the ACT with EVO intends, at the time it enters into the ACT to deliver the underlying NC if the EVO is exercised;
5. The buyer of a NC underlying the ACT with EO intends, at the time it enters into the ACT, to take delivery of the underlying NC if the EVO is exercised;
6. Both parties are commercial parties; and
7. The EVO is primarily intended, at the time the parties enter in to the ACT, to address physical factors or regulatory requirements that reasonably influence demand for, or supply of, the NC.

Final Interpretation on Forward Contracts with EVO

The First and Second Elements

Historic Interpretation

- Affirms that forward contracts with EVO should not be read to alter or expand the historic interpretation of the forward contract exclusion.
- Presupposes the existence of an underlying forward contract, as determined by applying the historic interpretation of the forward contract exclusion.

Circumstances

- Merely identifies the circumstances EVO in a forward contract would not operate to take the contract outside the forward contract exclusion.

The Fourth and Fifth Elements

Puts and Calls

- Clarifies that the interpretation applies to EVO in the form of both puts and calls.

Bandwidth Contracts

- Does not preclude bandwidth (swing) contracts, which provide for delivery of a NC within a certain minimum and maximum range from falling within the forward contract exclusion from the swap and future delivery definitions.

Intent

- Merely requires that the intent to make or take delivery required of the underlying forward contract extends to the EVO, so that both parties to the contract intend to make or take delivery of the NC under the contract if the EVO is exercised.

Quantity Delivered

- The EVO may operate to increase and/or decrease the quantity delivered under the underlying forward contract and still not take the contract out of the forward exclusion, provided that all elements of the CFTC's interpretation are satisfied.

The Seventh Element

Intent

- Clarifies that EVO must primarily be intended as a means of assuring a supply source or providing delivery flexibility in the face of uncertainty regarding the quantity of the NC that may be needed or produced in the future, consistent with the purposes of a forward contract.
- The focus is the intent of the party with the right to exercise the EVO at the time of contract initiation –intent may be ascertained by the relevant facts and circumstances surrounding the contract, including the parties' course of performance.

Counterparty Representations

- Commercial parties may rely on counterparty representations with respect to the intended purpose for EVO in the contract, provided they do not have information that would cause a reasonable person to question accuracy of the representation.
- Commercial parties may choose to rely on their good faith characterization of an existing contract.

Due Diligence

- Commercial parties are not required to conduct any due diligence in order to rely on counterparty representations.

Physical Factors

- "Physical factors" should be construed broadly to include any fact or circumstance that could reasonably influence supply of or demand for the NC under the contract. Facts could include environmental factors such as weather or location, as well as relevant "operational considerations and broader social forces such as changes in demographics or geopolitics.

Regulatory Requirement

- If the EVO is primarily intended at contract initiation to address concerns about price risk, the seventh element would not be satisfied absent an applicable regulatory requirement to obtain or provide the lowest price.

- Electric demand response agreements may be properly characterized as the product of a regulatory requirement.

Please let us know if you have any questions.