

INSIGHTS

Beginning October 12th All Book-Outs Must Be Confirmed To Avoid CFTC Regulation

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The Commodity Futures Trading Commission (CFTC) rule defining the term "Swap" (Products Rule) becomes effective October 12, 2012.¹ In the Products Rule, the CFTC exempted forward contracts (physically delivered contracts which are not commodity options) from inclusion as Swaps in CFTC regulation. As a component of its ruling, the CFTC determined that a forward contract that was financially settled rather than physically delivered, as a result of a subsequent agreement (booked-out), would still be considered a forward contract and not a Swap.

The CFTC determined that it would apply its "Brent Interpretation" to establish requirements for proper book-outs. According to the CFTC "what is relevant is that the book-out occur through a subsequent, separately negotiated agreement . . . [with] such agreement . . . followed in a commercially reasonable timeframe by a confirmation in some type of written or electronic form."²

In addition, the CFTC held that for a book-out to be proper under these standards: (1) the parties must be commercial market participants that regularly make or take delivery of the referenced commodity in the ordinary course of their business; (2) there is "intent to make or take delivery," which can be inferred from the binding delivery obligation of the original deal for the commodity; and (3) the parties do, in fact, regularly make or take delivery of the referenced commodity in the ordinary course of their business.

The CFTC included both "daisy chain" book-outs and transaction netting (a provision contemplating the reduction to a net delivery amount of future, unintentionally offsetting delivery obligations) as acceptable book-outs.

Therefore, beginning October 12, 2012, parties to forward agreements that are booked-out must document the subsequent agreement which amended the forward contract requiring delivery by way of the written or electronic confirmation within a commercially reasonable timeframe after such agreement.

While there is much ambiguity with respect to the manner and scope of such confirmation, it is clear that such a confirmation is required. The following language has been developed by the Edison Electric Institute Contract Drafting Committee for potential use:

Party A and Party B are parties to the following Transaction requiring the delivery of [the Product]:

List (or attach list of) Transaction

In the course of scheduling the delivery of the Product service, or for other commercial reasons, the Parties determined, in an agreement made subsequent to the execution of the Transaction, that, rather than deliver and receive the Product, the Transaction is booked-out.

The Parties hereby document their agreement to book-out the Transaction.

We expect an industry convention for book-out confirmations to ultimately evolve. While the above quoted language appears to be compliant with CFTC requirements, there may be additional ways in which the requirements can be met. However, whatever the approach used, market participants must utilize written or electronic book-out confirmations beginning October 12, 2012 to avoid inadvertently turning previously physical forward contracts into Swaps.

¹ *Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement," Mixed Swaps; Security-Based Swap Agreement Recordkeeping*, 77 Fed. Reg. 48208 (August 13, 2012).

² *Id.* at 48230.