Financial Services Advisory

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CFTC, SEC Finalize Swap Product Definitions

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I. Introduction

On July 9 and 10, 2012, the Commodity Futures Trading Commission and Securities and Exchange Commission (collectively, the "Commissions") approved joint final rules and interpretations regarding the definition and regulation of swaps, security-based swaps, mixed swaps and security-based swap agreements (the "Swap Definitions"). The Swap Definitions were adopted pursuant to Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act" or "DFA"), which mandated the CFTC and SEC to "further define" and refine the definitions in the DFA relating to swaps and security-based swaps (collectively, "Title VII instruments"). Under this framework, the SEC has regulatory authority over security-based swaps, the CFTC has regulatory authority over swaps, the agencies will jointly regulate mixed swaps, and the SEC will continue to have antifraud authority over certain CFTC-regulated instruments, including security-based swap agreements.

The Swap Definitions were published in the *Federal Register* on August 13, 2012,[1] and will become effective on October 12, 2012. The occurrence of the effective date for the Swap Definitions will trigger effective and compliance dates for many other rules promulgated by the Dodd-Frank Act, including the rule requiring registration with the CFTC for anyone who falls within the definition of Swap Dealer or Major Swap Participant (as defined in the DFA and related CFTC regulations).

II. Executive Summary

The Swap Definitions are extremely long and detailed and provide guidance on classifying particular agreements, contracts and transactions as swaps, security-based swaps or mixed swaps, which in turn determines the relevant agency or agencies, rules and regulations to which a particular instrument will be subject. The guidance includes both formal rules and interpretations based on existing law and precedent. Appendix 1 provides a non-exhaustive list of many of the different types of derivatives transactions discussed in the Swap Definitions and classifies them as either swaps or security-based swaps, citing to the relevant rules or interpretations behind such classification. The Swap Definitions also provide clarification that 1) security-based swap agreements are not subject to additional books and records requirements beyond those required by the CFTC for swap agreements, and 2) transactions that are deemed to have been structured to evade the registration requirements of Title VII will be treated as swaps nonetheless.

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).

III. Swaps

The Commissions adopted both final rules and interpretations in the Swap Definitions defining certain types of transactions as swaps.

The rules define the following transactions as swaps:

- Foreign exchange forwards and foreign exchange swaps (unless exempted by the Secretary of the Treasury)
- Foreign currency options
- Non-deliverable forwards in foreign exchange
- Currency swaps and cross-currency swaps
- Forward rate agreements

The interpretations provide that the following instruments are swaps:

- Title VII instruments based on interest rates and monetary rates, including interbank offered rates, money market rates, government target rates, general lending rates and rates from indexes, among others
- Title VII instruments based on rates or yields of US Treasury and other exempted securities (other than municipal securities)
- Title VII instruments based on broad-based security indexes
- Guarantees of swaps, to the extent that a counterparty to a swap position would have recourse to the guarantor in connection with the position
- Broad-based index credit default swaps that require cash settlement or auction settlement

Although not expressly mentioned in the Swap Definitions, commodity swaps and commodity options are swaps. Commodity swaps and options on such products are expressly included in the definition of a swap pursuant to Title VII. In addition, the CFTC's rule regarding commodity options states that all commodity options are to be treated as a swap for purposes of Title VII.[2]

The CFTC announced that it would address the practical implications of treating guarantees of swaps as swaps for regulatory purpose in a separate release and that market participants would not have to comply with this interpretation until the effective date of that other future release.

IV. Security-Based Swaps

The interpretations provide that the following instruments are considered security-based swaps:

- Title VII instruments based on yields, where "yield" is a proxy for the price or value of a debt security, loan or narrow-based security index, subject to certain exceptions for government debt obligations
- Total return swaps on a single security, loan or narrow-based security index
- Title VII instruments based on narrow-based security indexes, where "narrow-based security index" is defined by the criteria set forth in Section 1a(35) of the Commodity Exchange Act (the "CEA"), and the rules and regulations issued by the Commissions relating to the definition

The SEC will not regard the guarantee of a security-based swap as either part of the security-based swap or as a separate security-based swap. Rather, the SEC will consider requiring that the reporting of security-based swaps include the reporting of information about the guarantors of obligations under the security-based swap. The SEC also notes that because a security-based swap is a security, and that the guarantee of any security is also a security, the guarantee of a security-based swap is a security subject to federal securities laws and regulations.

2 "Commodity Options," 77 Fed. Reg. 25320 (April 27, 2012).

V. Mixed Swaps

Mixed swaps are swaps that fall under the definitions of both swaps and security-based swaps, governed by both the SEC and the CFTC. The scope of the mixed swap definition is intended to be narrow, designed to prevent gaps in the regulation of security-based swaps and swaps.

The Commissions adopted two rules with respect to the regulation of mixed swaps. First, bilateral uncleared mixed swaps will be regulated by the CEA, related CFTC rules, the Securities Exchange Act of 1934 (the “Exchange Act”) and related federal securities rules and regulations. Second, for all other mixed swaps, the rules establish a process by which parties to mixed swaps may request that the swap comply, as to parallel provisions, with either the CEA or the Exchange Act.

Examples of mixed swaps provided by the Commissions include the following:

- Total return swaps with either embedded interest rate optionality or a non-securities component
- A portfolio of securities and commodities
- Broad-based index credit default swaps requiring mandatory physical settlement

VI. Security-Based Swap Agreements

The Commissions define a security-based swap agreement (as opposed to a security-based swap) as a swap (such as a total return swap on a broad-based security index) that is regulated by the CFTC but which involves securities. (The CFTC confusingly refers to such swaps as “equity swaps.”) The CFTC has regulatory and enforcement authority over security-based swap agreements, but the SEC has antifraud, anti-manipulation and other authority. The interpretations provide that instruments such as swaps based on a broad-based security index and index credit default swaps based on a broad-based security index are security-based swap agreements. Despite the SEC’s regulatory and enforcement authority, the Swap Definitions clarify that security-based swap agreements are not required to comply with additional books and records requirements other than those adopted by the CFTC for swaps.

VII. Transactions That Are Not Swaps or Security-Based Swaps

One of the concerns voiced by commenters about the breadth of the definition of a swap in the DFA is that there are many products that might be inadvertently swept up into the new regulatory regime. A large portion of the Swap Definitions consequently deals with excluding transactions such as insurance products, consumer and commercial transactions, and forward contracts for nonfinancial commodities from the scope of the definitions.

Insurance

Insurance contracts are not considered swaps or security-based swaps if the contracts satisfy both a “Product Test” and “Provider Test.”

The “Product Test” requires that:

- The beneficiary have an insurable interest that is the subject of the contract;
- The loss occurs and is proven;
- The payment is limited to the value of the insurable interest; and
- The contract is not traded.

The “Provider Test” requires that the insurance contract must be provided by:

- A person subject to supervision by the insurance commissioner of any state or by the United States;
- The United States or any state or respective agency;
- In the case of reinsurance, a person providing the agreement, contract or transaction to another person who satisfies the conditions of the provider test, subject to certain limitations; or
- In the case of non-admitted insurance, a person located outside of the United States, subject to additional requirements.

The Swap Definitions provide a safe harbor for certain enumerated types of traditional insurance products. These enumerated products will not be considered swaps or security-based swaps provided they satisfy the Provider Test and are any of the following products:

- A surety or fidelity bond;
- Life, health, long-term care, title, disability or property and casual insurance;
- An annuity;
- Insurance against default on individual residential mortgages; or
- Reinsurance of any of the above products.

The Commissions provide that a product that does not fall into the preceding categories is not necessarily a swap or security-based swap. In such a situation, the Commissions require a further analysis to determine whether the product is an insurance product, a swap or a security-based swap.

The Swap Definitions additionally contain a grandfathering provision such that existing insurance products entered into prior to the effective date of the rules will not be considered swaps or security-based swaps.

Commercial and Consumer Transactions

Transactions entered into by consumers for primarily personal, family or household purposes will not be considered swaps or security-based swaps. Commercial agreements, contracts or transactions that involve customary business are also not considered swaps or security-based swaps.

The interpretations provide the following examples of commercial transactions that are not considered swaps or security-based swaps:

- Commercial loans by the Federal Home Loan Banks
- Commercial loans by Farm Credit institutions

The interpretations provide the following examples of consumer transactions that are not considered swaps or security-based swaps:

- Certain residential fuel storage contracts
- Service contracts
- Consumer options to buy, sell or lease real or personal property
- Certain consumer guarantees of loans, i.e., credit cards, automobile and mortgage
- Consumer transactions used to purchase nonfinancial energy commodities

Forward Contracts

Forward contracts in nonfinancial commodities[3] that intend for the physical delivery of the underlying commodity are not considered swaps[4] or security-based swaps. The CFTC continues to view such contracts as commercial merchandising transactions, the primary purpose of which is to transfer ownership of the underlying commodity and not to solely transfer price risk. The CFTC is also withdrawing its 1993 Energy Exemption. The definitions of swap and security-based swap exclude sales of nonfinancial securities or commodities for deferred shipment or delivery, as long as the transaction is intended to be physically settled. Security forward contracts are expressly excluded from the definition of a swap and are, in fact, securities, subject to regulation under the federal securities laws.

3 The CFTC interprets a nonfinancial commodity as a commodity that can be physically delivered and that is an exempt or agricultural commodity. In addition, intangible commodities that are not an excluded commodity and which can be physically delivered, such as emission allowances, also qualify as nonfinancial commodities.

4 The CFTC has stated that the forward exclusion for nonfinancial commodities in the swap definition and in any book-out transactions will be interpreted in a manner consistent with the CFTC's historical interpretations of the existing forward exclusion with respect to futures contracts.

VIII. Determination of Swap Classification

The Swap Definitions provide that the classification of a Title VII product must be determined prior to its execution, but that the product will retain its initial characterization throughout its life and will be regulated by the same agency and requirements until its expiration. This rule applies even if an instrument is based upon an index that migrates from narrow to broad or vice versa.

With respect to such instruments based on indexes that migrate from narrow to broad or vice versa, the rules provide the following example:

> "...if two counterparties enter into a swap based on a broad-based security index, and three months into the life of the swap the security index underlying that Title VII instrument migrates from being broad-based to being narrow-based, the Title VII instrument will remain a swap for the duration of its life and will not be recharacterized as a security-based swap."[5]

The Swap Definitions create a process by which any person may request that the Commissions issue a joint interpretation as to whether a contract, agreement or transaction is a swap, security-based swap or mixed swap. The concept of a joint interpretation is useful, but the process by which to obtain such an interpretation has not been executed in a market-sensitive or market-friendly way. The Commissions have discretion over which requests for interpretations they evaluate and, even if they decide to grant a request for interpretation of an instrument, they have 120 days to reach a decision.

IX. Anti-Evasion

The CFTC adopted rules that define transactions structured to willfully evade the provisions of Title VII as swaps. It is also unlawful to conduct activities outside of the United States in an effort to evade Title VII requirements.

X. Distinguishing Futures from Swaps

The Swap Definitions do not propose rules or interpretations to distinguish futures from swaps. The CFTC affirmatively declined to provide a clarification or adopt a rule to distinguish between the two economically similar products. A designated contact market may self-certify its contracts to be futures subject to the CFTC's oversight authority, request prior approval from the CFTC, request an interpretation from the CFTC or request a rulemaking by the CFTC.

[5] See "Swap Definitions," page 48286.

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Appendix 1: Product Classifications from the Swap Definitions

Instrument	Classification	Rule/Interpretation
Foreign exchange forwards and foreign exchange swaps	Swap, unless exempted by the Secretary of the Treasury	CFTC Rule § 1.3 (xxx)(2)(3); SEC Rule § 240.3a69-2 (b) and (c)
Currency options	Swap	CFTC Rule § 1.3 (xxx)(2); SEC Rule § 240.3a69-2 (b)
Foreign currency options	Swap	CFTC Rule § 1.3 (xxx)(2); SEC Rule § 240.3a69-2 (b)
Foreign exchange options	Swap	CFTC Rule § 1.3 (xxx)(2); SEC Rule § 240.3a69-2 (b)
Foreign exchange rate options	Swap	CFTC Rule § 1.3 (xxx)(2); SEC Rule § 240.3a69-2 (b)
Currency swaps and cross-currency swaps	Swap	CFTC Rule § 1.3 (xxx)(2); SEC Rule § 240.3a69-2 (b)
Forward rate agreements	Swap	CFTC Rule § 1.3 (xxx)(2); SEC Rule § 240.3a69-2 (b)
Non-deliverable forwards in foreign exchange	Swap	CFTC Rule § 1.3 (xxx)(2); SEC Rule § 240.3a69-2 (b)
Title VII instruments based on or referencing qualifying foreign futures contracts on the debt securities of the US government or of any one or more of the 21 foreign governments enumerated in rule 3a12-8 under the Securities Exchange Act of 1934, subject to certain conditions	Swap	CFTC Rule § 1.3 (bbbb); SEC Rule § 240.3a68-5
Permutations of, or options on, swaps	Swap	Interpretation II (C)(4)
Permutations of, or options on, security-based swaps	Security-based swap	Interpretation II (C)(4)
Contracts for differences	Swap or security-based swap, depending on the underlying product of that particular CFD transaction	Interpretation II (C)(5)
Title VII instruments based on interest rates and monetary rates, including interbank offered rates, money market rates, government target rates, general lending rates and indexes, among others	Swap	Interpretation III (B)(1)
Title VII instruments based on rates or yields of US Treasury and other exempted securities (other than municipal securities)	Swap	Interpretation III (B)(2)
Title VII instruments based on broad-based security indexes	Swap	Interpretation III (G)(4)
Guarantees of swaps, to the extent that a counterparty to a swap position would have recourse to the guarantor in connection with the position	Swap	Interpretation II (B)(1)(g)
Guarantees of security-based swaps	Security	Interpretation II (B)(1)(g)
Broad-based index credit default swaps that require cash settlement or auction settlement	Swap	Interpretation III (H)
Title VII instruments on futures that are not security futures	Swap	Interpretation III (E)
Title VII instruments on security futures[1]	Security-based swap	Interpretation III (E)

[1] Security futures are defined in both the CEA and the Exchange Act as a futures contract on a single security or a narrow-based security index, except an exempted security under Section 3(a)(12) of the Exchange Act.

Instrument	Classification	Rule/Interpretation
Title VII instruments based on yields, where "yield" is a proxy for the price or value of a debt security, loan or narrow-based security index, subject to certain exceptions for government debt obligations	Security-based swap	Interpretation III (B)(2)
Total return swaps on a single security, loan or narrow-based security index	Security-based swap	Interpretation III (C)
Title VII instruments based on narrow-based security indexes	Security-based swap	Interpretation III (G)
Quanto equity swaps	Security-based swap, subject to certain requirements	Interpretation III (C)
Total return swaps into which counterparties embed interest rate optionality or a non-securities component	Mixed swap	Interpretation III (C)
Broad-based index credit default swaps that require mandatory physical settlement	Mixed swap	Interpretation III (H)
Commodity swaps and commodity options		Title VII and the Commodity Option Release
Insurance products	Exempt, subject to certain requirements	CFTC Rule § 1.3 (xxx)(4); SEC Rule § 240.3a69-1
Forward contracts on nonfinancial commodities	Exempt, subject to certain requirements	Interpretation II (B)(2)
Consumer/commercial transactions	Exempt, subject to certain requirements	Interpretation II (B)(3)
Loan participations	Exempt, subject to certain requirements	Interpretations II (B)(3)

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