

## CFTC and SEC Finally Issue Product Definitions

July 11, 2012

Yesterday, the Commodity Futures Trading Commission (CFTC) approved final rules and interpretative guidance (Final Rules) to (1) further define the terms “swap,” “security-based swap” and “security-based swap agreement,” (2) prescribe regulations regarding “mixed swaps” and (3) establish books and records requirements for “security-based swap agreements.” The Final Rules are a joint rulemaking with the Securities and Exchange Commission (SEC) and were approved by the SEC on July 6 by seriatim (*i.e.*, without an open meeting).<sup>1</sup>

Market participants have been generally aware of the types of instruments that fall within the “swap” and “security-based swap” definitions due to the detailed definitions of those terms in the Dodd-Frank Act. The Final Rules serve to clarify the scope of the “swap” and “security-based swap” definitions with respect to, among other things, insurance, consumer and commercial transactions, and foreign exchange (FX) swaps and forwards. The Final Rules also provide guidance with respect to the forward exclusion from the swap definition for non-financial commodities and clarify the relationship between swaps and security-based swaps.

The Final Rules are a key component of the new regulatory regime imposed on the over-the-counter derivatives market by the Dodd-Frank Act. The effective date of the Final Rules, which will be 60 days after the publication of the Final Rules in the Federal Register, will trigger the effective dates of a number of final CFTC rules. As a result, market participants should anticipate having to comply with some of the new Dodd-Frank Act regulatory requirements as early as this fall.

The following discussion is based on a CFTC staff [fact sheet](#), [Q&A](#) and statements made by CFTC Commissioners and staff during an open meeting held yesterday. An archived webcast of yesterday's meeting and copies of CFTC Commissioners' statements are available on the CFTC's [website](#).

### Insurance

The Final Rules provide a safe harbor from characterization as swaps or security-based swaps for transactions that meet a “product” test and a “provider” test or that fall within a list of enumerated products and meet the “provider” test. The safe harbor is meant to ensure that traditional insurance products provided by regulated insurance providers are not swaps or security-based swaps. Failure to meet the safe harbor's requirements does not lead to a presumption that a transaction is a swap, however. Rather, in such a circumstance, a facts and circumstances determination must be made, which may lead to a conclusion that the transaction in question is not a swap or a security-based swap.

The Final Rules also contain a grandfather provision for transactions that (1) are entered into prior to the effective date of the Final Rules and (2) meet the safe harbor's “provider” test at the time they are entered into.

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<sup>1</sup> Pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), the CFTC has regulatory authority over swaps, the SEC has regulatory authority over security-based swaps, and both have regulatory authority over security-based swap agreements and mixed swaps.

## Consumer and Commercial Transactions

The Final Rules clarify that certain transactions entered into by consumers as principals and commercial transactions involving customary business arrangements, neither of which have historically been characterized as swaps, are not swaps. Such transactions include, among others, agreements or options to acquire, lease or sell real property; agreements that provide for an interest rate cap or lock on a consumer loan or mortgage; and agreements containing escalation clauses linked to an underlying commodity (e.g., an interest rate or consumer price index).

## FX Swaps and Forwards

The Final Rules stipulate that FX swaps and forwards are swaps. However, because the U.S. Treasury Secretary has discretion to exempt FX swaps and forwards from certain Dodd-Frank Act requirements (and has proposed to do so), the Final Rules also identify the requirements that would remain applicable to FX swaps and forwards if the Treasury Secretary were to exempt such transactions from regulation.<sup>2</sup> Moreover, the Final Rules indicate that, among others, foreign currency options, non-deliverable FX forwards, currency swaps, cross-currency swaps and forward rate agreements fall outside the scope of the Treasury Secretary's exemptive authority and are swaps subject to regulation.

## The Forward Exclusion

The Final Rules provide guidance with respect to the application of the statutory exclusion from the swap definition of non-financial commodity forward contracts (*i.e.*, agricultural and exempt commodities that can be physically delivered) that are intended to be physically settled (the forward exclusion). Specifically, the Final Rules adopt a seven-part test for determining the applicability of the forward exclusion that (1) places an emphasis on the physical delivery aspect of the forward exclusion and (2) is intended to mirror the CFTC's traditional interpretation of the forward exclusion with respect to futures. In order for the forward exclusion to apply to a particular transaction, such transaction must meet all seven parts of the test.

The Final Rules also (1) provide guidance with respect to options embedded in forward contracts that are based on the quantity of the underlying commodity (*i.e.*, volumetric optionality) – such transactions may qualify for the forward exclusion so long as the optionality is the result of physical factors or regulatory requirements outside of the control of the parties to the transaction and (2) provide that the principles underlying the CFTC's "Brent Interpretation" regarding "book-out" transactions, that apply to the forward exclusion from the definition of "future delivery" would also apply to the forward exclusion for swaps. The CFTC will accept public comments in response to this guidance and the seven-part test.

## Swaps and Security-Based Swaps

The Final Rules retain principles from the proposed version of the Final Rules about how transactions that are subject to Title VII are to be classified as swaps, security-based swaps or mixed swaps.<sup>3</sup> The Final

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<sup>2</sup> For more information, please see Sutherland's Legal Alert, "[U.S. Treasury Secretary Proposes to Exempt FX Swaps and FX Forwards from Dodd-Frank's 'Swap' Definition](#)." At yesterday's meeting, CFTC staff stated that, in light of the fact that the Final Rules have been adopted, the Treasury Secretary will likely issue a final determination in the near future.

<sup>3</sup> See [Further Definition of "Swap," "Security-Based Swap," and "Security-Based Swap Agreement"; Mixed Swaps; Security-Based Swap Agreement Recordkeeping](#), 76 Fed. Reg. 29,818 (May 23, 2011) (to be codified at 17 C.F.R. pts. 1 and 240).

Rules address the treatment of, among other things, total return swaps and index-based credit default swaps.<sup>4</sup> Also, according to the CFTC staff, there are no substantive differences between the Final Rules and the proposed version of the Final Rules with respect to the treatment of mixed swaps and security-based swap agreements.

**The Implications of the Final Rules**

The adoption of the Final Rules is significant because the effective date of a number of the CFTC final rules to implement Title VII of the Dodd-Frank Act’s requirements for over-the-counter derivatives will be triggered upon the effective date of the Final Rules. Among others, these regulations include the swap dealer and major swap participant registration rules, the external and internal business conduct standards for swap dealers and major swap participants rules, recordkeeping and reporting rules, and position limits rules.<sup>5</sup> The Final Rules will become effective 60 days after their publication in the Federal Register, which is expected to occur in the coming weeks. Accordingly, market participants may wish to begin preparing to comply with some of these new rules, because compliance will likely be required this fall.



*If you have any questions about this Legal Alert, please feel free to contact any of the attorneys listed below or the Sutherland attorney with whom you regularly work.*

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<sup>4</sup> Credit default swaps that are based on a broad index are deemed “swaps” subject to the CFTC’s regulatory authority, and credit default swaps that are based on a narrow index or a single security are deemed “security-based swaps” subject to the SEC’s regulatory authority.

<sup>5</sup> A list of compliance dates for all of the final rules that the CFTC has issued to date to implement the Dodd-Frank Act is available on the CFTC’s [website](#).