CFTC AND SEC ADOPT DEFINITION OF "SWAP" AND "SECURITY-BASED SWAP"

The Commodity Futures Trading Commission and the Securities and Exchange Commission have issued joint final rules and interpretations[1] that, among other things, further define "swap" under the Commodity Exchange Act and "security-based swap" under the Securities Exchange Act of 1934.[2] These product definitions become effective on October 12, 2012. This memorandum highlights a few of the rules and guidance points raised in the final rules.

Transactions that Are Not Swaps or Security-Based Swaps

The CFTC and the SEC (the "Commissions") clarified in the Release that certain products and transactions that traditionally have not been considered swaps, such as insurance products that meet certain conditions, certain consumer and commercial agreements and certain loan participations, are not, in fact, swaps.

The Insurance Safe Harbor

The broad definition of swap set forth in Title VII of the Dodd-Frank Act includes any agreement, contract or transaction (the "Subject Agreement") that provides for payment "dependent on the occurrence, nonoccurrence, or the extent of the occurrence of an event or contingency associated with a potential financial, economic or commercial consequence." Noting that the statutory definition of swap could be read to include certain types of agreements and transactions that have not previously been considered swaps, the Commissions clarified in the Release that (i) nothing in Title VII suggests that Congress intended for traditional insurance products to be regulated as swaps or security-based swaps and (ii) the Commissions themselves do not interpret this clause to mean that traditional insurance products should be included within the swap or security-based swap definitions.[3]

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1 Further Definition of "Swap," "Security-Based Swap", and "Security-Based Swap Agreement"; Mixed Swaps; Security-Based Swap Agreement Recordkeeping, 77 Fed. Reg. 48207 (August 13, 2012) (to be codified at 17 C.F.R. pt. 1, 230, 240 and 241) (the "Release"). Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Title VII") directs the CFTC and the SEC to define these terms. Pub. L. No. 111-203, 124 Stat. 1376 (2010).

2 The Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") defined, among others, the terms "swap" and "security-based swap."

3 The Commissions note various sections of the Dodd-Frank Act that address the status of insurance more extensively than Title VII and note that swaps and insurance are subject to different regulatory regimes as reflected in section 722(b) of the Dodd-Frank Act and new section 12(h) of the CEA, which provides that a swap "shall not be considered to be insurance" and "may not be regulated as an insurance contract under the law of any State."

Accordingly, in the final rules adopted by the Commissions (the "Final Rules"), the Commissions clarified the status of certain insurance products as outside the definition of swap and security-based swap by establishing a three-part safe harbor in the Final Rules (the "Insurance Safe Harbor") and a grandfather provision. The Insurance Safe Harbor requires that the Subject Agreement either (i) be one of the insurance products enumerated in the Final Rules[4] (the "Enumerated Products") or (ii) meet certain conditions, including the requirement that the beneficiary of the insurance contract have an insurable interest that is the subject of the transaction and thereby carries the risk of loss with respect to that interest continuously throughout the transaction (the "Product Test"). In addition, the Subject Agreement must be provided by a person that is subject to the supervision of the insurance commissioner of any state or by the United States (the "Provider Test").[5] Significantly, the Provider Test incorporates a requirement that the Subject Agreement be regulated as insurance under applicable state or federal law, thus incorporating a regulated insurance product within the Provider Test. The Final Rules also include a grandfather provision that excludes from the swap and security-based swap definitions a Subject Agreement entered into on or prior to the effective date of the Final Rules, provided that at the time it was entered into, the Subject Agreement was provided by a person meeting the Provider Test.

The Final Rules also address reinsurance and retrocessions within the Provider Test and the Enumerated Product test.

The Commissions further confirmed that the Insurance Safe Harbor is nonexclusive and that transactions falling outside the Insurance Safe Harbor are not presumed to constitute a swap or security-based swap. Subject Agreements that do not satisfy the Insurance Safe Harbor will require further analysis of the applicable facts and circumstances to determine whether they are insurance and thus not swaps or security-based swaps. The Release establishes a process for submission of a request to the Commissions to provide a joint interpretation of whether a particular agreement, contract or transaction (or class thereof) is a swap or security-based swap.

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[4] Such enumerated insurance products include the following types of products: (i) surety bond; (ii) fidelity bond; (iii) life insurance; (iv) health insurance; (v) long-term care insurance; (vi) title insurance; (vii) property and casualty insurance; (viii) annuity; (ix) disability insurance; (x) insurance against default on individual residential mortgages; and (xi) reinsurance of any of the foregoing products.

[5] In addition, the United States or any state or any of their respective agencies that issue a contract meeting the Product Test pursuant to a statutorily authorized program would satisfy the Provider Test, and in the case of non-admitted insurance, a person that is located outside of the United States and listed on the Quarterly Listing of Alien Insurers as maintained by the International Insurers Department of the National Association of Insurance Commissioners, or meets the eligibility criteria for non-admitted insurers applicable under state law and issues a contract that meets the Product Test, would also meet the Provider Test.

Forward Contract Exclusion

The definitions of "swap"[6] and "security-based swap"[7] exclude "any sale of a nonfinancial commodity[8] or security for deferred shipment or delivery, so long as the transaction is intended to be physically settled." The CFTC stated that it will interpret the forward exclusion for nonfinancial commodities from the swap definition in a manner consistent with its historical interpretation of the existing forward exclusion with respect to futures contracts. The CFTC's historical interpretation has been that forward contracts with respect to nonfinancial commodities are "commercial merchandising transactions," the primary purpose of which is to transfer ownership of the commodity and not to transfer solely its price risk. An intangible commodity such as an environmental commodity may also qualify as a nonfinancial commodity so long as ownership of the commodity can be conveyed and the commodity can be consumed. The CFTC emphasized that for a transaction to qualify for the forward exclusion, there must be an intent to physically settle the transaction. The Release clarifies that subsequent book-outs or alternative settlement methods will not alter the original character of the agreement as a commercial merchandising transaction so long as the original agreement contemplated physical delivery of the commodity. In addition, the presence of certain provisions such as liquidated damages and renewal/evergreen provisions does not necessarily render an agreement ineligible for the forward exclusion.

The CFTC also confirmed that while commodity options are swaps under the statutory swap definition, a forward contract with embedded commodity options will be considered an excluded nonfinancial commodity forward contract if the embedded options (i) may be used to adjust the contract price but do not undermine the overall nature of the contract as a forward contract, (ii) do not target the delivery term, so that the predominant feature of the contract is actual delivery, and (iii) cannot be severed and marketed separately from the overall forward contract in which they are embedded. In addition, a forward contract with embedded volumetric optionality may fall within the forward contract exclusion if, in addition to meeting certain other requirements,

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6 Generally, a "swap" under the CEA could be any transaction that is not settled by delivery of the underlying commodity, including, but not limited to, (i) options, such as puts, calls, caps, and floors on most reference assets, (ii) swaps, such as those on interest rates, broad-based securities indices and other reference assets, (iii) credit default swaps, (iv) any other instrument "that is or becomes commonly known as a swap," (v) foreign exchange swaps and foreign exchange forward contracts, and (vi) any instrument that combines any of the above. The definition of swap excludes futures and most forward contracts. CEA § 1a(47).

7 Generally, a "security-based swap" under the Securities Exchange Act of 1934 (the "Exchange Act") could be any transaction that is a swap and is based on (i) a narrow-based security index (including any interest therein or value thereof), (ii) a single security or loan (including any interest therein or value thereof), or (iii) the occurrence or nonoccurrence of an event relating to a single issuer of a security or the issuers of securities in a narrow-based security index, provided that such event directly affects the financial statements, financial obligations, or financial condition of the issuer. Exchange Act § 3(a)(68).

8 The CFTC interprets the term "nonfinancial commodity" to mean an exempt commodity or an agricultural commodity that can be physically delivered. See Release at 48232.

(i) the embedded optionality does not undermine the overall nature of the contract as a forward contract, (ii) the predominant feature of the contract is actual delivery, (iii) the embedded optionality cannot be severed and marketed separately from the overall contract in which it is embedded, (iv) the seller (the buyer) of a nonfinancial commodity underlying the contract intends, at the time of entering into the contract, to deliver (accept the delivery of) the underlying nonfinancial commodity if the optionality is exercised, and (v) the exercise or nonexercise of the optionality is due to factors or regulatory requirements beyond the control of the parties and are influencing demand for, or supply of, the nonfinancial commodity, and the parties intended at the time of entering into the contract to make and accept delivery of the underlying nonfinancial commodity.

The CFTC also stated in the Release that certain physical commercial arrangements that have option-like features but that are similar to leases may qualify for the forward exclusion if, among other things, the payment for the use of the specified facility represents a payment for its use rather than just the option to use it.

As previously proposed, security forwards are not swaps or security-based swaps because they would fall within the forward contract exclusion to the extent they are intended to be physically settled and also because transactions involving a purchase or sale of a security on a fixed or contingent basis are excluded from the statutory definition of swap.[9]

Foreign Exchange Products

The Commissions confirmed that foreign currency options (other than those traded on a national securities exchange), non-deliverable forward contracts involving foreign exchange, currency swaps, cross-currency swaps and forward rate agreements are swaps and subject to the CFTC jurisdiction. The Commissions also stated that swap includes foreign exchange forwards and foreign exchange swaps until such time as the Secretary of the Treasury determines to exempt these instruments from the definition of swap.[10] It should be noted that these instruments would remain subject to certain reporting requirements and business conduct standards even if the Secretary of the Treasury makes such a determination.

Finally, the Commissions clarified that bona fide foreign exchange spot transactions (i.e., foreign exchange transactions that are settled on the customary timeline of the relevant spot market) and retail foreign currency options will be neither swaps nor security-based swaps.

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9 CEA § 1a(47)(B)(v)-(vi).

10 The Secretary of the Treasury had proposed to exempt foreign exchange forwards and foreign exchange swaps from the definition of "swap" in the CEA. For more information on the proposal, please see our client memorandum, dated May 4, 2011, entitled "Treasury Proposes to Exclude FX Swaps and FX Forwards from Most CFTC Oversight."

Relationship Between Swaps and Security-Based Swaps

The classification of an instrument as a swap or a security-based swap (collectively referred to herein as "Title VII Instruments") generally is to be made no later than when parties offer to enter into the transaction. The classification of the instrument will generally remain the same throughout the life of the instrument. For example, a Title VII Instrument on a broad-based security index that becomes narrow-based during the life of the instrument will remain a swap subject to the CFTC regulation unless the instrument is amended or modified in a material respect by the parties.

The Release provides that, generally, Title VII Instruments based on interest rates and other monetary rates that are not themselves based on one or more securities are swaps regulated by the CFTC, and Title VII Instruments based on yields of a debt security, loan, or narrow-based index are security-based swaps regulated by the SEC. However, a Title VII Instrument where the only underlying reference is a U.S. government security would be a swap and not a security-based swap.

The Commissions further clarified that a Title VII Instrument where the underlying reference is a security future would be a security-based swap, and a Title VII Instrument where the underlying reference is a futures contract that is not a security future would be a swap.

Total Return Swaps ("TRS")

As a general rule, a TRS on a single security, loan or narrow-based security index would be a security-based swap and a TRS on a broad-based security index or on two or more loans would be a swap. However, if an interest-rate optionality or a non-security-based component is embedded into a TRS, such TRS would be a mixed swap. The Commissions explained in the Release that they would view a quanto equity swap as a security-based swap if it has certain characteristics. By contrast, a compo equity swap would be a mixed swap.

"Narrow-Based Security Index"

The Commissions reaffirmed their prior interpretation of the term "narrow-based security index," which, among other things, must have nine or fewer component securities. The Commissions, however, will apply a new test for determining whether an index credit default swap (a "CDS") is based on a narrow-based security index. The test focuses on whether there is public information available about a predominant percentage of the reference entities included in the index, or, in the case of an index CDS on an index of securities, about the issuers of the securities or the securities underlying the index.

Security Indexes and Portfolio of Securities

The determination of a Title VII Instrument as a swap or security-based swap is made prior to the execution of the instrument, and such classification will not change for the duration of its life. For example, a Title VII Instrument on a broad-based security index at the inception of the instrument would generally remain a swap throughout its life.

If parties to a Title VII Instrument have discretion to alter the composition/weighting of securities in a portfolio, however, the portfolio would be treated as a narrow-based security index and therefore, a Title VII Instrument on that security portfolio would be a security-based swap. If the change in the composition/weighting of securities in a portfolio is a result of predetermined criteria or a self-executing formula, then, generally, a Title VII Instrument on such security portfolio would be a swap or security-based swap depending on the character of the underlying index. If, however, the predetermined criteria or self-executing formula would cause the underlying index to change from being narrow-based to broad-based or vice versa, the Title VII Instrument would be treated as a mixed swap.

Mixed Swaps

A mixed swap is a transaction that is both a swap and a security-based swap. The Final Rules provide that bilateral, uncleared mixed swaps, where one of the counterparties is dually registered with the CFTC as a swap dealer or major swap participant and with the SEC as a security-based swap dealer or major security-based swap participant, will be subject to all applicable provisions of the federal securities laws and certain provisions of the CEA and rules thereunder. For all other mixed swaps, a person may request that the Commissions determine the provisions under each of the CEA and the Exchange Act with which such person should comply.

Anti-Evasion Rules

The CFTC adopted anti-evasion rules that define as swaps those transactions that are willfully structured to evade the requirements of the Dodd-Frank Act.

Effective Date

The Final Rules and interpretations will generally become effective on October 12, 2012, with some exceptions, including certain interim relief provided by the SEC that will remain in effect until February 10, 2013.

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