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Swap Product Definitions Finalized: Compliance Dates Set

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The Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”) provides definitions for the terms “swap”, “security-based swap”, and “security-based swap agreement” (collectively, “swap products”). The Dodd-Frank Act also directs the Securities and Exchange Commission (“SEC”) and the Commodity Futures Trading Commission (“CFTC”), in consultation with the Board of Governors of the Federal Reserve System, to further define the swap products. The SEC and the CFTC (together, the “Commissions”) approved joint final rules to further define the swap products in accordance with such directive on July 6, 2012, and July 10, 2012, respectively. The joint final rules also establish a regulatory framework for “mixed swaps”, which are both swaps and security-based swaps. The joint final rules were published in the Federal Register on August 13, 2012 and can be found [here](#). Publication of the final rules in the Federal Register triggered the compliance dates for various CFTC rules relating to derivatives that have been tolled, pending the adoption of the swap product definitions. This client alert provides an overview of the swap product definitions, as well as a timeline for compliance with certain of the key CFTC rules that have been tolled.

Swap Product Definitions and Related Interpretations

Swaps versus Security-Based Swaps. The definitions of swaps and security-based swaps are set forth in the Dodd-Frank Act. The Commissions have provided guidance through the joint final rules and

related interpretations in the final rule releases as to whether certain transactions are swaps or security-based swaps, as discussed further herein. The determination as to whether a transaction is a swap or security-based swap is made at the time of the transaction, and that determination will hold through the life of the transaction. The Commissions provided the example of a narrow-based security index that becomes a broad-based security index after the determination. In such instance, the instrument remains a security-based swap under the jurisdiction of the SEC. Likewise, if a broad-based security index becomes a narrow-based security index after the determination, the instrument remains a swap under the jurisdiction of the CFTC.

Insurance Products. The joint final rules provide a safe harbor from the definition of a swap or security-based swap for insurance transactions. Insurance transactions are eligible for the safe harbor if they meet both a “Product Test” and a “Provider Test”. The Product Test generally requires: (1) the beneficiary to have an insurable interest through the life of the contract; (2) that payment under the contract be limited to the value of the insurable interest, dependent upon the occurrence of a loss, and the loss must be proved; (3) that the contract not be tradeable separately from the insured interest; and (4) in the case of financial guaranty insurance, that payments can be accelerated only by the insurer upon payment default or insolvency of the obligor. The Provider Test principally requires the provider to be supervised by a state insurance regulator. The joint final rules also extend the safe harbor to various traditional insurance products enumerated in the rules (such as life insurance, health insurance and surety or fidelity bonds), if such products are offered by a provider meeting the Provider Test. The safe harbor is non-exclusive; if a transaction does not meet the above requirements, it nevertheless may not be a swap or security based swap in light of the facts and circumstances present in that particular transaction.

The joint final rules also grandfather from the swap and security-based swap definitions any transactions entered into before the effective date of the joint final rules if the provider in the transaction meets the Provider Test at the time of the transaction.

Consumer and Commercial Transactions. The Commissions’ interpretations clarify that consumer and commercial transactions that have not been considered swaps or security-based swaps generally are not swaps or security-based swaps under the statutory definitions. These include, for example, consumer agreements or transactions entered into primarily for personal, family or household purposes. These purposes can include transactions that relate to the acquisition or lease of property, obtaining a mortgage and personal services or the assignment of rights owned by the consumer. The interpretations also provide that commercial agreements, contracts or transactions involving customary business or commercial arrangements are not swaps or security-based swaps. Such

commercial transactions include, for example, employment contracts, agreements to effect a business combination, transactions in real property, intellectual property, equipment or inventory, and warehouse lending arrangements.

Forward Contracts. The interpretations provide that security forwards are not swaps or security based swaps under the statutory definition. This interpretation applies to the treatment of mortgage-backed securities eligible to be sold in the “to-be-announced” or “TBA” market.

The CFTC’s interpretations address the application of the forward contract exclusion for nonfinancial commodities that is included in the statutory swap definition. The CFTC will interpret the forward exclusion in a manner consistent with its historical interpretation of, and precedent relating to, the existing forward contract exclusion with respect to futures contracts, consistent with Dodd-Frank legislative history. The CFTC interpretations also provide that “booked-out” transactions that are accomplished through a subsequent, separately negotiated agreement meeting the requirements specified in the CFTC’s Brent Interpretation, qualify for the forward exclusion from the swap and future delivery definitions. The CFTC will require oral book-outs to be followed by a confirmation in written or electronic form within a commercially reasonable time. The CFTC release provides other interpretations relating to the forward contract exclusion, including guidance regarding forwards with embedded optionality and that certain contract provisions (such as liquidated damages or evergreen provisions) will not disqualify transactions from the forward exclusion.

Guarantees. The CFTC’s interpretations provide that a guarantee of a swap is a swap to the extent that a counterparty to the guaranteed swap would have recourse against the guarantor in connection with the position. The CFTC also indicated its intention to address the practical implications of this interpretation, including applicable reporting requirements, in a separate release. The SEC is treating guarantees of security-based swaps as separate securities, consistent with its historical approach to guarantees of securities. The SEC will consider (in connection with its rulemaking relating to the reporting of security-based swaps) whether to require the reporting of information relating to guarantees of security-based swaps and guarantors.

Loan Participations. Pursuant to the interpretations, loan participations are not swaps or security-based swaps if they reflect an ownership interest in the underlying loan or commitment and meet certain other conditions.

Foreign Exchange Products. Foreign exchange forwards and swaps are swaps under the final rules, subject to the Secretary of the Treasury’s determination to exempt them from the definition as provided in the Dodd-Frank Act. The Commissions also provide several interpretations with respect to foreign exchange transactions, including: certain forward

exchange spot transactions will not be treated as foreign exchange forwards under the Commodity Exchange Act (“CEA”); retail foreign currency options described in Section 2(c)(2)(B) of the CEA are not swaps; and options on swaps or security-based swaps, forward swaps or security-based swaps, and certain contracts for differences are considered to be swaps or security-based swaps.

Rate- or Yield-Based Instruments. The interpretations provide that instruments based on interest rates and other monetary rates are swaps. Yield-based instruments, where yield is a proxy for the price or value of a debt security, loan or narrow-based security index, are security-based swaps, except in the case of certain exempted securities. Instruments based on rates or yields of U.S. Treasuries or certain other exempted securities (other than municipal securities) are swaps, not security-based swaps.

Mixed Swaps. Mixed swaps are transactions that meet the definition of both swap and security-based swap. Mixed swaps involving a dealer or major participant, dually registered with the CFTC and SEC, are subject to key provisions of the CEA and related rules, as well as federal securities laws. Other mixed swaps are subject to the parallel requirements of the CEA and the Securities Exchange Act of 1934 (“Exchange Act”) unless the Commissions enter a joint order establishing either the CEA or the Exchange Act as the governing law for the transaction.

Total Return Swaps. Total return swaps on a single security, loan or narrow-based security index generally are security-based swaps regulated by the SEC. Total return swaps on broad-based security indexes or on two or more loans however, are swaps regulated by the CFTC. Total return swaps that include embedded interest-rate optionality or a non-securities component (such as the price of oil or a currency hedge) are treated as mixed swaps.

Commission Guidance on the Definitions. The Commissions will provide joint interpretations for persons seeking guidance on whether a particular transaction is a swap, a security-based swap, or a mixed swap. A request for guidance must include: all material information about the transaction; the economic characteristics and purpose of the transaction; the requesting party’s view on the appropriate classification for the transaction and the party’s basis for the conclusion; and any other information requested by the Commissions.

Implementation of Swap Regulations by the CFTC

The compliance dates of many CFTC regulations are tied to the August 13th date of publication in the Federal Register of the final rules, which define the terms “swap” and “security-based swap.” Sixty days after such date — October 12, 2012 — swap dealers and major swap participants

("MSPs") will be subject to a host of new regulations and obligations. The compliance dates for certain of these and other key regulations are as follows:

<p>October 12, 2012</p>	<p>Swap dealers and MSPs are required to register with the CFTC. (Limited relief available for foreign swap dealers and MSPs.)</p> <p>In addition, regardless of their registration status, these entities will be required to comply with a number of obligations, such as:</p> <ul style="list-style-type: none"> • customer clearing documentation and timing of acceptance for clearing; • internal business conduct rules; • recordkeeping and reporting requirements for interest rate and credit swaps (including off-facility); • new position limit rules; and <p>privacy of consumer financial information and business affiliate marketing and disposal of consumer information rules.</p>
<p>October 15, 2012</p>	<p>Compliance with external business conduct standard policies for swap dealers and MSPs.</p>
<p>December 31, 2012</p>	<p>Compliance with the Rule 4.5 and 4.13(a)(3) commodity pool operator and commodity trading analyst registration exemption.</p>
<p>January 1, 2013</p>	<p>Certain internal business conduct standards for swap dealers and MSPs (e.g., business continuity and disaster recovery rules and designation and duties of a chief compliance officer).</p>
<p>January 9, 2013</p>	<p>Compliance by swap dealers and MSPs with the recordkeeping and reporting rules for all remaining asset classes, including equity swaps, foreign exchange swaps,</p>

	and other commodity swaps.
April 9, 2013	Compliance with recordkeeping and reporting rules by non-swap dealers and non-MSPs.

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