

CFTC and SEC approve Final Rule and Interpretation for Swap Product Definitions

At a meeting held on July 10, 2012, the Commodity Futures Trading Commission ("**CFTC**") voted to issue final rules pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act ("**Dodd-Frank Act**") further defining the terms "swap", "security-based swap", "mixed swap", and "security-based swap agreement" ("**Product Rule**"). The Securities and Exchange Commission ("**SEC**") unanimously approved the Product Rule in a private meeting. Once the Product Rule is published in the Federal Register ("**FR**"), the timetable will be fixed for compliance with several of the critical rules imposing substantive obligations with respect to swaps. The CFTC also issued a final rule regarding the end-user exemption from the swap clearing requirement ("**End-user Rule**") and a proposed rule exempting certain swaps entered into between cooperatives and their members from the clearing requirement ("**Proposed Cooperative Exemption**"). Below is an overview of points discussed during the meeting, based on the fact sheet and Q&A released by the CFTC and the discussions themselves. This overview is subject to the release of the final text of the Product Rule.

Scheduling

- **Clearing rules.** Chairman Gensler stated that the CFTC is likely to vote next on (i) a proposal of the first mandatory clearing determinations (which will focus on interest rate swaps and credit default swaps that are already being cleared) and (ii) the final phased compliance schedule for clearing and trade execution requirements. Chairman Gensler indicated that the clearing rules could be considered at a meeting in July, with the result that the first mandatory clearing determinations, pursuant to the statutory review period, could become effective in October, and then be subject to the phased compliance schedule (i.e., 90, 180 or 270 days after the effective date of the final mandatory clearing determination), so that the first swap products will be subject to mandatory clearing by swap dealers, major swap participants, and "active funds" in January 2013.

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- **Other rules.** Chairman Gensler also stated that after considering the above clearing rules, the CFTC is likely to vote on proposals on inter-affiliate swaps and conforming rules, as well as final rules on block trades and swap execution facilities. Chairman Gensler also mentioned that staff will make recommendations for a rule on enhanced segregation of customer funds "at some point".
- **Countdown to compliance.** Following publication of the Product Rule in the FR, the clock for compliance with several of the substantive rules will begin. As noted by the commissioners, the first compliance date for rules regarding real-time public reporting, swap data recordkeeping and reporting, business conduct standards, and position limits will occur 60 days after the Product Rule is published in the FR.
- **SDRs.** Chairman Gensler noted that the CFTC has approved provisional registration for one entity as a swap data repository ("**SDR**"), ICE Trade Vault LLC, and that four other entities are working on applications for SDR registration. The SDR registration and core principles rule will become effective upon the effective date of the Product Rule (i.e., 60 days following publication of the Product Rule in the FR).

Key Points on Product Rule

- **Guarantees.** The Product Rule includes an interpretation by the CFTC that a guarantee of a swap is an integral part of the swap and, therefore, the term "swap" includes a guarantee of a swap to the extent that a swap counterparty would have recourse to the guarantor. CFTC staff is preparing a separate release regarding the regulatory consequences of this interpretation, including reporting requirements. The SEC interprets guarantees of security-based swaps to be securities, and plans to separately address reporting requirements for guarantees.
- **Insurance.** Insurance contracts that satisfy requirements of a safe harbor in the Product Rule with respect to (i) insurance products ("**Product Test**") (i.e., the beneficiary has an insurable interest that is continuous through the life of the contract and that cannot be traded separately from the contract; that payment is dependent on loss having occurred and been proven, and is limited to the value of the insurable interest; that the contract cannot be trade separately from the insured interest; and, with respect to financial guaranty insurance only, that payments under the policy can only be accelerated at the discretion of the insurer if the obligor defaults in making a payment or becomes insolvent) and (ii) the provider of the insurance products ("**Provider Test**") (i.e., the provider is subject to supervision by a state insurance regulator) would not be swaps or security-based swaps. The Product Rule also includes an enumerated list of traditional insurance products (i.e., life insurance) that the Commissions have determined would not be swaps or security-based swaps if they are offered by persons that meet the Provider Test. Even if the safe harbor criteria (i.e., the Product Test and Provider Test) are not met, an insurance contract may still not be a swap or security-based swap, but it would be subject to a facts-and-circumstances analysis by the Commissions. An insurance contract entered into on or before the effective date of the Product Rule would not be a swap or security-based swap, so long as it was provided in accordance with the Provider Test.
- **Foreign exchange products.** Even if the Secretary of the Treasury exempts foreign exchange swaps and foreign exchange forwards from regulation as swaps, the Product Rule provides that other foreign exchange products that meet the swap definition would still be regulated as swaps, such as currency swaps, cross-currency swaps, foreign currency options, and non-deliverable forward contracts ("**NDFs**") involving foreign exchange. According to CFTC staff, NDFs would not be exempt if the Treasury Secretary exempts foreign exchange forwards, because, unlike foreign exchange forwards, NDFs only involve a single currency. Additionally, staff said the Product Rule clarifies that retail foreign currency options subject to the CEA's retail foreign exchange regime are not swaps or security-based swaps.
- **Total return swaps.** A total return swap based on a single security or loan or a narrow-based security index would be a security-based swap, but may be a mixed swap if it embeds interest rate optionality or other non-securities components. A total return swap based on more than one loan or a broad-based security index would be a swap.

■ Forward contract exclusion

- **7-part test.** The Dodd-Frank Act excludes forward contracts in nonfinancial commodities from the swap definition. The CFTC will interpret this exclusion consistently with its interpretation of the exclusion of forward contracts with respect to futures. A forward contract would be excluded from the swap definition if it meets all parts of a 7-part test (the elements of which were not discussed during the meeting) under the Product Rule. CFTC staff also noted that "booked-out" transactions in nonfinancial commodities between commercial participants, where the transaction is done through a subsequent and separately negotiated agreement, would qualify for the forward contract exclusion.
 - **Embedded Volumetric Options.** The CFTC is requesting comment on the treatment of forward contracts with embedded volumetric options, which are typically used in electricity markets. The Product Rule states that if the volumetric optionality is due to physical factors or regulatory requirements "beyond the control of the parties", the agreement would still qualify as an excluded forward contract.
- **Request for Commission interpretation.** Under the Product Rule, market participants can submit a request to the Commissions to provide a joint interpretation on whether a particular transaction is a swap, security-based swap, or mixed swap. The Commissions must generally issue an interpretation within 120 days, unless they provide reasons for not doing so, and may also seek public comment prior to issuing an interpretation.
- **Evasion.** Under the Product Rule, transactions that are *willfully* structured to evade the Dodd-Frank Act's requirements will be treated as swaps. The Product Rule does not provide a bright-line test for determining what constitutes evasion.
- **Chilton dissents.** Commissioner Chilton cast the lone dissenting vote on the Product Rule, citing concerns that the Product Rule would not prevent market participants from developing forward contracts that include embedded options as a way to circumvent regulation.

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